



# ESG and Internal Audit

## How to Leverage Internal Audit to Keep Pace in ESG Evolution

November 2021

# What's inside

“

Information is the lifeblood of good decision making. Capital markets are hungry for information linked to enterprise value creation, but they cannot easily digest what comes from a fragmented reporting landscape”

Robert K. Steel  
Chair, SASB Foundation Board of Directors

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## Keeping Pace in the Environment, Social, and Governance (ESG) Evolution

### Leveraging Internal Audit Expertise

## Rooted in our core values



**Make a difference**



**Reimagine the possible**



**Act with integrity**



**Work together**



**Care**

# Executive summary

The last 12 months has seen an unbelievable level of activity in ESG.

Stakeholders are recognizing the need to look at investments through an ESG lens and this has reached a point where we are seeing a fundamental rewiring of capital markets.

Third parties rely on available ESG information for ratings and investors are linking ESG positions and performance as a proxy for business resilience. There is an appreciation that good ESG performance leads to long-term increases in shareholder value. Stakeholders are reviewing financial and non-financial information, like ESG data, to assess consistency and are looking for harder quantitative metrics to support qualitative disclosures.

It's apparent why regulators are focused on information quality and have proposed rule making in areas such as climate change, human capital management, board diversity, and cybersecurity. More and more, regulatory bodies are requiring companies disclose – and in some cases, assure, certain information on the way they operate and manage social and environmental challenges.

ESG reporting has its challenges. Multiple reporting frameworks and disclosures channels exists and misstatements pose financial, regulatory, and reputational risk.

There is a growing role of the audit function within ESG. Internal Audit and the Chief Audit Executive (CAE) should play a key role in the collective effort by building an understanding of and connecting with the requirements of ESG reporting and assurance.

# What is ESG?



## ESG Definition

Environment, Social and Governance (ESG) is a lens to characterize an organization's operation as sustainable, responsible and ethical. ESG can be thought of as a report card that stakeholders use to understand a company's resilience to environmental, social and governance risks.



## Environmental

Considers how an organization performs as a steward of nature.<sup>1</sup>

### Related Topics<sup>1,2</sup>

- Carbon emissions
- Waste management
- Water management
- Raw material sourcing
- Climate change vulnerability
- Natural resources
- Pollution
- Environmental opportunities



## Social

Examines how organizations manage relationships with investors, employees, customers, and the greater community.<sup>1</sup>

### Related Topics<sup>1,2</sup>

- Corporate responsibility
- Labor management
- Data privacy & security
- Health and safety
- Diversity, equity and inclusion
- Human capital



## Governance

Referred to as rules or principles, responsibilities and expectations and the way organizations govern.<sup>2</sup>

### Related Topics<sup>1,2</sup>

- Corporate governance
- Business ethics
- Executive pay
- Audit & controls
- Intellectual property protection
- Shareholder rights

## ESG Reporting and Assurance

In the face of urgent issues, like climate change, **commercial success will be measured by more than a company's financial performance**. The lens is broadening and now includes a wide view of enterprise and societal value creation. Investors are linking ESG positions and performance as a proxy for business resilience and appreciate that good ESG performance leads to long-term increases in shareholder value. Pressure from other stakeholders, including customers, regulators, and non-governmental organizations is increasing with a greater demand for transparent disclosure with consistent high-quality information that outlines strategic plans for long-term value creation.

**The SEC recently issued statements regarding climate change disclosure and a reminder of audit committees oversight responsibilities in financial reporting.<sup>3</sup>** This shift in stakeholder expectations, along with regulatory developments have led organizations to revisit purpose and strategy through an ESG lens to reflect on risks and opportunities. Disclosure of financial and non-financial information flows from that strategy. Reporting on material ESG information using both a qualitative commentary and quantitative metrics is common in annual reports, sustainability reports, and company websites. More and more, organizations are being expected to tell a consistent story across each Financial and ESG reports with audit quality non-financial information that aligns with frameworks and standards such as Sustainability Accounting Standards Board (SASB) and the Task-force on Climate Related Disclosure (TCFD). Misstatement, including omissions of material information is a risk.

Internal audit functions and the Chief Audit Executives (CAE) play a vital role in assessing the effectiveness of ESG governance, processes and internal controls and providing assurance that information is accurate and reliable.

### Notes:

1 *Internal audit's role in ESG reporting*, published by the Institute of Internal Auditors

2 *Enterprise risk management - Applying enterprise risk management to environmental, social and governance-related risks*, by COSO and WBCSD

3 <https://www.sec.gov/news/public-statement/statement-role-audit-committees-financial-reporting>

# Why it's important

## Investors are catching up on ESG - and they're ready to act.

More and more, investors prize clarity about the initiatives companies are undertaking, the reporting they are doing—and the returns they will generate. New PwC research, conducted in September 2021 outlines how investors are thinking about ESG risks and opportunities in traditional business models and ways of creating more sustainable value creations in the future.

Attitudes towards ESG risks and opportunities, % of respondents

ESG risks are an important factor in investment decision-making

79%

Companies should address ESG issues, even if doing so reduces short-term profitability

75%

ESG performance measures and targets should be included in executive pay

68%

I am willing to divest from companies that aren't taking sufficient action on ESG issues

49%

Source: PwC 2021 Global Investor Survey

**Sustainability and ESG initiatives will be key to the expected global economic growth outlook expected in the next 12 months**

## PwC Director and CEO Survey Highlights

In 2021, we see a real shift in how Boards and CEOs are thinking about and addressing ESG.

More boards are linking ESG to company strategy. Almost two-thirds of directors (64%) now say their strategy is tied to ESG issues—a 15-point jump since last year, and a strong indicator of how quickly things are changing. Directors are also more likely to say that ESG is a part of risk management discussions (62%, up from 55% in 2020).



**64%**

of directors now say their strategy is tied to ESG (a 15% increase from 2020).



**62%**

of Directors are more likely to say that ESG is part of risk management discussions (up from 55% in 2020).



**26%**

of Canadian CEOs are concerned about the availability of key skills across the organization.

## The need to future fit Internal Audit

The PwC National Internal Audit Survey was conducted between September and October 2020 and respondents spanned over 100 organizations in seven Canadian cities and across multiple industries.

Respondents include Chief Audit Executives (CAEs), Heads of Risk, Chief Financial Officers (CFOs) and Chief Executive Officers (CEOs). The following were identified in the survey as priority areas for Internal Audit to assist the business in an assurance or advisory capacity:

- Environmental, social and governance (ESG)
- Emerging technologies

- Corporate Culture
- Health and safety and environment

- Diversity and inclusion (D&A)
- Privacy and security

# Why Internal Audit should be part of the story

**Stakeholders want consistent, high quality information**

**Financials are only part of a company's story**

## Investor decision-making

Investors are increasingly asking for better and more reliable information.



## Regulations

Regulations are changing and ESG topics on regulators agenda include: climate change, human capital management, corporate board diversity and cybersecurity risk governance.



## Disclosure & Assurance

Companies are improving ESG disclosures in response to stakeholder requests and in anticipation of assurance expectations.



The 'responsible investor' has changed and investors are fundamentally rewiring capital markets.

**94%**

of the top 50 companies in Canada provide ESG disclosures using ESG Frameworks/Standards.

Enhanced ESG reporting can represent a big step for many organizations, especially if the current approach does not include internal controls and governance over the data collection, information analysis and reporting.

**Internal Audit can play the role of being a trusted advisor and partner throughout the ESG journey.**



**Internal audit and independent assurance is critical to effective sustainability reporting**



## Board and Management Comfort

- Comfort over systems and processes
- Knowledge that disclosures are based on accurate and reliable information.
- Trusted data for board decision-making



## Strengthened Relationships

- Build trust with key stakeholders
- Connect non-financial metric owners to the established financial reporting and disclosure teams



## MSCI, CDP & external ratings

- Understanding potential gaps in reporting
- Maintain and progressively improve scores with a third party rating agencies

# Where Internal Audit can support

Internal Audit functions do not need to wait until their organizations have integrated and mature ESG programs to get involved, instead they should be engaged partners provide meaningful guidance and actionable insights along each step of the ESG maturity journey.

## ESG Disclosure Maturity

### Limited

- Little-to-no guidance on disclosure format or metrics
- Disparate data sources and offline spreadsheets
- Highly manual reporting, processes and information flow
- No controls or established governance framework

### Manual and ad hoc

- Limited guidance provided on disclosure formats and metrics
- Disparate data sources and offline spreadsheets - data issues addressed ad-hoc
- Data visualization and transformation tools starting to be utilized (i.e. Tableau, Alteryx)
- Limited policies, procedures, and governance controls/certifications

### Manual with governance

- Clear guidance provided on disclosure formats and metrics
- Most data is defined but not in a central repository
- Data visualization and transformation tools are used to report key metrics
- Movement towards utilizing enterprise reporting architecture
- Mature policies, procedures and governance controls/certifications

### Integrated

- Reporting and sourcing data through the enterprise reporting system architecture and process
- Central “source of truth” source of key ESG data and metrics
- Real time reporting and analytics to inform decision making
- Matured and enforced policies, procedures and governance/certifications
- Investors have a coherent narrative and metrics around value creation

## Internal Audit Activities

- Provides advisory support in establishing a strong and effective internal control environment which underpins ESG Reporting
- Advises on ESG governance, roles, and responsibilities given the broader understanding and application of lines of defence across the organization
- Assists in recommending/providing feedback on reporting metrics, inclusive of insights into data quality
- Recommends the adoption of generally accepted standards

- Reviews the adequacy of available policies and procedures for alignment current approach
- Assesses the ESG program (e.g. governance, process, controls) to ensure key risks are proactively identified and managed
- Evaluates the organization's approach to enhancing its ESG practice (roadmap) to ensure it will yield sustained outcomes
- Assesses the quality of existing ESG reporting to ensure metrics are accurate, relevant, consistent and timely (inclusive of KPIs and KRs)

- Evaluates current state ESG practices against regulatory requirements
- Assesses internal control environment supporting the ESG practices to ensure risks are identified and controls are operating as intended to mitigate the risks
- Incorporates ESG into Internal Audit universe and periodically assess the organization's capability as the area takes on greater significance
- Reviews ESG disclosures to ensure reporting accuracy and consistency

- Engages industry subject matter specialists to evaluate the maturity of the organization's ESG practices against industry peer practices
- Reviews current and future state ESG reporting indicators and identify optimization opportunities (e.g. incorporation of strategic risk data lake, leveraging market intelligence tools, etc.)
- Assess ESG processes to identify opportunities to incorporate best practices and new developments (e.g. effort duplication, process redundancies)
- Assess whether and how ESG risks and opportunities have been integrated within an organization's ERM processes

# What roles do Internal Audit and CAE have in ESG

The IIA's International Professional Practices Framework (IPPF) describe that internal audit adds value by "bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

As ESG practices and related risks become increasingly intertwined with an organization's success, Internal Audit functions are uniquely positioned to add value by delivering strategic advice to the business and providing stakeholders with independent assurance on how ESG risks are being managed. The following are common challenges organizations grapple with during ESG disclosures and where Internal Audit can support:

## Challenges with ESG Maturity

## Internal Audit Opportunities

1

**Oversight:** Board and Senior Management stakeholders do not have sufficient awareness, expertise and/or adequate oversight over significant ESG risks and opportunities.

Advise Board and Senior Management on emerging risks and industry trends (inclusive of ESG), adequacy of Management's existing ESG position and embedding ESG within the IA planning cycle.

2

**Strategy:** Inadequate ESG strategy deployed given limited understanding of current state ESG capabilities, inadequate alignment to Enterprise strategy and not devoting resources to foundational elements of the program.

Assess how complete ESG considerations are integrated into the strategy and enterprise risk management processes and how performance and progress are monitored and measured.

3

**Reporting and Data:** Informal processes for compiling ESG related data and information could lead to ESG misstatements which pose financial and reputational risks.

Increase involvement in the assessment of key control effectiveness (manual and system) to ensure accurate, consistent and complete data is being used for ESG reporting and disclosures.

4

**Regulatory:** Multiple reporting frameworks exist and disclosure expectations are evolving. Investors rely on ESG information and misaligned reporting could lead to long-term risk adjusted returns or reduced ratings from third party raters.

Evaluate the organization's disclosure approach in alignment with generally accepted standards. Understand how requirements are identified, assessed, managed, and reported on, and assured.

5

**Agility:** Inability to adapt to external stakeholders' increasing focus on ESG may lead to loss of competitiveness and reduced capability in attracting capital.

Assess Management's ability to identify and adapt to industry leading ESG practices by continuously identifying opportunities for improvement, conducting market scans and attending industry roundtable events.

6

**Governance:** Lack of role clarity and responsibilities in steering the ESG strategy may lead to misunderstanding of the objectives and activities, misguided efforts and inefficient use of resources.

Proactively assess ESG accountabilities to determine whether roles are clearly documented and understood. Assess collaboration effectiveness and approaches used for consistency and when delivering stakeholder engagements.

# How PwC can help

## Where Do You Start

PwC can help you get started in ways that are tailored to your needs.

### ESG Maturity Assessment

Leveraging PwC's ESG specialists to assess your organization's existing ESG capabilities relative to industry sound practices, regulations and emerging stakeholder expectations.

### ESG Management Approach

PwC's ESG team can assist with governance, ESG strategy, risk mitigation, management approaches and reporting to meet stakeholder expectations, identify opportunities and create business resilience.

### Co-sourced Internal Audit

PwC internal audits and/or industry leading ESG specialists can work collaboratively with your Internal Audit function to execute an audit of your ESG practices.

### Outsourced Internal Audit

PwC internal auditors supported by industry leading ESG specialists can evaluate your organization's ESG practices.

### Knowledge Transfer

Build Board and Senior Leadership expertise and/or management capabilities through engagements and training workshops.

### External Assurance

Options over levels of assurance includes limited, reasonable or a hybrid approach. Rating agencies (such as Carbon Disclosure Project (CDP) accept each of these options for assurance verification scores).

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