



Fostering sustainability: the central role of internal audit in the climate change agenda

Climate change will present a whole range of risks: it will fall to the internal audit function to help build an understanding of these risks and how to tackle each one.

No-one can predict the future with total accuracy. But if there is one thing most observers agree on, it is that the next ten years will see a significant rebalancing in the relationship between the established economies of the West and those economies we currently class as emerging markets.

And the economic environment in which this will play out is also uncertain. Clearly, while the global economic recovery has taken hold in some regions, serious dangers remain. Fiscal tightening and de-leveraging by western households may stall the incipient growth. Meanwhile the threat of bank failures and sovereign default may have temporarily slipped down the news agenda, but they remain real.

The Eurozone will remain, at least for the short term, to be the focus of attention. Politics aside, instability and uncertainty within the zone will bring with it a significant financial risk, principally focused on currency movements. For corporates, the fluctuations in currency prices will present one of the most immediate threats in the coming years.

Naturally currency movements will pitch the world's economies further into a competition, and clearly corporates in all regions will need to be aware of the dangers of trade disputes and the rise of protectionism. In that context, sectors outside banking and finance - automotive and pharmaceutical, for example - will be vulnerable to shocks. In short, while many of the risks are clear, others are less so. But if it is impossible to predict the economic outlook in 2050, the state of the planet in thirty years' time is even more uncertain.

Climate change and the challenges it presents have risen steadily up the corporate agenda in the last five years. Supply chain, energy costs, shareholder activism, changing markets: all will have a material affect on all corporates in the coming years.

Since climate change and sustainability have appeared on the corporate agenda, the focus has tended to fall on a narrow band of functions: the board for its role in setting sustainability policy; procurement, for its vital part in greening the supply chain and improving energy purchasing; facilities management for the way in which it runs operations.

However, with the sustainability issue now firmly established as a key business risk, its impact is being felt by a wider range of functions. Internal audit (IA) is one such, and its response to the challenges (and opportunities) of sustainability will have a significant impact on how much influence the function has in the coming years.

This can't happen in isolation, and so in order to maintain quality of management across the business, competencies must be improved. Audit leaders across the corporate space are waking up to the fact that the more independent and proactive the risk function becomes, the better it must be.

Ultimately the momentum within most large corporates is towards greater integration of risk functions. In parallel to that, internal auditors now have an opportunity to truly demonstrate value by acting as consultants to the rest of the business. Indeed one internal audit leader has given their general GRC function the title 'Risk Advisory', reflecting the changed nature of the role it performs: working across the organization to develop proactive risk management techniques and thinking into everyday operations.

In the main, the risks can be broken down into five categories. Firstly, strategic risks, which can incorporate changing customer preferences, strategic investments, new market entry and stakeholder communications and investor relations, will clearly demand attention.

Secondly, the regulatory framework that has grown up around this area illustrates how much the climate change agenda will demand of IA. More than 250 climate change-related government actions were implemented globally in the last two years. In addition, there is a significant body of new regulation and international standards relating to health and safety, human rights and employment laws, anti-bribery and disclosure. And as a consequence, many will have an audit dimension.

Following on from that, focus will fall on the financial implications of an organization's climate change policy: climate change and sustainability is becoming more important in analysts' rankings and indices, for example. It will, in turn, affect access to/cost of capital once banks start factoring climate change risk into lending and due diligence procedures.



Then there are trade and marketplace risks (consider the potential loss of customers and market share if the company is slow to respond) and cost of compliance, e.g., purchase of offsets, legal liabilities; that's not to mention rising energy, transportation and insurance costs, and adaptation costs in response to climate impacts, such as extreme weather events.

The last 12 months have demonstrated clearly the reputational risks presented by climate change and sustainability. Organizations must now manage the expectations of all key stakeholders to reduce risk - including investors, employees, customers, suppliers, local communities, non-governmental organizations (NGOs) and the media. The value of a brand is inextricably linked to sustainability performance, with greater scrutiny than ever before falling on this area. That is reflected by the 40% increase in reported shareholder action in this area since 2009.

These risks all sit alongside the very real physical and operational risks presented by climate change. Business interruption due to extreme weather, the need to reduce the environmental impacts of products and processes and pressure to green the supply chain have all been day-to-day challenges for businesses across the world for several years.

It is becoming abundantly clear that IA and risk functions as a whole are beginning to engage in this area far more. And it is also clear that IA can bring a lot to the debate. As sustainability becomes more deeply embedded into an organization's strategy, assurance and risk management becomes even more important.

Given the uncertain nature of the effects of climate change, there is a clear opportunity for the GRC function to get on to the front foot in this debate. Whether it be better management of energy use or developing new products to meet changing customer expectations, the next 10 years will see some real strategic investments which have a whole host of uncertainties and risks associated with them. Those risks are heightened by the uncertainty over what the future regulated environment will look like.

Any organization's strategic risk assessment must now include a clear sustainability element. So for example, to what extent is sustainable supply chain risk included within the strategic risk register, or the potential physical effects associated with changing climate? Or, does the business with extensive operations in Africa realize that in five years' time it will have to close its plants down because there's not enough water to keep them going?

Encouragingly, anecdotal evidence suggests audit is grasping the nettle. Some are concentrating on the issue of disclosure while others are developing frameworks for audit and assurance around energy use. One senior auditor recently worked on a "CO2 governance audit," which was driven by the need to audit the many different touch points into the company of the carbon agenda.

Those issues encompass trading, operations, product development and so on; and it soon became clear there were a lot of areas in the business where people were working to address these issues, and the difficulty came in deciding who coordinates the response. Is there a useful overview? Is there a coherent strategy and structure in place? In order to take control of this, the auditor is moving toward a more holistic audit approach.

In practical terms that can take a range of forms. There are many actions that IA can take in order to demonstrate its important place in the effort to tackle the risks associated with climate change:

1. Embed climate change and sustainability as part of the IA risk assessment.
2. Understand and assess key climate change and sustainability risks including: regulatory, financial, reputational, strategic and physical/operational.
3. Validate that key climate change and sustainability risks are appropriately identified, prioritized and controlled within each audit project.
4. Review processes for climate change and sustainability reporting, including evaluation of the integrity and alignment of data across all reporting channels.
5. Share insights with management and the board so they have a clear understanding of the regulatory environment complexities.
6. Coordinate climate change and sustainability risk assessment with other key risk functions.
7. Review the corporate risk register and risk management policies for appropriate inclusion of climate change risks.
8. Review and refresh the assessment of climate change and sustainability risk impact on a regular basis.
9. Monitor and assess impact of existing or potential government regulations.
10. Report on climate change and sustainability risks regularly to the board.

It should also be said that the sustainability and climate change agenda is not just about risk. It is about opportunity: to gain competitive advantage through better energy management; to streamline and adapt business operations in line with leading practice; and to develop new revenue streams in response to changing market demands and customer preferences. Once again, the risk function must be at the vanguard in meeting these challenges.

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