



GLOBAL KNOWLEDGE BRIEF

The ESG Risk Landscape

Part 3: Evaluating ESG Risks



Contents

Introduction.....	3
A tangled ESG web	3
ESG Awareness in 2022.....	4
Awareness but unease.....	4
Expanding the ESG conversation.....	5
Know industry relevance.....	5
Shared ESG risk responsibilities across the value chain	7
ESG Risk Evaluation.....	8
The materiality assessment.....	8
Double materiality assessments	9
Benchmarking.....	9
Climate risk and other ESG risk assessments	9
Conclusion.....	11
An ever-evolving risk.....	11



About the Experts

Michelle Uwasomba

Michelle Uwasomba is a principal in the Consulting Enterprise Risk practice of Ernst & Young LLP (EY US) with more than 17 years of experience leading major strategic, risk, ESG, and resilience program transformations globally. Uwasomba helps EY clients harness value through strategic risk management over enterprise and program portfolios, and she also has proven experience working in energy risk management at a multinational professional services company and as a corporate and program risk manager overseeing a US\$2.25 billion portfolio.

Shannon Roberts

Shannon Roberts is a principal in the Climate Change and Sustainability Services practice of Ernst & Young LLP (EY US). She is a passionate sustainability and environmental, health and safety (EHS) professional with a BS in Chemical Engineering and 15 years of proven technical experience across sectors. Shannon currently leads an EY team of professionals supporting clients in achieving their ESG goals in environmental impacts, including climate risk; decarbonization; circular economy and product stewardship, including health and safety and diversity, equity, and inclusion (DEI); and governance, including operating model and risk management. She provides ESG services to major companies in strategy, culture transformation, risk management, operational excellence, supply chain, audit, digitalization, and reporting services.

Introduction

A tangled ESG web

As discussed in previous iterations in this series, the Environmental, Social, and Governance (ESG) landscape is vast, containing a large number of topics which an organization must manage as part of its business strategy to better align with the expectations of today's stakeholders. Established subjects that fall under one or more elements of ESG include:

- Climate change, greenhouse gases (GHGs), waste management, and biodiversity (“environmental”).
- Diversity, equity, and inclusion, and worker health and safety (“social”).
- Organizational roles, responsibilities, and accountability measures (“governance”).

Additionally, as ESG market and regulatory expectations mature for each individual topic, it is becoming clear just how complex the greater ESG conversation truly is. Climate change, for example, which is currently a focus for global regulatory reporting, has significant societal implications that go far beyond environmental concerns. Indeed, organizations must also consider the social and governance implications of managing climate risk and decarbonization. As a result, key stakeholders, including investors (and related ESG ratings agencies), customers, and employees have accelerating expectations; global industry standards are emerging and maturing; and global regulations are being proposed. Each vary and influence the ways a company must manage and report on this risk. Accomplishing this will require risk evaluation and assurance providers within organizations to take a comprehensive, ever-evolving strategic approach. Without this, the ability for organizations to achieve goals and operational performance aligned with accelerated market and regulator expectations will be compromised.

With this challenge in mind, this third and final part of *The ESG Risk Landscape* series will discuss how internal auditors can better identify and evaluate ESG risks within their own organizations, as well as provide some real-world strategies employed by internal audit functions currently in the field. To aid in this task, Michelle Uwasomba, Principal, Consulting Enterprise Risk Practice, and Shannon Roberts, Principal, Climate Change and Sustainability Services Practice, of Ernst & Young LLP (EY US) agreed to share some of their experiences in supporting companies in the development and execution of management programs to identify, assess, and respond to ESG risks (both upside and downside).

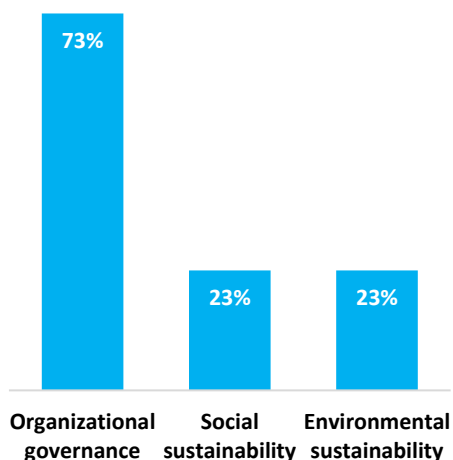
ESG Awareness in 2022

Progress in some areas, not others

Awareness but unease

Although the increasing prominence of ESG on the international stage cannot be disputed, not all elements of ESG are currently given equal weight by organizations. Although this is to be expected, as not every ESG risk is equally relevant to every organization, the disparity in knowledge and understanding among the separate ESG-related topics is stark. Indeed, The IIA's *OnRisk 2022: A Guide to Understanding, Aligning, and Optimizing Risk* paints a complex view of ESG risk understanding.

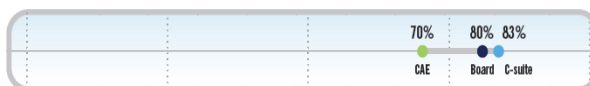
Exhibit 1: CAE Knowledge of ESG



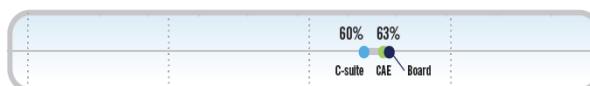
Note: *OnRisk 2022* survey question: How knowledgeable are you about each of the following risks? Percentage who gave a rating of 6 or 7 on a scale of 1 to 7. *n* = 30.

Exhibit 2: Risk Relevance

Organizational governance



Social sustainability



Environmental sustainability



Note: *OnRisk 2022* survey question: How relevant are the following risks in your current organization? Percentage who gave a rating of 6 or 7 on a scale of 1 to 7. *n* = 90 (evenly divided between C-suite, Board, and CAE)

For example, 73% of CAEs rated their personal knowledge of organizational governance as a 6 or 7 on a 7-point scale, with 1 being the lowest rating (not at all knowledgeable) and 7 being the highest (extremely knowledgeable). This contrasts significantly with their reported personal knowledge ratings on social sustainability and environmental sustainability, which are both at 23% (Exhibit 1). The report notes there may be several possible explanations, such as the immediate challenges and focus the COVID-19 pandemic created for organizational governance. Internal audit has extensive knowledge and experience in this area, but in other ESG-related areas, internal auditors may recognize that their technical nature may be beyond their grasp – at least in the short term. Additionally, some internal auditors may have difficulty understanding which ESG risks are most relevant to their organization in the first place, which can complicate early efforts on ESG risk evaluation. This issue is addressed in more detail in the section on risk and materiality assessment.

Despite growing investor pressure for organizations to implement more robust ESG-focused measures such as expanded ESG reporting, the risk relevance of social sustainability and environmental sustainability – two of the three categories



under the ESG umbrella — ranked in the report's bottom quartile. When asked about risk relevance to their organizations, 63% of CAEs rated social sustainability as a 6 or 7, and only 50% did the same for environmental sustainability. Expanding the conversation beyond the internal audit function, the picture grows even more disturbing. For C-suite respondents, 60% rated the relevance of social sustainability risks a 6 or 7, and 40% did so for environmental sustainability (Exhibit 2). All of this points to an overall unease with at least certain elements of ESG when measured against risks that are both relevant to the internal audit function's organization *and* within its grasp to understand and act on. As one C-suite respondent said, "Most organizations want to have good environmental sustainability policies, procedures, and programs, but it is not always front and center when dealing with all these other risks."¹

Expanding the ESG conversation

While leaders are maturing their knowledge and management of ESG, conditions in the global market demand advancement in integrated ESG risk management approaches. According to the World Economic Forum's (WEF's) [Global Risks Report 2022](#), environmental and social risks comprised eight of the top 10 most severe risks over the next 10 years, with climate action failure, extreme weather, and biodiversity loss taking the top three spots. Additionally, the WEF report indicates that several ESG-related risks have worsened significantly since the beginning of the COVID-19 pandemic, specifically social cohesion erosion, livelihood crises, climate action failure, mental health deterioration, and extreme weather — all of which rank significantly higher than the next listed risk, which is debt crises.²

For risk management functions, the challenge in the coming years will not necessarily be to promote organizational ESG education and awareness in their strategic plans — though that should remain an ongoing priority — but to monitor the dynamic and changing ESG risks for an organization. Over time, risk functions should, through their organizational responsibilities, be converting long-term concerns to short-term actions by integrating ESG into ERM and conducting internal audits.

Know industry relevance

To begin the journey from awareness to action, it can be useful to narrow the scope of ESG relevance from a broad, general view to a focused, industry-specific one. Some ESG risks, such as those related to governance, are widely applicable, but environmental and social are usually relevant based on industry and an individual business' context.

"As an enterprise risk management practitioner for our practice, I have seen where ESG risks broadly speaking now constitute top 10 risks for many organizations across the business sector — in many cases top two, as the [EY 2022 CEO Outlook Survey](#) indicates," says Uwasomba³. "This prominence is driven by many variables. One is investor-related concerns as investor and analyst communities begin to factor ESG-related considerations into their decisions on value. Another is consideration of the rigor and level of regulatory disclosure requirements around ESG risks."

The latter is apparent in the push for SEC guidance related to climate disclosures in the U.S., for example. Outside the U.S., there is an even greater regulatory push from the EU. This is evidenced by the Corporate Sustainability Reporting Directive (CSRD), which includes new requirements around materiality assessments, reporting requirements, and assurance under the umbrella of sustainability-related risks and risk factors (for holistic ESG beyond climate). Beyond the investor and regulatory-related perspective, companies are making some big bets related to corporate strategy and value proposition as they seek to balance the opportunities and threats in their sector, as ESG is impacting industry sectors very differently.

1. *OnRisk 2022, A Guide to Understanding, Aligning, and Optimizing Risk*, The IIA, 2022, <http://theiia.mkt5790.com/OnRisk2022/?webSyncID=a36abe78-0176-13d4-2e22-e271c4e47a0b&sessionGUID=3d51a40c-22aa-c2ba-c0ae-06d82424d6a4>.
2. *Global Risks Report 2022*, The World Economic Forum, January 11, 2022, <https://www.weforum.org/reports/global-risks-report-2022>.
3. *Will Bold Strategies Fuel Market Leading Growth? EY 2022 CEO Outlook Survey*, EY, January 10, 2020, https://www.ey.com/en_gl/ceo/will-bold-strategies-fuel-market-leading-growth.



Energy, for example, is one industry where many ESG links can be easily drawn in some respects but may be less obvious in others.

“In the energy sector, we are seeing the physical impact of climate change on infrastructure,” says Uwasomba. “For example, in the power and utilities space, we are seeing an emphasis on enterprise resiliency — particularly in terms of service reliability, asset integrity, and maintenance. Infrastructure and operations teams now look to analyze scenarios and plan how existing assets can be re-tuned to withstand higher levels of impacts — and in some cases, more frequent occasions of disruption — than previously seen. Similarly, in the oil and gas sector, we are all well aware of the environmental impacts, including the strong commitment of major players to reduce emissions and decarbonize. However, we are also seeing strategic and operational considerations that go beyond climate-related risks, to include the social value proposition of the industry. This includes perception of the sector from employees and the community. The ability to attract talent and compete for scarce human resources — or the ability to attract investment to drive opportunities and innovation — is directly tied to social perception, which is inherently ESG related.”

The impact of social perceptions of ESG can be seen in other industries, as well. Even in consumer sectors, says Uwasomba, one can find numerous examples of ESG being a long-term driver of value and perception. “People are now becoming more conscious of the choices they make,” she says. “We now have entire fashion lines and brands founded on these issues. ESG topics have a tendency to focus on the downside, but there is also tremendous upside where the organizational risk is not necessarily what the organization will lose, but rather what the organization could be poised to gain. This is playing out in new products and choices for consumers, some of which are translating to revenue or reduced costs.”

“Companies need to manage and report on the ESG of their operations, value chain, and products as part of their corporate strategy,” says Roberts. “First, they must develop ESG strategy, governance, and reporting that supports stakeholders in understanding how they are delivering long-term value. It’s important to understand who are your stakeholders and are you able to answer their tough questions related to ESG? Organizations also need to understand whether their products and services are strategically positioned in this ESG revolution, which is being heavily driven by changes in the accelerated energy transition and the need for companies to improve their social impacts, such as diversity and inclusion and health and safety. Does your company have a place to play in this ESG future? For example, healthcare is highly focused on evolving its products and services to be focused on health equity and access to healthcare. Another example is how automotive and manufacturing companies are considering whether their products will fit in a low carbon economy.”

The financial sector presents a good case study where all of these elements coalesce. “We see an incredible increase in the financial sector measuring and reporting on the ESG outcomes of their investments,” says Roberts. “They are increasingly concerned that they are financing environmentally and socially responsible companies and products. For example, many banks are starting to measure environmental impacts, such as how investments are contributing positively or negatively to greenhouse gas emissions. They are also considering the social impacts and how investments are driving equity.”

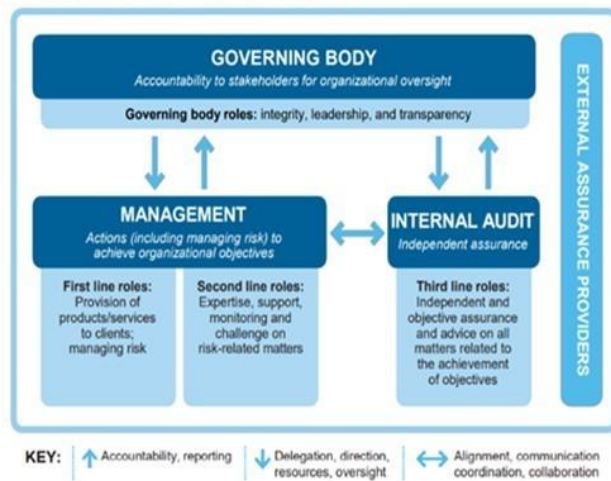
Shared ESG risk responsibilities across the value chain

ESG risk evaluation responsibilities do not fall to a single organizational function. Indeed, regardless of organizational size and structure, this is very much a shared responsibility that necessitates transparency, communication, and alignment across all organizational lines, from onsite operations in the first line, to second line functions such as compliance, to independent, objective assurance providers in the third line. These values remain consistent regardless of risk, in fact, and are the foundation of The IIA's [Three Lines Model](#).

Additionally, internal audit can operate in an advisory capacity from within its third line role. “Internal audit is not just the after-the-fact assurance provider,” says Uwasomba. “Our view is that internal auditors should have a seat at the table even when they are trying to understand what material ESG risks their organizations face. Even if the internal audit function is not necessarily best suited to assess a particular ESG-related risk within the organization, which may require skillsets found on the first or second line, it can provide some clarity as to perhaps risk rating criteria and considerations. Internal audit functions also have a broad purview of operations that other functions do not, which can be a key asset in ESG evaluation on an individual organization level. On a basic level, investors are looking for trust, and internal audit consultation plays a huge role in establishing that.”

Roberts agrees. “What is keeping leadership teams up at night is their communication approaches to ESG and not meeting the mark in terms of regulatory needs. There’s so much information flying out the door in terms of ESG communication and strategy, it can be difficult to establish a strategic approach and consistent market narrative with focused KPIs. Voluntary sustainability disclosures have been common for years, for example, but all of a sudden, investors are making concerted efforts to hold organizations accountable for what they disclose. Even if internal audit does not necessarily have the capabilities to assess ESG reporting accuracy on its own, it does have the capabilities to monitor the robust processes and controls needed to ensure reporting reflects reality. There is no one better than internal audit to be a strategic advisor in supporting its organization to enhance the governance, processes, and controls needed to advance ESG,” she says.

The IIA's Three Lines Model



ESG Risk Evaluation

Tools at internal audit's disposal

The materiality assessment

There are a variety of approaches and tools at internal audit's disposal to provide significant value-add to organizations seeking to better understand ESG risk. For example, one common tool used by sustainability professionals to identify material ESG topics of focus is called a materiality assessment.

"Materiality assessments are a standard approach to prioritize ESG topics as part of an organization's strategy, reporting, and risk management," says Roberts. "These are used to qualitatively and quantitatively measure ESG topics of relevance based on their importance to your business and stakeholders, which ultimately supports the organization in identifying what elements of ESG should be used in its strategy, goals, and risk management approaches."

Despite some inherent similarities, the process of conducting materiality assessments contains some key differences from conducting traditional risk assessments. For example, by its nature, a materiality assessment contains a much broader context that goes beyond organizational impact from risk. The most widely accepted model for ESG materiality assessments comes from the [World Business Council for Sustainable Development \(WBCSD\)](#), which divides the process into seven steps:

- Define the purpose of the materiality assessment.
- Determine the ideal materiality cycle.
- Establish the organization's perspective on materiality (the business case perspective and/or the societal impact perspective).
- Identify the topics.
- Determine stakeholders' involvement in the assessment.
- Establish criteria for calculating materiality scores.
- Based on materiality scores, select the material topics to include in the final assessment.⁴

Materiality assessment may also be used to support embedding ESG risk within an organization's risk management processes in enterprise risk management (ERM) and internal audit. Integrating ESG into ERM may be informed by the COSO and WBCSD guidance, [Enterprise Risk Management: Applying Enterprise Risk Management to Environmental, Social, and Governance-related Risks](#).⁵

4. *The Reality of Materiality: Insights From Real-world Applications of ESG Materiality Assessments*, World Business Council for Sustainable Development, June 20, 2021, <https://www.wbcsd.org/Programs/Redefining-Value/Redesigning-capital-market-engagement/Resources/The-reality-of-materiality-insights-from-real-world-applications-of-ESG-materiality-assessments>.

5. *Enterprise Risk Management: Applying Enterprise Risk Management to Environmental, Social, and Governance-related Risks*, COSO and World Business Council for Sustainable Development, October 2018, <https://www.coso.org/Documents/COSO-WBCSD-ESGERM-Guidance-Full.pdf>.



“There are only a small number of mature companies that have integrated ESG into ERM, which we expect to advance in the short-term as ESG risks must be integrated and aligned with other company risks,” says Roberts. “Material ESG topics should also be used to identify the internal audit plan.”

Double materiality assessments

It is also worth noting that materiality assessments are evolving. Although details are not finalized, the EU has announced requirements for applicable organizations to soon conduct “double materiality” assessments. In the case of ESG, equally important to risk impact on organizations for investors (and for presumably complying with future regulatory standards) is the organization’s impact, environmentally and socially, within the society it operates. A double materiality assessment gives equal weight to both sides – even if such information does not necessarily reflect positively on the organization. For example, a company must report the impact of risk it faces due to climate related issues along with the impact the organization has on the environment with its greenhouse gas emissions, which may show significant room for improvement. The organization is an entity responding to the changing risk landscape, but it is also a risk unto itself. Without assessing both, organizations may not be analyzing the full picture of financial and reputational consequences.

“Companies are just now starting to explore conducting double materiality assessments, which will support a high level of sophistication regarding ESG risk evaluation,” says Roberts. “However, the use of the double materiality approach is expected to change as the EU requirements come into effect,” says Uwasomba. The concept of risks, interrelated risk drivers, and their relationship are areas that internal audit and other risk functions understand and can help their organizations with as they navigate this type of assessment. Internal audit functions are encouraged to include these in their audit plan where applicable in order to begin understanding more about this area, particularly if the organization has operations in the EU, she added.

Benchmarking

For internal auditors looking to guide their organizations in taking the next step toward such maturity, it can be beneficial to look at the advancements made by others. “In an environment where some organizations may be more mature than others, internal audit is brilliantly positioned in their space to provide an organizational benchmarking by way of some kind of maturity assessment,” says Uwasomba. “They are in a position to ask and answer pertinent questions such as ‘How are others in my sector or outside of my sector doing this, and how does my company compare?’ To provide that kind of insight to the company on where the gaps exist related to ESG programs is invaluable.”

One of the clearest resources internal auditors can use in the benchmarking process is company disclosures, which companies have been under increased pressure from investors and other stakeholders to provide. Particular focus has been placed on climate risk disclosures, but other ESG topics such as diversity and human rights have received attention, as well. Although there are frameworks in existence that can provide a foundation for quality ESG reporting such as the [Greenhouse Gas Protocol](#) and the [Task Force on Climate-Related Financial Disclosures \(TCFD\)](#), with global reporting standards yet to be formally announced, evaluating the quality of a peer company’s disclosures against one’s own – and providing assurance that adjustments are made accordingly – can be a valuable deterrent against associated reporting risks such as unintended (or intended) greenwashing. This type of analysis also can be included in internal audit plans.

Climate risk and other ESG risk assessments

After establishing which risks are most relevant to the organization and assessing the frameworks currently in place, the next step in maturing an organization’s ESG risk assessment strategy is the implementation of specific risk assessments. These include climate risk assessments, but also additional assessments associated with social and governance risks. While some of these risk assessments require a high level of technical analysis and are still maturing in industry (e.g., a TCFD climate scenario analysis to inform climate risks and opportunities will likely require external expertise to conduct),



engaging internal audit as part of the process can be invaluable to helping the organization understand whether they have been completed; internal audit can also support which ones to prioritize by industry, stakeholder demands, and available resources.

“Climate risk assessments and other such assessments can be looked at as almost a subset of one of the broader ESG risk areas that may be the outcome of the company’s materiality assessment,” says Uwasomba. “In the case of climate risk assessments, for example, this assessment is an opportunity to really focus in to gain a deeper understanding of the organization’s risk exposure to climate change. This might not be what the organization should prioritize first, but once you understand what is material to the company, as part of early ESG strategy development, completing a climate risk assessment should be the next goal.”

The IIA has found the latter variable of particular consideration due to the current reality of the risk landscape. Following the COVID-19 pandemic, for example, a significant number of internal audit functions experienced budget cuts. According to the *2022 North American Pulse of Internal Audit*, 18% of all internal audit functions surveyed reported budget decreases in 2021 from the previous year – a year that saw the highest percentage of reported budget cuts among internal audit functions in the history of the survey (36%).⁶ While this is an improvement to near pre-pandemic levels, the same cannot be said for internal audit functions reporting budget increases. According to the data, 2020 and 2021 saw the lowest percentages of survey respondents reporting internal audit budget increases since 2008 (20% in 2020 and 24% in 2021, respectively). “Sluggish growth in internal audit budgets may reflect general uncertainty or cautiousness among organizations as the world slowly emerges from two years of COVID-19 disruption, as well as a reluctance to return to pre-pandemic travel,” the report states. Should such sluggishness continue, internal audit functions in some instances may be prompted to prioritize certain short-term ESG topics (organizational governance) over others that necessitate a more long-term view (social sustainability).

Roberts adds that while that while completing such assessments should be the goal, in order to follow the industry standards identified in frameworks such as the [TCFD scenario analysis](#), an extremely high level of technical knowledge is necessary. A climate risk assessment, for example, entails incorporating diverse data sets that require diligent monitoring and assurance for transparency, accuracy, and consistency. In most cases, this will be beyond the knowledge base of the internal audit function. Internal audit should not be focusing on completing such assessments themselves, but participating in the process as an advisor through collaboration with external functions that specialize in the field. These assessments benefit from assessing climate risk aligned with the organization’s broader approach to risk evaluation (e.g., aligning use of impact and likelihood).

This does not mean that internal audit should not strive to expand its knowledge base of ESG, however. Quite the contrary, in fact. “CAEs and their functions need to get educated themselves,” says Uwasomba. “This is an exciting area and an opportunity for internal audit teams to learn more about a risk that is having a real transformational impact on their organizations. For the internal function that seeks to be an advisor preparing its organization for these risks and opportunities, they need to be building an understanding themselves.”

6. *2022 North American Pulse of Internal Audit*, The IIA, March 2022, <https://www.theiia.org/en/resources/research-and-reports/pulse>.



Conclusion

An ever-evolving risk

ESG risks in themselves run the gamut – with some risk areas gaining more prominence in recent times. And as is the nature of risk, a few continue to evolve and mature even as internal auditors' understanding of the topics under ESG evolve and mature. In many ways, 2022 represents a current apex in this topic, and never before has so much onus fallen to organizations to be active, willing, and genuine participants in the ESG discussion. Even so, as ESG awareness heightens globally, and governments, organizations, and organizational stakeholders down to the individual consumer become more invested in the ESG conversation, organizations must be prepared to respond to their concerns and demands.

Much like flying an airplane without navigational equipment or hiking in the woods without a compass, fulfilling the demand for more action regarding ESG evaluation while waiting on formal regulatory guidance can prove difficult – as well as costly – if mishandled. However, even in this risk environment, internal audit has tools at its disposal to provide substantial organizational value – through objective assurance of ESG controls, through advisory services on ESG risk evaluation, and even through simple promotion of ESG risk awareness and education. In many ways, it is through internal audit that quality communication, transparency, and alignment among the three lines and stakeholders run. This is an invaluable position to be in, and one that should be actively encouraged and pursued by today's CAEs.

About The IIA

The Institute of Internal Auditors (IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 210,000 members from more than 170 countries and territories. The association's global headquarters is in Lake Mary, Fla., USA. For more information, visit theiia.org.

About EY

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets. Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate. Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the U.S.

Disclaimer

The IIA publishes this document for informational and educational purposes. This material is not intended to provide definitive answers to specific individual circumstances and as such is only intended to be used as a guide. The IIA recommends seeking independent expert advice relating directly to any specific situation. The IIA accepts no responsibility for anyone placing sole reliance on this material.

The views reflected in this article are those of the authors and do not necessarily reflect the views of the members of the global EY organization or Ernst & Young LLP.

Copyright

Copyright © 2022 The Institute of Internal Auditors, Inc. All rights reserved. For permission to reproduce, please contact copyright@theiia.org.

March 2022



The Institute of
Internal Auditors

Global Headquarters

The Institute of Internal Auditors
1035 Greenwood Blvd., Suite 401
Lake Mary, FL 32746, USA
Phone: +1-407-937-1111
Fax: +1-407-937-1101

