



The importance of culture for ESG

How Internal Audit can contribute



KPMG

—
04 April 2023

Internal audit can already focus on the foundation of ESG: organizational culture.

At the moment, one of the challenges for internal audit is to gain momentum in the area of ESG.

Intrinsically driven or driven by laws and regulations, organizations are preparing for the integration of sustainability in strategy, policy and processes.

It is a time of uncertainty. On the one hand because the expectations of the stakeholders in the field of Environmental, Social and Governance (ESG) are not always clear and on the other hand because it is unclear which laws and regulations companies want and must comply with.

Where do you start if it is not yet clear which ESG information should be disclosed? And how do you gain insight into the management of ESG risks if the exact scope has not yet been determined? You can wait and do nothing or be proactive and learn and adapt along the way.

Traditionally, internal audit has played a role in managing risks and how they are responded to. That is no different for ESG.

Regardless of the choice that is made, it is primarily about the right culture and mindset. Whether ESG is really in the DNA is shown by what people strive for, do and experience. The internal auditor can play a role in this.

In this article, we discuss that role and how the internal auditor can be of value in assessing ESG culture.



Why? And how?

Internal audit could and should already focus on organizational culture.

For two reasons:

The first driver is the CSRD. Although it is not an obligation to report on organizational culture itself, this directive does require companies to account for how they promote a healthy culture around environmental, social and employee-related aspects. This is closely related to organizational culture and may therefore mean that companies disclose information about their culture and values. And not every organization is familiar with that. Research by the Dutch Investors' Association (Vereniging van Effectenbezitters or VEB) and Erasmus University Rotterdam in 2019 showed that 42% of the companies in the AEX index (the 25 largest listed companies in the Netherlands) did not yet have information about their core values on their websites. It is a given that tomorrow's standard will be different from today's. Behaviors from the past, in the field of manners, discrimination and intimidation, are punished harshly in the present day. It calls on organizations to think carefully about what they stand for. And not only today, but also tomorrow and the day after.

The second motive has to do with the support for the sustainability goals. Stakeholders expect organizations to be accountable for their commitment to sustainability and social responsibility. Is the organization truly purpose-driven and intrinsically motivated to be sustainable? Are sacrifices being made in the short term (e.g. profitability) to achieve long-term goals (e.g. carbon neutrality throughout the chain)? And is there a clear correlation between what is said and what is done?

The question is therefore to what extent the culture supports the ESG strategy.

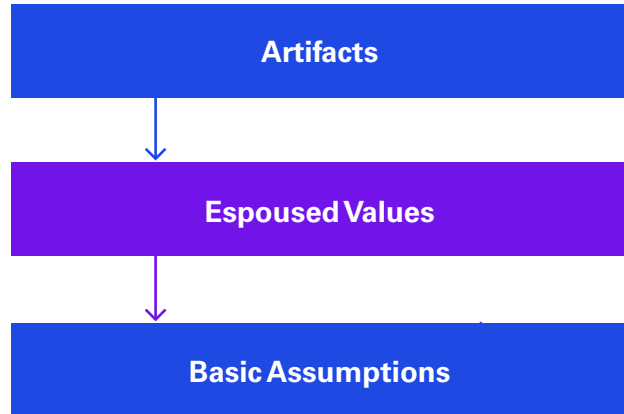
The internal auditor can be of value here. On the one hand in an obvious area, that of evaluating policy documents, protocols and process descriptions, and on the other hand in a less traditional area, that of the underlying assumptions and Soft Controls. But how do you do that in a structured and systematic way?

Culture requires an approach on three levels (I)

Edgar Schein¹ distinguishes three levels in an organizational culture: artifacts, professed values and underlying assumptions.

His model (see figure 1) exposes the difference between what people say (pursuit) and what people do (behavior). A difference between these is often caused by the underlying assumptions: the Soft Controls. These factors, which relate to the perceptions of directors and employees, can stimulate or block the implementation of the ESG strategy.

As an auditor, you can say that the 'Ist' can be found in both the artifacts and the underlying assumptions, and the 'Soll', often the starting point of the audit, in the professed values. This 'Soll' is shown centrally in the figure:



Starting point. Espoused values: the Soll

A logical starting point for the internal auditor is to determine what the organization strives for and what policy has been drawn up for this in terms of ESG.

The European Sustainability Reporting Standards (ESRS) G1-1, which relate to organizational culture, are relevant in this context. They show that companies must have, among other things:

- A description of the culture and values and how they are integrated into business operations and decision-making processes.
- A code of conduct, explaining how it is communicated to employees and other stakeholders. This code should include topics such as anti-bribery and corruption, conflicts of interest and ethical conduct.
- A whistleblowing policy. Companies should disclose their whistleblowing policies, including how employees can report concerns and how the company responds.
- Anti-Corruption and Anti-Bribery Policies. This should show what the organization is doing to prevent corruption and bribery and how potential risks are identified and managed.
- Corporate social responsibility policies, in which organizations indicate, among other things, how they address human rights, labor standards and involvement in the community.

Internal audit can help to determine how mature the organization is in the above aspects.

¹ Edgar Schein's Organizational Culture Model (expertprogrammanagement.com)

How can KPMG help?

KPMG has a multitude of standards, benchmark data and good examples of policy documents from various sectors. The following quality criteria, among other things, are used to test the effectiveness of policies.

- **Completeness:** does the policy cover the relevant subjects (substantive quality test)?
- **Clarity:** is the policy understandable to the intended users?
- **Accessibility:** is the policy relatively easy to access and find for the intended user?
- **Coherence:** is there consistency with other policies, both in content and tone?
- **Internal actuality:** is the policy up to date and is it in line with changes in the organization?
- **External actuality:** does the policy match the current vision of stakeholders, relevant laws and regulations and standard practices in the sector?
- **Feasibility:** is the goal pursued by the policy feasible in practice? For example, does it address gray areas and dilemma situations?
- **Authenticity:** is the policy characteristic of the company? In other words: to what extent do the intended users recognize the relationship of the policy with what the organization stands for? And to what extent does the organization have an intrinsic motivation to implement the policy?

KPMG supports clients by reviewing policy documents and providing feedback on possible improvement potential.



Culture requires a three-level approach (II)



Artifacts: the 1st

ESRS G1-1 goes beyond simply describing culture and values. The organization must be able to explain how these are integrated into the business processes and decision-making. Design, existence and operation: the domain of the internal auditor. What the internal auditor can do at the level of the Artifacts is: look, listen and feel.

When walking around in an organization or participating in a (hybrid) meeting, an internal auditor will become aware of observations and emotional reactions. For example, in workplaces, through the decoration and the atmosphere that is the result of the way employees behave towards each other and the internal auditor. With a view to ESG, a number of issues may arise. CSRD G1-1-Corporate culture and business conduct policies can then help provide the right focus.

In the area of 'Environment', the following question arises: to what extent is the environment a topic of discussion for management and employees? Does the organization have visible environmental goals? Is less energy being used? Is procurement more sustainable? And does a carbon reduction policy include how transport can be made greener?

With a view to the 'Social' side of ESG, diversity and inclusion can be looked at, among other things: do people look alike or do you see differences on the outside? What is included in job descriptions? Is there communication about safety? Are there instruments for reporting and following up on undesirable behavior? And do ethics play a role?

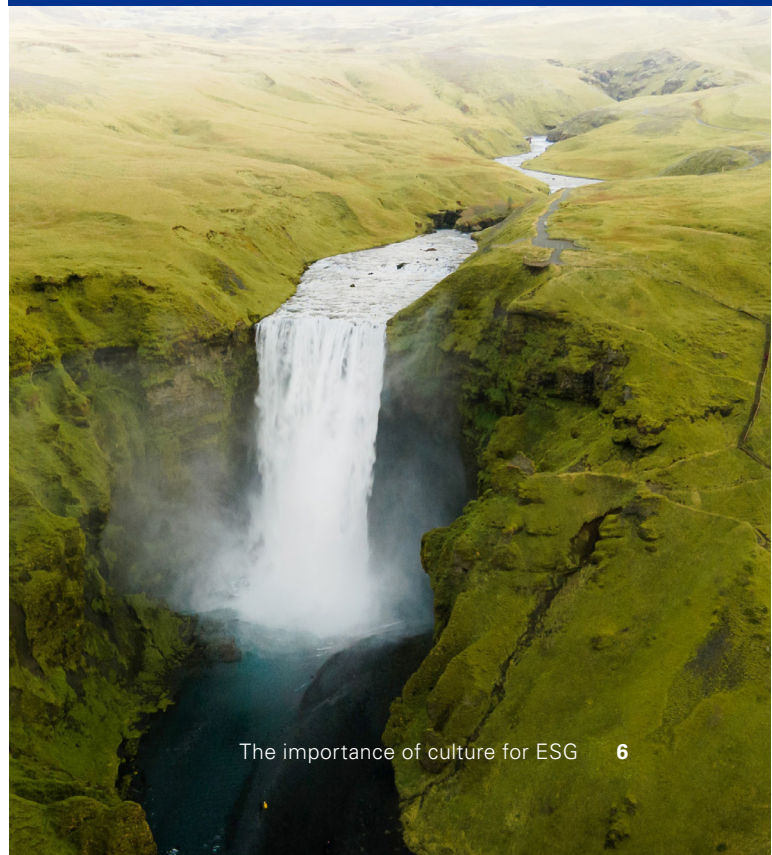
And, finally, 'Governance': is sustainability part of appreciation and reward? What is accounted for? And is that internal or also external? And what is not (yet) accounted for?

It is especially important to register this and not to give it any meaning yet, since it is not yet clear what all this means.

How can KPMG help?

Partly, you can summarize observation aspects in an observation protocol. KPMG has observation protocols for various themes, such as psychological safety, handling confidential information and learning from mistakes. These are themes that are conditional to achieving objectives in the field of Human Rights, Circularity and Co₂ emissions.

At the same time, observing, watching and listening are skills that you can learn through practice and experience. KPMG helps clients along the lines of 'learning by doing'. A training is the start of this. We then put what we have learned into practice and look at culture in a varied way: structured, using our Soft Controls model, and less structured, by becoming more aware of what presents itself and acting inquisitively, curiously and as neutral as possible.



Culture requires a three-level approach (III)



Underlying basic assumptions: the 1st

Ultimately, behavior determines the success of the ESG strategy: what do employees and directors do and what choices do they make? Deep-seated basic assumptions, beliefs and perceptions influence this behavior and are therefore relevant to map in the context of governance.

The observations (Artifacts) that are made require further investigation without immediately giving an interpretation. The interpretation, perception and experience of the auditee are central here. Due to its independent role, internal audit is suitable for providing insight into these Soft Controls, which can stimulate or hinder the implementation of the ESG strategy.

Given the 8 primary Soft Controls², the following questions are relevant to internal audit in the context of ESG goals:

- 1 Clarity:**
Is it clear which behavior contributes?
- 2 Lead by example:**
Do leaders and colleagues show constructive behavior?
- 3 Involvement:**
Can employees identify with this?
- 4 Achievability:**
Are employees facilitated?
- 5 Transparency:**
Is it visible which behavior contributes?
- 6 Open to discussion:**
Are dilemmas discussed?
- 7 Accountability:**
Are people held accountable if agreements are not kept?
- 8 Enforcement:**
Are people rewarded or, if necessary, sanctioned?

² Auditen van cultuur en gedrag: een overzicht | Instituut van Internal Auditors (iia.nl)

How can KPMG help?

Individual or group interviews and/or surveys provide insight into the underlying assumptions and perceptions of employees. KPMG assists clients with the rollout of Soft Controls surveys, combined with group interviews, and features:

- a database of questions (including ESG-related questions);
- automated tools to roll out questionnaires;
- the ability to create an interactive dashboard;
- Benchmark data from different sectors.

In addition, KPMG provides support in conducting Soft Controls investigations. These investigations can be thematic in nature, such as a readiness assessment of the ESG culture within the organization, or focused on identifying root causes: if audits show that the management of ESG objectives is ineffective, it may be worthwhile to analyze the root cause. KPMG helps clients find out where blockages are using a root cause analysis methodology. This prevents symptom relief.

The importance of culture in ESG: how internal audit can contribute

Focused, motivated and supported to get started with ESG

Exactly what the ESG structure will look like may not yet be entirely clear. Internal audit can be of value here by already looking at the foundation: the culture. Insight into the extent to which the Soft Controls support the ESG ambitions can help the board make timely adjustments so that employees can work with ESG in a focused, motivated and sustainable manner.



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