



Climate Assurance: The role of Internal Audit



Climate Assurance.

Embedding assurance that delivers confidence.

BRAVE.

THE ASSURANCE IMPERATIVE.



- Climate risk is a **strategic imperative**
- **Directors' duty** to promote the success of the company requires the same level of confidence in climate risks, mitigation plans, opportunities, commitments and disclosures as financial risks
- Financial priorities can drive short-termism – climate risk is a **longer term issue**
- Challenge of integrity, authenticity and **unforeseen consequences**
- Risks must be addressed through **choices and actions**
- Apply a **commercial lens** – focus on the customer and your products and services
- Challenge of **visibility** – across systems and processes – where is the data?
- **Third party implications** – supply chain questions
- **Culture is critical** in managing risks and benefiting from the opportunities

The Corporate Responsibility Monitor 2022: *“the rapid acceleration of corporate climate pledges, combined with the fragmentation of approaches, means that it is more difficult than ever to distinguish between real climate leadership and unsubstantiated greenwashing”.*

Building society CAE: *“executive management are learning how to have the right discussions, but data and the quality of information is a challenge when we are looking out over 30 or 40 years. For us it’s a real commercial issue as we look to design new products for customers.”*

STAKEHOLDER EXPECTATIONS.



- S172 of the Companies Act 2006 – consider a broader range of stakeholders
- Who are your stakeholders?
- What are your corporate responsibilities toward your stakeholders?
- Need to develop assurance plans that deliver on expectations
- Question of education – what level of assurance is really required?
- Opportunity for discussion – need for disclosure
- Assurance mapping and the future Audit and Assurance Policy provide an opportunity

Your stakeholders will be asking:

- Do I trust and want to buy this company's products or services?
- Do I feel aligned with this company's values sufficiently to want to work for them?
- Am I prepared to work in partnership with this company?
- Do I trust the commitments made by the company sufficiently to use it as a supplier?
- Will I become a charitable partner or advocate of this company?
- Should I be campaigning to see change in this company?
- Is this company going to contribute responsibly to our local community and should we give planning permission?
- Do I want to invest or disinvest?

REGULATORY POSITION.



Regulation is immature but is developing rapidly – lack of clarity or certainty:

- Listed companies in the UK with more than 500 employees, banks and insurers have to comply with TCFD in annual reporting. UK-based non-listed companies and LLPs with 500 or more employees and a turnover of more than £500m will follow shortly
- PIEs that are companies (but not other entities) above the threshold of 750+ employees and £750m+ turnover will need to produce an Audit and Assurance Policy probably from 2025
- FRC is consulting on proposals to revise the UK Corporate Governance Code to include wider responsibilities of the Board and Audit Committee for expanded sustainability and ESG reporting and, where commissioned by the company, associated assurance
- The EC Corporate Sustainability Reporting Directive (CSRD) will shortly mandate all large companies and all companies listed on regulated markets to have enhanced sustainability reporting in the annual report and require at least limited assurance. Non-European companies with a net turnover of €150m in the EU and at least one subsidiary or branch in the EU will also have to comply
- The US SEC has proposed mandatory disclosures for public companies on climate-related risks, emissions and net-zero transition plans, with proposed mandatory assurance by external auditors

WHAT ARE WE ASSURING?



The Committee of Sponsoring Organisations of the Treadway Commission's (COSO) framework describes control objectives as:

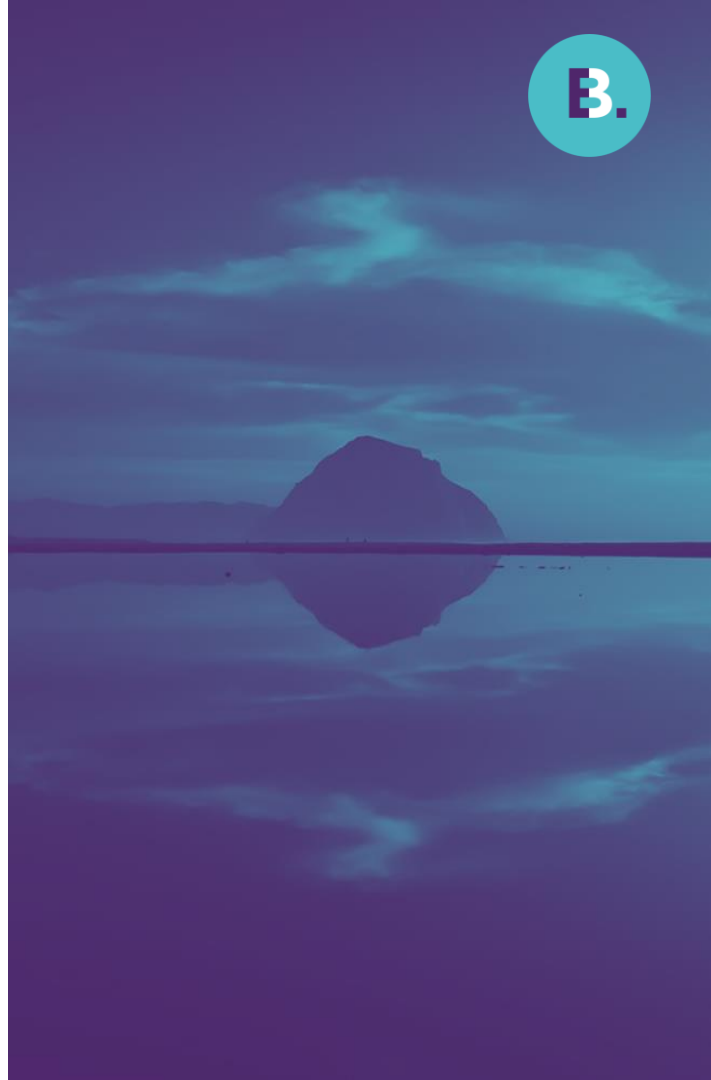
- Accuracy and reliability
- Compliance with laws and regulations
- Effectiveness and efficiency of the underlining process and operations.

It will be essential to disaggregate the nature of risks:

- Strategic risk in embedding climate factors within the wider business strategy and plan
- Reputational risks and alignment with what the organisation is saying
- Compliance risks aligned with relevant standards or expectations
- Change and transformation risks, and embedding operational and strategic changes into business as usual
- Control effectiveness, including data, processes, and reporting.

NATURE OF ASSURANCE.

- Substantive testing of specific data points, metrics, disclosures or commitments
- End-to-end process and control reviews
- Continuous assurance and real-time monitoring
- Programme and transformation assurance
- Benchmarking progress and readiness
- Ad-hoc advice and real time reviews (in project steering groups etc)
- Formal external audit and assurance reporting, including within annual reporting structures.



EMBEDDING ACCOUNTABILITY.



- Directors are ultimately responsible for managing climate risk and for what they commit to and disclose
- Senior executives must have confidence they are meeting commitments throughout the year (and not only in year end annual report)
- Is there real understanding of what is being reported or what commitments are made?
- Requires appropriate Board and Executive reporting and oversight structure
- Authority and accountability must be delegated from the top down
- Understand the roles of functions across the organisation – marketing, HR, operations
- Integrated in internal audit and assurance reporting through to the Audit Committee
- Training will be required – highlighting the culture of accountability

Portfolio NED: “sustainability can sit outside of finance, but the CFO has to be responsible for oversight of the annual report. However, finance people rarely have sufficient lived experience of non-financial data. We had a conversation with 11 people in room on TCFD: it was a little bit of everyone’s job, so who is really responsible?”

Portfolio NED: “clear accountabilities are important, including clarity on what you are capturing and why. The internal process is critically important. It then enables you to get assurance by a third party to inform you as to where they see gaps. It provides quality assurance over the internal assurance without limiting the scope.”

LINES OF DEFENCE.



- Management in the first line must own and manage the risk and associated mitigating activities and controls. Management attestation that controls over climate risk are working as intended will become ever more important.
- In the second line, look at climate risk through a multi-function lens (financial, legal, commercial, scientific, and technical). There will often be a Head of Sustainability whose role is to create policies and to monitor compliance with these policies, whilst determining and advising on the relevant metrics and wider commitments that the organisation needs to be able to comply with. Coordination of these functions will be necessary to avoid duplication and create a pragmatic and optimised approach.
- Internal audit in the third line owns the overall internal assurance framework and process and is best placed to integrate the three lines and drive consistency with the second line. There is a strong case for internal audit to act as coach and facilitator across the three lines, as many do for other strategic risks that manifest in multiple ways.

Audit Committee Chair of a Housing Association: “we need internal audit to help the organisation in thinking forward appropriately and in ensuring all risks are considered”.

NED for a major utility provider: “we thought we had a three line of defence model, but our experience of environmental reporting evidenced that it was not working. The first and second line were operating as one whilst the third line was not sufficiently involved in oversight.”

OPTIONS FOR ASSURANCE.

Options	Advantages	Disadvantages
Assurance delivered by an external audit provider	<p>Independent from management with Inherent investor credibility and trust</p> <p>Aligned with financial statement audit under recognised assurance standards and subject to regulatory oversight</p>	<p>Restrictions around nature and extent of work by company's own external auditor</p> <p>Only options are 'limited' and 'reasonable' assurance which limit scope and may not be understood</p> <p>Higher cost than internal activities</p>
Assurance delivered by another third-party assurer	<p>Independent from management</p> <p>Specialist firms with deep experience in specific capabilities</p> <p>No external audit independence concerns</p>	<p>Not subject to specific assurance standards</p> <p>Lack understanding of audit and assurance</p> <p>Less well known to stakeholders and higher cost than internal activities</p>
Internal audit	<p>Independent from first and second-line management</p> <p>In-house understanding and able to work alongside management providing real time advice and assurance</p> <p>Process and risk-based reporting with thematic findings</p> <p>Follow standards set by the IIA</p> <p>Trusted by the Audit Committee to whom they report</p>	<p>Not subject to regulatory oversight in same way as external audit providers</p> <p>May not have same level of credibility with stakeholders as opinions generally not published externally</p> <p>Limited resource and capability pool unless working with co-source provider</p>
Management or second line assurance	<p>Work within the company at all stages providing real time advice and assurance</p> <p>Direct accountability for getting things right embedded within the organisation</p>	<p>Not operating to specific standards and may lack understanding of audit and assurance</p> <p>Views will not be considered to be independent or reliable externally</p>

INTERNAL AUDIT PERSPECTIVE.



- Internal audit is expert in providing assurance over non-financial and operational risks
- Climate risk is a strategic imperative – it provides an opportunity for internal audit to evidence its value
- Engage early and as widely as possible – including with the external auditors
- Consider the range of internal audit reporting options available
- Embed internal audit in the transition and change programme to deliver continuous and real time assurance
- Requires capability – what is specialist and what is a core audit skill?

Head of Internal Audit for a building society: “We have focussed on building a team internally. Young team members are emotionally attached and keen to work in this area. We’ve given people space and empowered them. We’ve worked alongside third parties for benchmarking. But data analysis, modelling and scenario analysis are core internal audit competencies.”

EXTERNAL AUDITORS AND ASSURANCE.



- Increasing regulatory requirements for external auditors to build climate risk into their audit plans
- External audit standard setters are seeking to evolve their framework
- Concepts of materiality are subject to discussion
- Certain specific disclosures within the annual report are likely to require external assurance
- ISAE (UK) 3000 provides for two forms of assurance:

1. Limited assurance, where the assurance provider's conclusion provides comfort over whether the subject is plausible against defined criteria, framed in a negative manner, for example, 'nothing has come to our attention to indicate the management assertion is not properly prepared'

2. Higher level reasonable assurance, where the assurance provider does more testing and obtains sufficient evidence to confirm whether the specific subject conforms to the defined criteria, framed in a positive manner, e.g. 'in our opinion the management assertion is properly prepared'.

- Important to see this as an additional layer to meet regulatory and investor expectations, but to embed confidence internally first

GETTING STARTED.

- Map out climate risks and commitments, as well as opportunities
- Create an inventory of short, medium and longer term implications
- Focus first on risks and opportunities, and the underlying processes, and only after this the reporting standards
- Be strategic – what is most important commercially?
- Determine the associated systems and underlying processes
- Determine the third party hand-offs and points of reliance
- Document where assurance is currently available and how it maps to the commitments, risks and opportunities
- Be clear on roles – across the lines of defence
- Create an assurance map
- Potential to use TCFD as a starting point: focus on Strategy; Governance; Risk Management; Metrics and Targets



CRITICAL QUESTIONS FOR DIRECTORS.



1. What are the most pressing climate risk strategic priorities?
2. What risks are you most concerned about?
3. What does climate risk mean for your customers?
4. What are your investors most concerned about?
5. How do your employees feel about climate risk?
6. What are your regulators focussed on and in what time frame?
7. Which are your critical third parties?
8. What do you need and want to report, disclose or commit to?
9. How do you disaggregate processes and risks?
10. Do you have the necessary capabilities across the lines of defence?
11. How do you build capability using transferable skills?
12. How do you optimise the use of internal audit and second line functional capability?
13. What is the strength of the underlying processes?
14. What systems are critical to managing climate risk?
15. How do we create a data policy and approach that is optimised?

MAKING OPTIMAL ASSURANCE DECISIONS.



- Clearly articulate your assurance needs – processes, systems, reporting, commitments
- Be clear on accountabilities and responsibilities
- Be aware of risk appetite and materiality
- Use the mechanisms and capabilities that exist already
- Consider quality, flexibility, credibility and nature of assurance requirements
- Drive early engagement between internal audit and the wider business
- Assess the range of options available to you
- Understand the approach of your external auditor and the available limited and reasonable assurance options
- Consider the need for third party assurance
- Drive commercial value through the integrity of your climate risk management and mitigation plans

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