



# ESG and Internal Audit

Insights and guidance to make  
impact as Internal Audit



KPMG Netherlands

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# Environmental, Social and Governance...

..have become key principles for organizations, and developments in these areas have resulted in increased pressure to prioritize ESG considerations. With ESG metrics becoming integral to corporate performance and decision-making, it is essential to ensure that these practices are effectively implemented and independently verified.

ESG risks have become one of the most significant challenges for organizations today. Neglecting these risks could result in severe reputational damage and could impact a company's future resilience. Organizations must adapt and unlock the potential of this new reality in order to thrive.

**Effective Internal Auditing** is essential in managing ESG risks and validating controls to mitigate these risks. In addition, Internal Audit is critical in providing objective assurance and advice on ESG reporting and wider sustainability matters. By taking on this critical role, Internal Audits can help shape a more sustainable and responsible business future. Further, in doing so, they can mitigate reputational risks and ensure that the organization's ESG goals and objectives align with stakeholder needs. Internal Audit should be critical in providing objective assurance and advice on ESG reporting and sustainability matters more broadly.

## Navigation

This white paper provides **insights and guidance** on the indispensable link between ESG and the role that the Internal Audit Function should play to make impact. It gives insight in the ESG and CSRD developments and the different roles Internal Audit can play. In addition, we will share the market developments and provide several practical examples on the role that the Internal Audit Function can play related to ESG and sustainability more broadly.





# ESG – what does it mean?

## Why the drive for sustainable change now?

ESG issues are increasingly relevant for all organizations. As a result, ESG has gone from a nice-to-have to an integral piece of long-term financial success. The recent white paper from the Institute of Internal Auditors (IIA), ‘Internal Audit’s role in ESG reporting’, highlights several driving factors that are hastening this change, such as the increasing expectations of stakeholders and the public for companies to manage ESG risks and consider the ESG impact of their initiatives.

Sustainability and, specifically, ESG have become increasingly important considerations for organizations, for various reasons. One of the primary factors is the growing awareness of environmental and social issues such as climate change, pollution, social inequality, unethical labor practices, human rights, diversity and inclusion, and engagement in corrupt practices.

This focus on towards attention for ESG and sustainability is further strengthened and accelerated by new regulations such as the European Green Deal and the Corporate Sustainability Reporting Directive (CSRD) (see also next page for specific information on CSRD). These new regulations are implemented on top of current legislation such as EU Taxonomy. All these regulatory requirements accelerate the need for organizations to act accordingly. Organizations not

complying with these requirements can face legal penalties, reputational damage, and loss of business opportunities.

Besides being socially responsible, there are several benefits associated with incorporating ESG into business operations. Companies adopting ESG considerations may attract and retain talent, improve their brand reputation and relationships with stakeholders and access new markets and investment opportunities. In addition, investors are increasingly seeking out companies that prioritize ESG factors. They believe that companies that operate sustainably and are socially responsible are more likely to deliver long-term value and are less risky in the long run.

All these developments have led to an increased demand for companies to act and report in a more sustainable and socially responsible manner. A number of topics to report on are included in the figure below, though the specific aspects to report upon depend per organization. To identify material ESG metrics to report on, companies will usually conduct a stakeholder materiality assessment and peer benchmarking. Internal Audit can challenge the assessment of the metrics on which the company must report while also playing different roles. We elaborate on these roles in the following sections.

Figure 1: **Environmental, Social and Governance elements and metrics**



# CSRD – what does it mean?

The CSRD is a proposed legislation by the European Commission that aims to revise and update the existing Non-Financial Reporting Directive (NFRD) coming into force as soon as 1 January 2024 (for entities already in scope of the NFRD). The CSRD is expected to significantly impact how organizations report their sustainability information and will play a key role in promoting ESG considerations in organizations.

The CSRD proposes extending the scope of reporting requirements to include more companies, including third parties in the supply chain, and to make the reporting requirements more consistent and comparable across companies. It also aims to improve the quality of sustainability reporting by introducing more detailed and standardized reporting requirements, including mandatory disclosures in a broader range of ESG issues (as shown in the figure below). In this way, the CSRD allows companies to demonstrate their commitment to sustainability, improve their reputation, and enhance their long-term financial performance.

As part of the CSRD requirements, organizations are required to:

1. disclose additional information on certain aspects (a.o. depending on their own double materiality assessment);
2. report in accordance with the new sustainability reporting requirements;
3. use digital tagging to make their sustainability information easier to search and read.

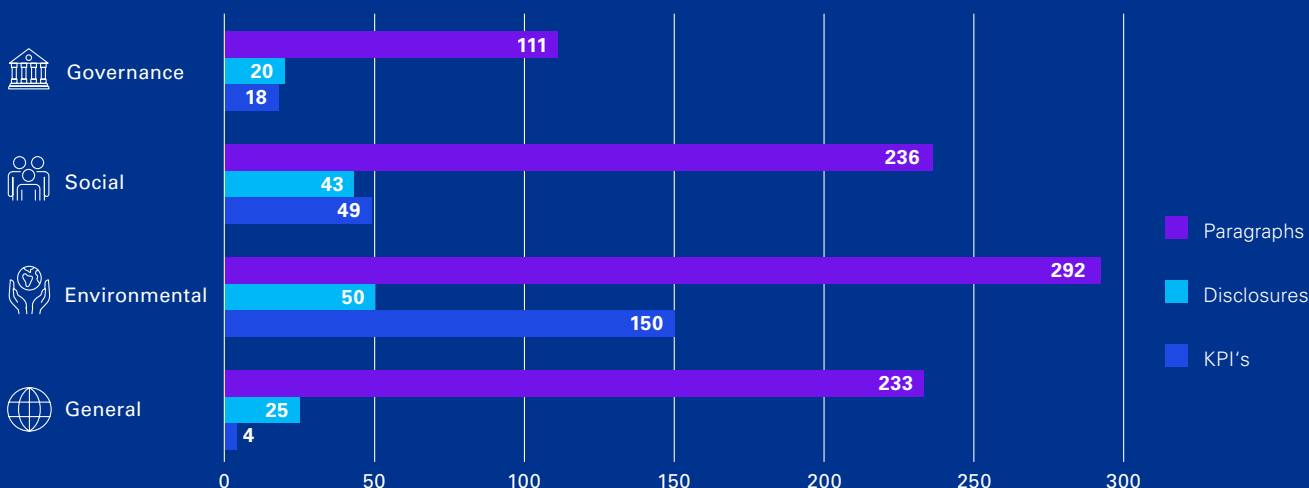
This disclosure information will need to be standardized, with the same import as financial information disclosures. It must be published in the management report and audited (starting with limited assurance but likely graduating to reasonable assurance).

The board and specifically Audit committees will have responsibilities under the CSRD, including:

- informing the organization's administrative or supervisory body of the outcome of sustainability reporting
- outlining the role of the audit committee and its contribution to the integrity of sustainability reporting;
- monitoring the sustainability reporting process, including the digital reporting process and the process to identify the information reported according to relevant reporting standards;
- monitoring the effectiveness of the organization's internal control and risk management systems as well as its Internal Audit functions;
- monitoring the assurance of annual and consolidated sustainability reporting;
- reviewing and monitoring the independence of the assurance providers.

Among the topics mentioned above, Internal Audit can provide assurance to the Board and audit committees.

Figure 2: Reporting requirements KPI's, disclosures and paragraphs under CSRD



# ESG in the Internal Audit methodology

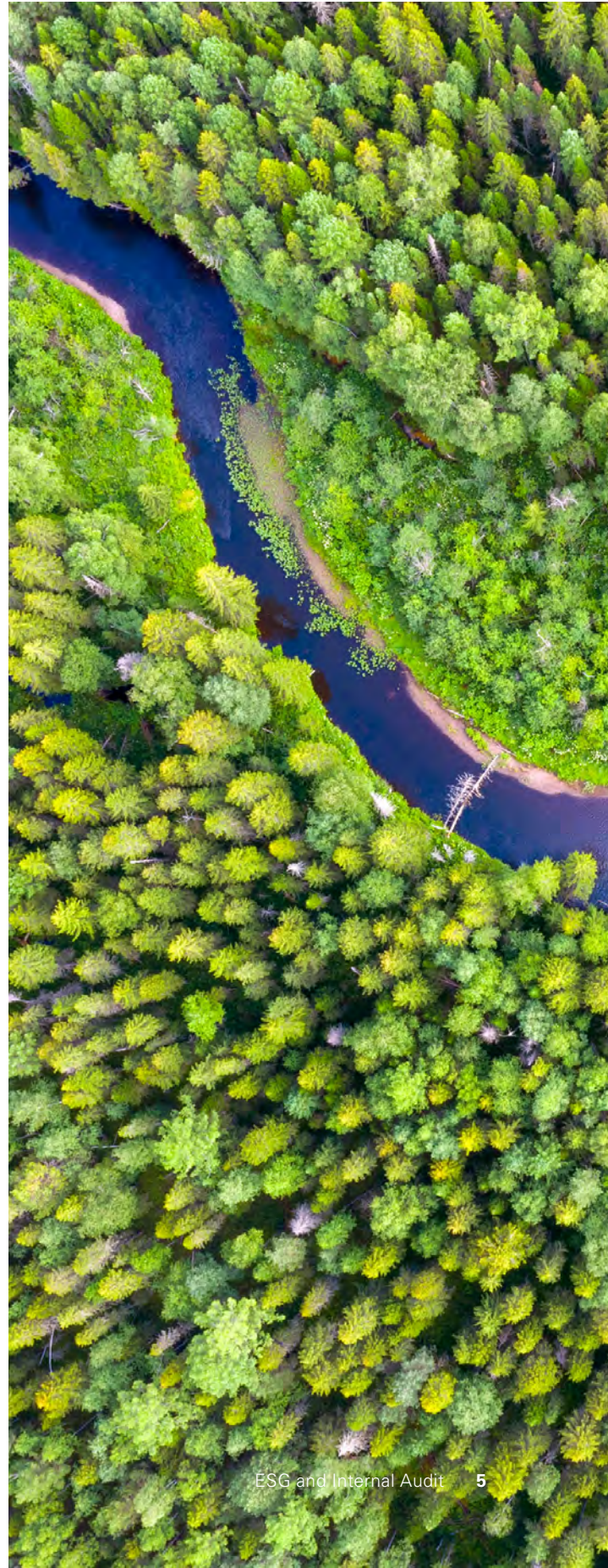
Related to ESG, each organization must adapt a model fit for its own purpose. Internal Audit, in this context, may play a significant role in the organization's sustainability journey. It provides assurance and insight on essential areas of the organization, like the achievement of the organization's strategic objectives, effectiveness and efficiency of operations and programs as well as compliance with laws, regulations, policies, and procedures. In addition, it can add value in an advisory role by helping to identify and establish a sustainability control and risk environment and providing the governing body and management with insights.

The IIA stipulates the mission of Internal Audit is: *"to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight."* 'Risk-based' is (partly) accomplished via the audit plan in which the function determines the topics that are subject to audit. In line with the IIA Standards, these audit plans should be aligned with the organization's strategies, objectives, risks, et cetera, and adjusted at intervals. As such, it is expected that the Internal Audit Function focuses its efforts on the critical risks of the organization, and ESG is expected to be one of these key risks and areas of interest.

As mentioned, Internal Audit is uniquely positioned within the organization to provide guidance, add value, and leverage its experience to operationalize ESG strategies and goals in the wake of upcoming changes.



**Internal Audit can and should play a significant role in an organization's Sustainability journey. It can make impact in an advisory capacity by helping to identify and establish a functional control environment. It also can offer critical assurance support by providing an independent and objective review of the effectiveness of sustainability risk assessments, responses, and controls.**







The identification of strategic ESG risks is critical. ESG risks are often interconnected, with each other and with core strategic and operational risks. Furthermore, ESG risks do not exist in isolation to

other existing risks and processes. We believe organizations should consider ESG at least during the activities shown below in figure 3 as part of their audit methodology.



Figure 3: **ESG consideration during the audit activities**

# Guidance in the role of Internal Audit in ESG

To be able to develop and drive forward the many topics surrounding ESG and sustainability, Internal Auditing should reflect on its self-image. Does it see itself more as an *assurance unit* - or as an *advisory partner*?

The *assurance unit* is the classic image of an Internal Audit function that looks into specific topics and ensures everything is running correctly there. Conversely, the *advisory partner* thinks along, challenges the organization, asks questions, and questions decisions. It signals to other teams: "We see that you have something new in front of you. We'll be happy to look at it with you during the project."

We envisage that Internal Audit adopts a dual role related to ESG. Depending on the type of question Internal Audit receives, it can decide what role Internal Audit plays. Specifically, we included several practical examples, differentiating between the *assurance unit* and *advisory partner* in figure 4 below.

Further, on the following pages, we included the development we see in the market and several typical audit questions that the Internal Audit Function may support. Your Internal Audit plan should be driven by your organization's ESG maturity. We recommend starting with either audits or consulting around internal controls over ESG reporting and ESG program governance. We have included potential examples of focus points for Internal Audit on pages 9 and 10 of this white paper.

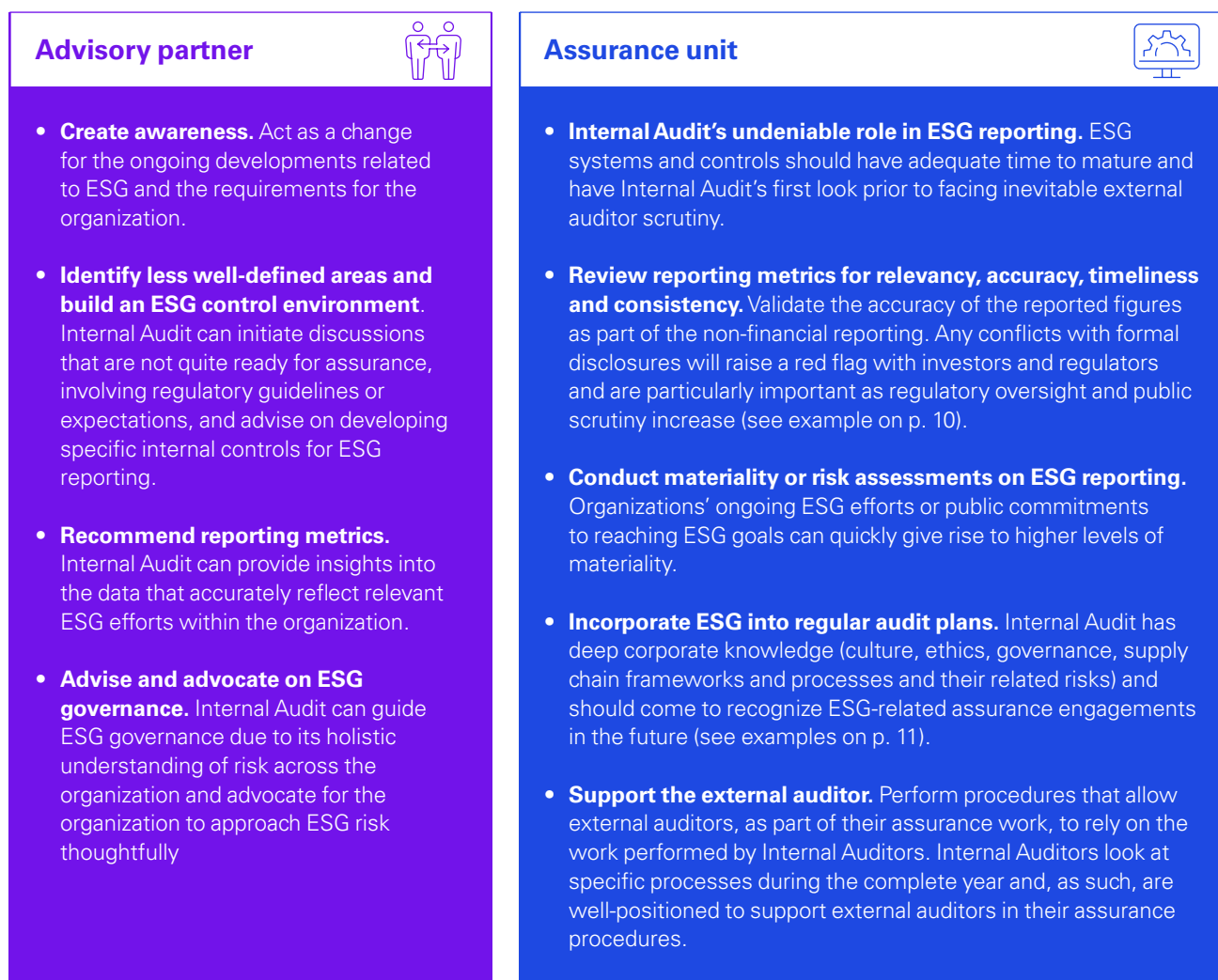


Figure 4: Internal Audit roles in ESG



# ESG Internal Audit market developments

Internal Auditing has been evolving to keep up with the increasing importance of ESG issues for companies. Here are some of the key developments seen by KPMG:

- 1 Increased focus on ESG risks.** Internal Auditors are paying more attention to ESG risks and assessing the organization's risk management processes and controls for ESG issues.
- 2 Integration of ESG into risk assessments.** Internal Auditors are integrating ESG risks into the overall risk assessment process so that ESG risks are given the same level of attention as other types of risks.
- 3 Development of ESG audit programs.** Internal Auditors are developing specialized ESG audit programs to assess the organization's ESG performance and identify areas for improvement.
- 4 Increased collaboration with ESG teams.** Internal Auditors are working more closely with the organization's ESG teams to ensure that ESG risks are properly managed and reported.
- 5 Use of data analytics.** Internal Auditors are using data analytics to gather and analyze ESG data more effectively, providing more accurate and reliable information on ESG risks and performance.

These developments in internal Auditing show a growing recognition of the importance of ESG issues for companies and the need for Internal Auditors to play a role in ensuring that companies are effectively managing and reporting on their ESG performance. By keeping up with these developments, Internal Auditors can help companies to mitigate ESG risks, improve their ESG performance, and create long-term value for stakeholders.





# Potential areas of Internal Audit focus



## Audit on reporting process

As part of its nonfinancial reporting, resulting from the CSRD requirements, organizations have to report on several criteria. One of these criteria is to report on diversity indicators within the workforce. Typically, this information is available in a decentralized form throughout the various regions or locations where the organization is active. Therefore, to report on the metrics, organizations collect key figures via Excel documents from various HR departments and aggregates these manually at the headquarters.

When examining this process, an Internal Audit function will conclude that a process exists and has fulfilled the requirement for its function (i.e., reporting on the diversity indicators). A figure had to be reported under CSRD and the organization did so (irrespective of this figure being accurate).

However, an advisory type of Internal Audit Function will note that this reporting structure is risky and that it would be appropriate to have technology-based processes in place. By performing an Internal Audit of the reporting process, the Internal Audit Function can identify weaknesses that may lead to inaccurate reporting. Auditing this process would result in higher data consistency and quality, less errors, and faster metrics compilation. Furthermore, by auditing (and improving) the reporting process, the external auditor may rely on the work performed as part of their assurance procedures.



# Potential areas of Internal Audit focus



## Governance review

Governance is a key aspect in the CSRD. Good governance is also becoming increasingly important with Corporate Governance Codes being issued in many countries. Although not all organizations must adhere to all principles included, it provides a great starting point for every organization.

The Dutch Corporate Governance Code was recently renewed in Q4 2022 to include new provisions. This updated Code highlights the importance of organizations considering the social impacts of their operations and calls for greater transparency and accountability in this area. One main focus point is sustainable long-term value creation, and the Code guides effective collaboration and management.

An audit function is well-positioned to validate whether the organization complies with the principles included in the Code (and is aligned with better practices in the field of governance). Internal Audit can validate to what extent the organization has set up its governance processes in line with the Corporate Governance Code and assess the maturity of these processes.

Based upon this assessment, the audit function can assess the gaps with the required and ambition maturity level and recommend achieving this ambition level.



## Human rights / social audit

Human rights are an essential aspect of an organization's social responsibility and can greatly impact its reputation and success. As such, it is important for organizations to regularly assess their adherence to human rights standards. In this space, Internal Audit focuses on evaluating the company's policies, practices, and performance related to human rights, with the aim of identifying areas of improvement and ensuring compliance with relevant laws and regulations. The following could be an example of an Internal Audit on human rights:

- Review of business policies and procedures related to human rights, such as those addressing forced labor, child labor, and discrimination.
- Assessment of the organizational due diligence processes in identifying and addressing human rights risks in its operations and supply chain.
- Evaluation of the organization's training and communication programs on human rights for employees and contractors.
- Investigation of any reported or potential human rights violations and the company's response to them.
- Analysis of the organizational performance and reporting on human rights, including its disclosure in annual reports and sustainability reports.
- Recommendations for improvement in the business human rights management systems and practices, based on the findings of the audit.

The Internal Audit team would report their findings and recommendations to senior management, who would then take appropriate action to address any issues and improve the company's human rights performance.







# How can KPMG support?

In today's dynamic world, it is no longer possible for organizations to have sufficient knowledge and experience in all substantive ESG areas to carry out all Internal Audit activities themselves. In addition, there are many costs involved in maintaining the correct level of knowledge and training.

KPMG Internal Audit Service adds value on the ESG journey of your company. Our offerings can range from supporting on incorporating ESG in the Internal Audits as part of our 'Internal Audit as a Service'

solution, examining the aspects of the company's ESG governance policy such as high-level oversight, risk assessment, due diligence procedures as part of a governance assessment and a review and assessment of controls in place to support existing ESG commitments and provide assurance over ESG reporting.

KPMG has profound experience and a tested methodology to deliver the following solutions:

Solution	Internal Audit as a Service	ESG governance assessment	Internal Controls over sustainability reporting
<b>Objectives</b> 	<p>Assist in implementation of an internal approach related to ESG and setting course for embedding ESG into the Internal Audit Function by:</p> <ul style="list-style-type: none"> <li>Supporting on preliminary ESG risk assessments to help determine areas of focus and embedding ESG considerations into the audit universe and audit plans;</li> <li>Supporting on Internal Audit methodology, reporting strategy, policies, controls, people, technology, data, etc., to achieve overall readiness for incorporating ESG as part of the audit processes;</li> <li>Delivering Subject Matter Experts on different ESG topics such as data privacy, governance, integrity, waste management, compliance and culture.</li> </ul>	<p>Assess the organization's ESG governance structure in alignment with Corporate Governance and CSRD/ESRS frameworks. Assessments may include consideration of the following:</p> <ul style="list-style-type: none"> <li>Board oversight and committee structures;</li> <li>Stakeholder management;</li> <li>Materiality assessment and review;</li> <li>Evaluate ESG Risk &amp; Control framework and assess maturity level;</li> <li>Strategy to link identified ESG risks to a company's business imperatives including its business model;</li> <li>ESG culture and behavior;</li> <li>Operational plan implementation (target operating model implementation).</li> </ul>	<p>Identify published ESG commitments and metrics along with an assessment of controls, policies, procedures and data to support external ESG reporting.</p> <ul style="list-style-type: none"> <li>Assess ESG commitments and metrics against peers and regulatory expectations;</li> <li>Assess entity-level and ESG reporting processes and controls;</li> <li>Assess whether policies, procedures, and controls are in place to ensure incorporation of complete and accurate reporting of key metrics, including regulatory reporting considerations for metrics impacted by recent CSRD developments.</li> </ul>
<b>KPMG accelerator</b> 	<p>ESG operational risk templates, such as audit programs, ESG Risk &amp; Control assessments, audit reports, and ESG training programs.</p>	<p>ESG governance framework with leading practices underpinned by CSRD, Dutch Governance Code, e.g., followed by COSO 2023 later this year.</p>	<p>Metric risk assessment methodology and risk accelerator tooling for a set of common metrics, including process flows, RACIs and Risk and Control Matrices.</p>

## We differentiate ourselves by:



### Expertise

Our team of experts, with a background in both internal audit and ESG, possesses the necessary skills and knowledge to deliver innovative internal audit services across various industries.



### Flexible methodology

KPMG's Internal Audit methodology is adaptable to meet each organization's unique requirements. This can range from examining aspects that define the company's ESG policy like high-level oversight, risk assessment and awareness to the ESG policy's implementation and validating quality and consistency of reporting aspects.



### Multidisciplinary approach

We have access to a broad range of expertise within KPMG. Our seasoned and highly qualified core team can draw upon additional subject matter professionals within the KPMG network as needed. Furthermore, KPMG can serve as a comprehensive solution and assist organizations with the implementation of any identified areas for improvement arising from the Internal Audit.

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