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Internal Audit’s Role in Sculpting a Sustainable ESG Strategy

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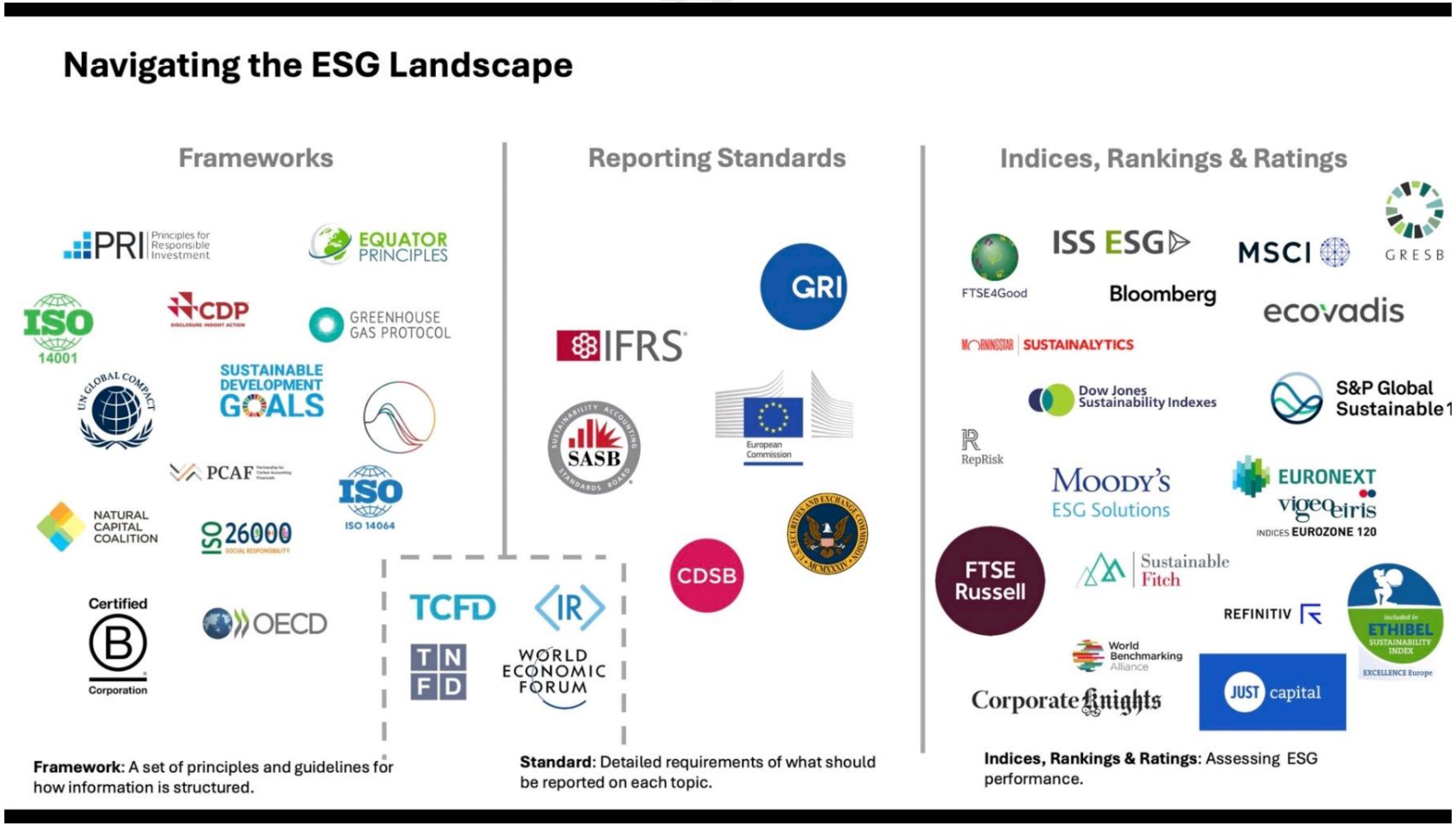
Milton Friedman: "there is one and only one social responsibility of business - to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

The Only Responsibility of Business Is to Maximize Profit

Complicated World of ESG



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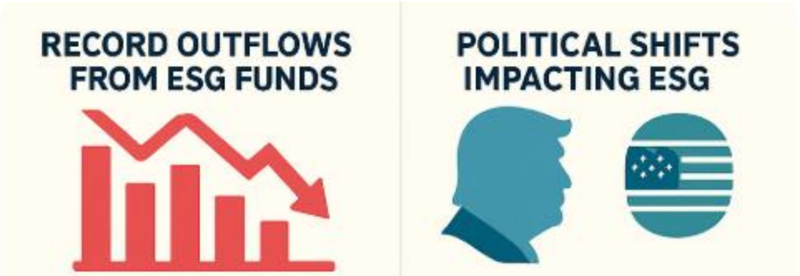
ESG is Not Longer Important

Record Outflows from ESG Funds
In Q1 2025, global sustainable funds experienced a record outflow of $8.6 billion, with Europe seeing its first net outflow since 2018.

Political Shifts Impacting ESG
The return of U.S. President Donald Trump has led to a rollback of climate and social initiatives, influencing global asset manager strategies and marketing of sustainable products.

Greenwashing Crackdown
The EU's upcoming stricter anti-greenwashing rules led 335 funds to change their names in Q1 2025, including 116 that removed ESG references.

Regulatory Simplification Efforts
The EU is considering simplifying its ESG reporting obligations by consolidating various regulations into a single omnibus regulation, aiming to reduce the regulatory burden on companies.



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Trump agenda drives record outflows from global sustainable funds, Morningstar says. https://www.reuters.com/sustainability/climate-energy/trump-agenda-drives-record-outflows-global-sustainable-funds-morningstar-says-2025-04-24/?utm_source=chatgpt.com
ESG fund outflows hit record as sustainable investing backlash grows. https://www.ft.com/content/9f425c25-4fc3-45de-bcc5-e9c75d6d14d3?utm_source=chatgpt.com
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ESG Is Not Longer Important

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Corporate Pushback on ESG Regulations

Major European companies, including TotalEnergies and Unilever, argue that stringent ESG regulations are placing them at a competitive disadvantage compared to U.S. counterparts, potentially leading to considerations of relocating listings or investments.

Defense Industry and ESG Conflicts

Private credit firms are reconsidering ESG restrictions to enable financing of Europe's expanding defense industry, driven by strategic imperatives following geopolitical tensions.

Farmer Protests Against Environmental Policies

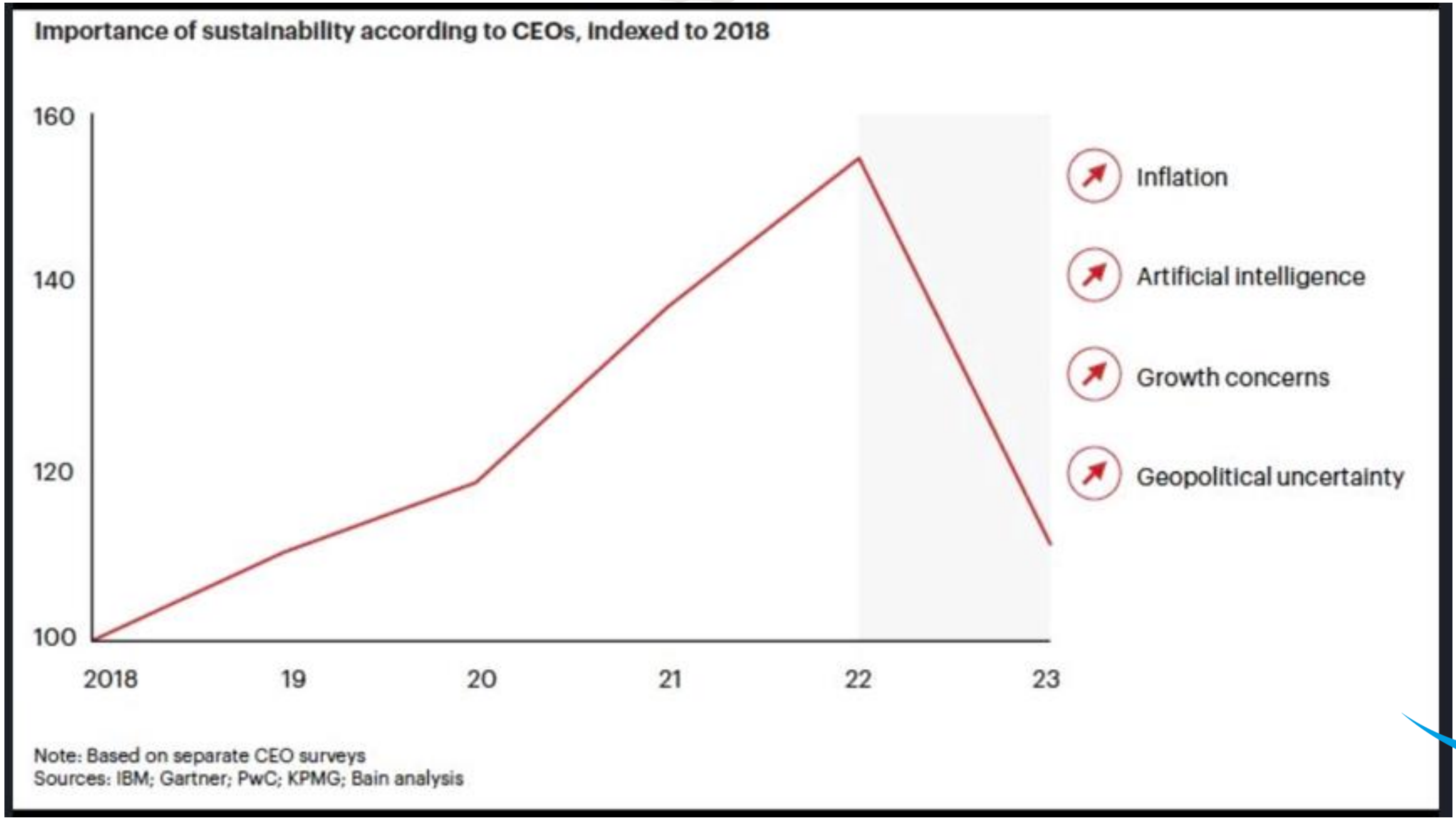
A wave of farmer protests has erupted across Europe, demanding an easing of the EU's environmental policies, highlighting tensions between sustainability goals and economic realities for certain sectors.

Investor Concerns Over ESG Rollbacks

A group of investors representing €6.6 trillion in assets is urging the EU not to dilute ESG regulations, warning that doing so could create regulatory uncertainty and jeopardize the bloc's sustainability goals.

Sources:
Investors With $6.8 Trillion Warn EU Not to Bow to ESG Backlash: https://www.insurancejournal.com/news/international/2025/02/06/811013.htm?utm_source=chatgpt.com
The anti-ESG backlash is not just an American phenomenon as Europe waters down its sustainability agenda. https://fortune.com/europe/2024/02/22/anti-esg-backlash-america-europe-waters-down-sustainability-agenda-environment-politics/?utm_source=chatgpt.com
Private credit firms take aim at ESG for holding back financing for European defence. https://www.ft.com/content/5c1b8f61-1399-4057-bd07-f3ae71b3336c?utm_source=chatgpt.com

CEOs Do Not See ESG As Business But Rather a Regulatory Issue



And the Costs of ESG Are Rising

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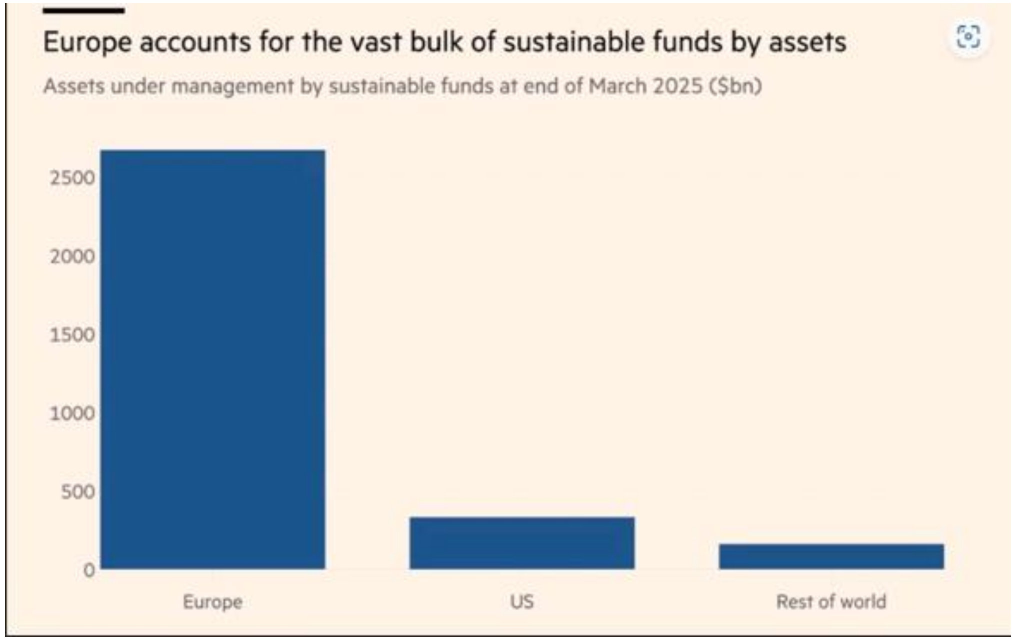
The EU's sustainability reporting and due diligence framework[20] is a major source of regulatory burden, magnified by a lack of guidance to facilitate the application of complex rules and to clarify the interaction between various pieces of legislation. The goal of this framework is to strengthen rules concerning the social and environmental information that companies have to report. This entails a major compliance cost for companies in the EU[21], ranging from EUR 150,000 for non-listed undertakings to EUR 1 million for listed ones[22]. Moreover, risks of over-compliance (e.g. over-reporting) exist across the value chain. Reasons for this currently include unclear definitions

Still, There Are Some Bright Spots

- 81% of consumers prefer sustainable brands, and 66% are willing to pay more for sustainable products .
- ESG commitments resonate with potential employees, particularly millennials and Gen Z, who seek employers aligned with their values. This trend is echoed in research showing that companies prioritizing ESG are more likely to attract and retain top talent .
- ESG performance has improved investor confidence, leading to better access to capital. Studies have found that companies with strong ESG practices often experience a lower cost of capital due to increased investor confidence .



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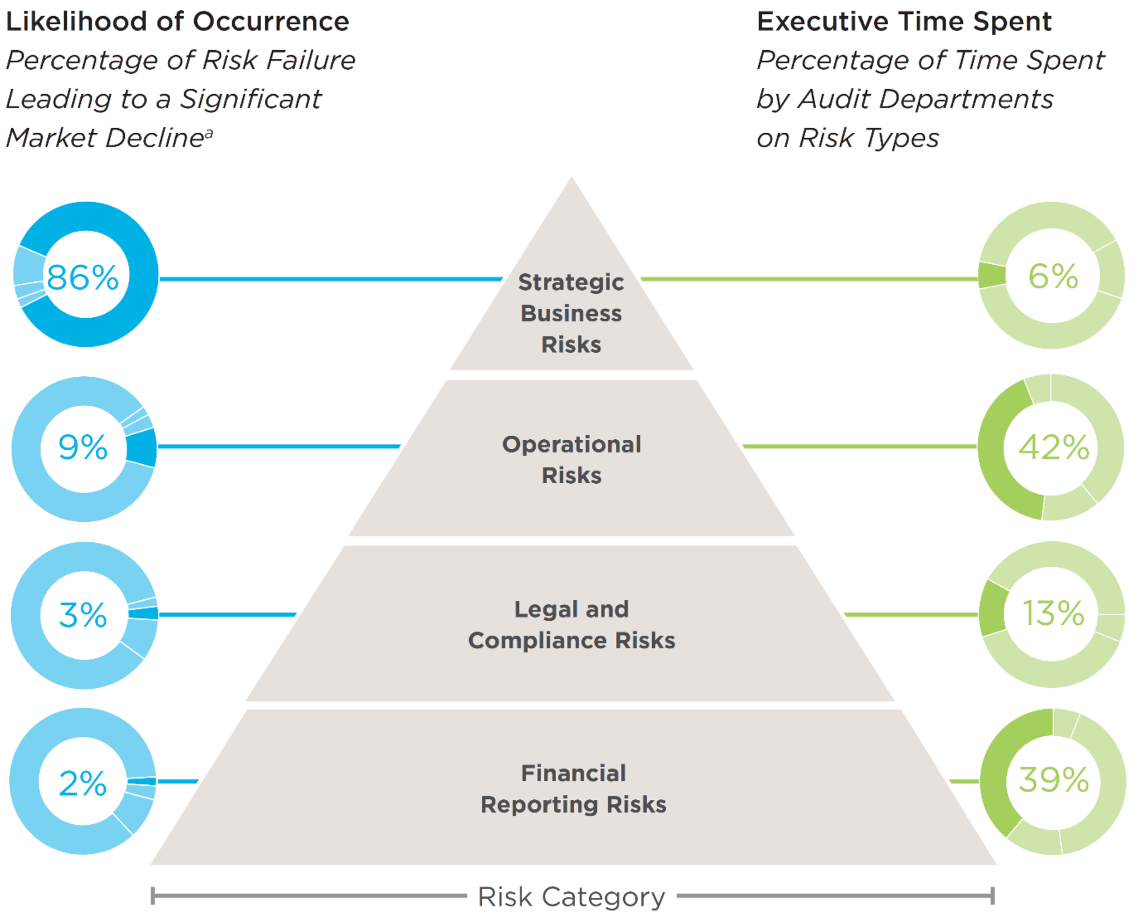
https://dash.harvard.edu/server/api/core/bitstreams/7312037d-76e5-6bd4-e053-0100007fdf3b/content

Why Internal Auditors Are Focusing on Compliance and Not ESG Strategy?



Sources:CEB 2014. Share Shocks Analysis.

Connecting ESG and Strategy

- Competitive advantage is defined by an organization’s ability to outperform its competitors and deliver added value to customers.
- An essential aspect that ties into all these steps is the need to be politically savvy within the organization when it comes to sustainability. Sustainability is often perceived as a pet project, a regulatory/compliance issue, or merely a good PR strategy.
- Internal auditors should leverage their organizational power — without which change is impossible — to convince decision-makers that sustainability is not only an ethical business practice, but also a sound financial strategy.

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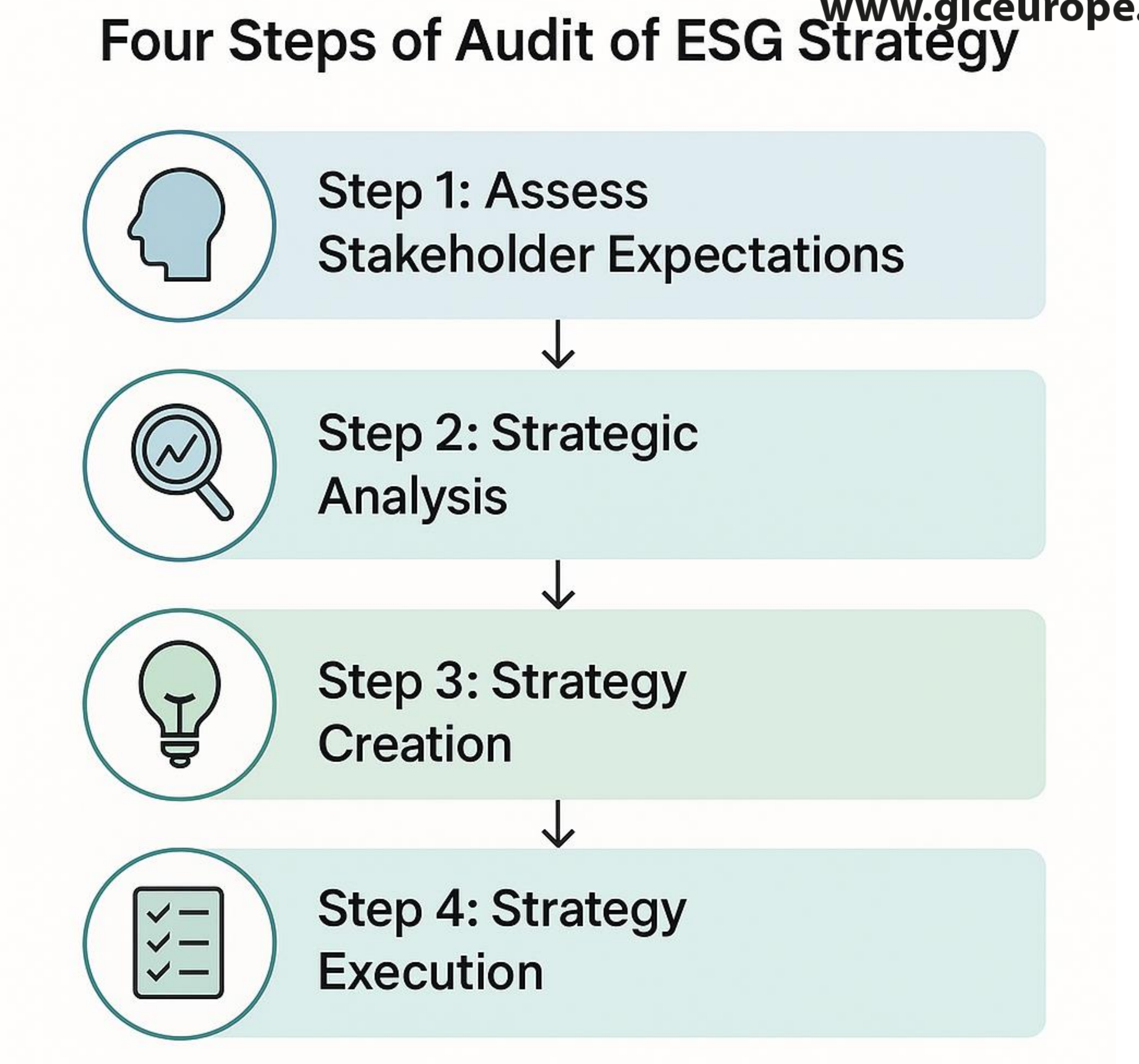
Four Steps of Audit of ESG Strategy



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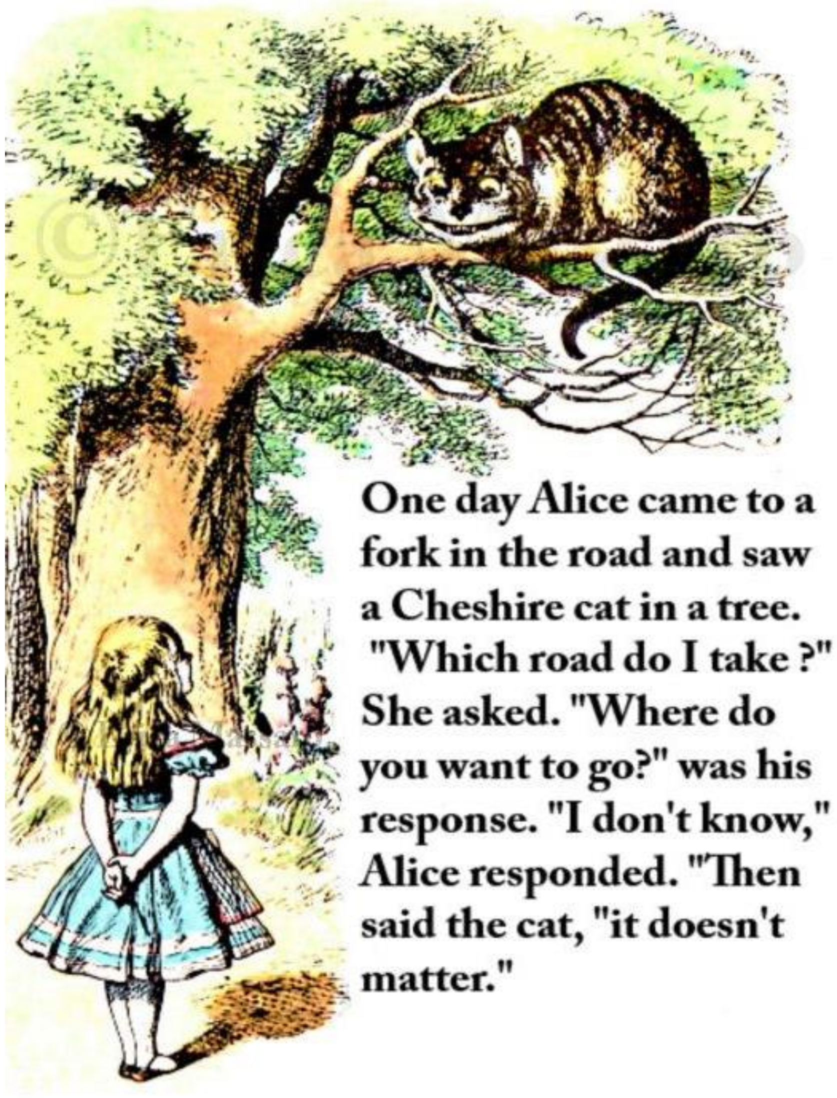
ESG Strategy
Step 1: Assess Stakeholder Expectations

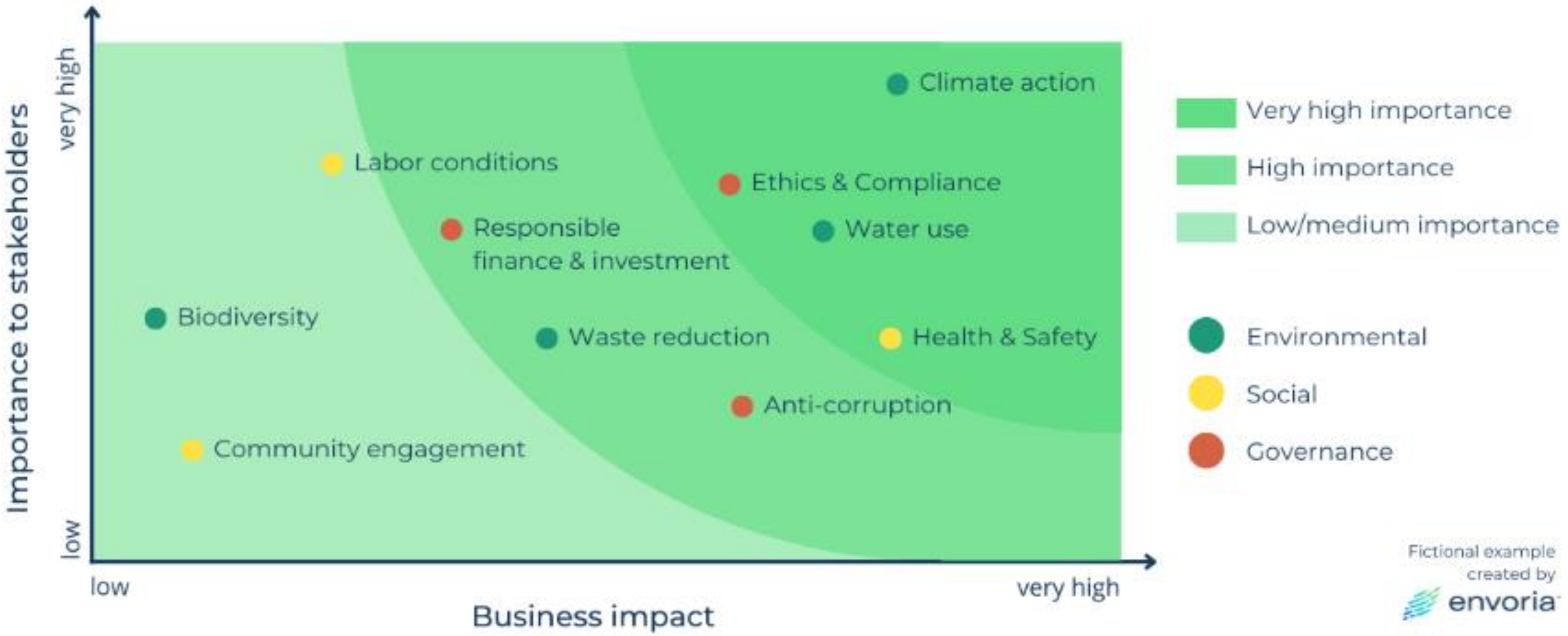
A detailed assessment **of key stakeholder expectations** — including customers, employees, suppliers, local communities, and shareholders — is critical for a valid stand-alone ESG strategy.

These expectations should be used to set **clear strategic priorities**.

Auditors should assess whether the organization performed the materiality assessment **objectively** by using appropriate techniques and including a broad spectrum of internal and external stakeholders.



The Materiality Assessment



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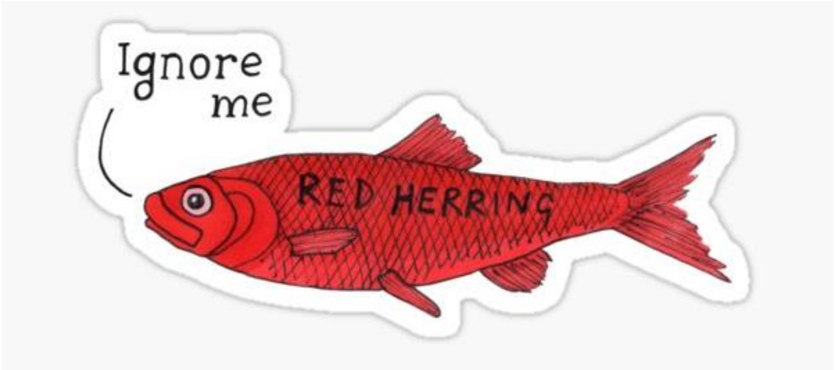
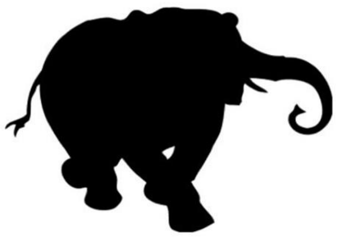
ESG Strategy
Step 2: Strategic Analysis

- **Reliable Data Sources**. Internal auditors should pay particular attention to the source of the data, as unreliable and politicized information and greenwashing are widespread.
- **Black Elephants**. Ignoring trends such as climate change, the need for work-life balance, and the importance of pay equity puts organizations at risk because once the elephant becomes real, the quick-win solutions will no longer suffice.
- **Red Herring:** These are distractions—initiatives or data points that draw attention away from core issues. Internal auditors must be alert to efforts that look impressive but don't address fundamental risks, such as flashy ESG reports that mask deeper operational problems or diversity metrics that lack meaningful inclusion efforts.





BLACK ELEPHANT: "A cross between "a black swan" (an unlikely, unexpected event with enormous ramifications) and the "elephant in the room" (a problem that is visible to everyone, yet no one still wants to address it) even though we know that one day it will have vast, black-swan-like consequences."

Tom Friedman distilling Adam Sweidan

ESG Strategy
Step 2: Strategic Analysis

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ESG Components. Organizations often focus only on identifying environmental risks and opportunities, so internal audit should ensure they pay attention to social and governance risks, as well.

Best Practices. Internal audit should look for sustainability best practices both within and outside the organization's industry.

Sustainability Opportunities. Companies with play-to-win strategies rely on opportunities and breakthrough innovations rather than on mitigating risks and developing incremental innovations.

ESG Strategy
Step 3: Strategy Creation

ESG Integration.

Internal auditors should check whether sustainability is really a core part of the organization's overall strategy, with clearly defined activities and objectives, and not just a part of some minor activities.

Participation.

Internal auditors should assess who participated in strategy development and whether the organization integrated ideas and suggestions from overlooked or less-influential groups.

Shadow boards can help companies with two pressing issues:

- Millennial workers' disengagement
- Executive teams' inability to keep up with changing market conditions.

They can help with business model reinvention, cultural transformation, and process redesign.

- **Business model reinvention**. Facing increasing pressure from Airbnb, French AccorHotels needed a new business model. Top management asked marketing to develop a brand for Millennials. However, after two years marketing came up empty. Arantxa Balson, chief talent and culture officer, decided to turn the project over to a shadow board. In 2018, the Jo&Joe brand was born. Considered "an urban shelter for Millennials," the brand communicates creativity, flexibility, and a strong sense of community. According to Balson, the shadow board succeeded in part because they focused on their vision and developed their point of view "regardless of all internal and cost constraints."

ESG Strategy
Step 3: Strategy Creation

- <u>Goal Setting</u>. Internal audit’s role should be to focus on how the organization plans to achieve its ESG mission and goals and assess whether they are based on the strategy.

- <u>Performance Indicators</u>. Internal auditors should assess whether the organization has put KPIs in place with targets for all strategic objectives and sustainability impacts. Internal auditors also should check whether KPI metrics are methodologically sound and based on reliable data.

ESG Strategy Execution Risks

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ESG Strategy
Step 4: Strategy Execution

- Cascading. Lack of ownership and accountability is one of the main reasons why sustainability strategy execution fails. While the ultimate responsibility for implementing a successful strategy lies with the board, good cascading ensures a high level of hierarchical alignment along strategic objectives.

- Communication. Employees should receive timely and relevant information, which should flow from top to bottom and vice versa.

- Tone at the top. Internal auditors should look for tangible signs of a positive sustainability tone by checking minutes of board and management meetings and the frequency and depth of ESG discussions.

ESG Strategy Step 4: Strategy Execution

- Rewards. Internal auditors should check that the right sustainability KPIs are included, and that appropriate weight is given to ESG criteria.

- Check-ups. What gets measured gets done. This is even more true for sustainability, where the KPIs and measurement systems are evolving.

Essential Steps for ESG Strategy Success

- Leadership buy-in and support.
- Skilled implementation.
- Alignment between specific initiatives and general strategy.
- Effective planning.
- Good communication.
- Ability to manage organizational change.
- Adequate funding for strategy implementation


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