INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
OF UGANDA

ESG CONSIDERATIONS: THE ROLE OF INTERNAL AUDIT

APRIL 2022

Plot 42 Bukoto Street, Kololo, P.O. Box 12464, Kampala, UGANDA
Tel: 041-4540125, 0393-262-333, 0393-265-590
standards@icpau.co.ug
www.icpau.co.ug

TABLE OF CONTENTS

ABOUT ICPAU

The Institute of Certified Public Accountants of Uganda (ICPAU) was established in 1992 by the Accountants Act, Cap 266. This has now been repealed and replaced by the Accountants Act, 2013.

The functions of the Institute as prescribed by the Act are to regulate and maintain the Standard of Accountancy in Uganda and to prescribe and regulate the conduct of accountants and practising accountants in Uganda. Under its legal mandate, the Institute prescribes professional standards to be applied in the preparation and auditing of financial reports in Uganda.

Vision

A globally recognised promoter of accountants for sustainable economies.

Mission

To develop and regulate accountants for professional excellence and sustainable impact.

Core Values

1) Professional Excellence
2) Accountability
3) Integrity
4) Responsiveness

International Affiliations

The Institute is a member of the International Federation of Accountants (IFAC) and the Pan African Federation of Accountants (PAFA).

DISCLAIMER

This guide is aimed at providing information that will inform internal auditors about how they can support their organisations to embrace environmental, social and governance (ESG) considerations in their operations.

Internal auditors should utilize the Paper in light of their professional judgment and the facts and circumstances involved in their organisations and each particular engagement.

While every care has been taken in the preparation of the guidance, neither ICPAU nor its employees, members of council and its committee accept any responsibility or liability that may occur, directly or indirectly, as a consequence of the use and application of this Guide.

1.0 INTRODUCTION

World over, there is a growing corporate governance trend that seeks to reject the old notion of shareholder primacy and shift focus to organisations building quality social relationships with all their stakeholders. Environmental, Social and Governance (ESG) considerations are growing at a rapid pace and have become one of the most significant emerging topics in the recent years. The demand for ESG considerations has ceased being an investor and/or regulators' activitism, but it now ranks among the top business priorities world over. Today ESG considerations encompass strategy, risk and opportunities for organisations as ESG risks are now a top priority. Besides the assurance and advisory roles in traditional auditable areas such as safeguarding of assets, information technology and compliance, internal auditors need to quickly adapt ESG considerations as they are well positioned to support their organisations in the furtherance of ESG objectives given their broad purview of their organisations. Internal audit can play a pivotal role in an organisation's ESG performance and reporting goals by providing both recommendations and independent assurance on ESG governance, processes and internal controls. This Paper is developed specifically to enhance awareness about ESG considerations and to inform internal auditors about their role in supporting their organisations in the adoption of ESG performance and reporting.

2.0 ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) CONSIDERATIONS

The demand for ESG considerations has ceased being an investor and/or regulators' activism, but it now ranks among the top business priorities world over.

While ESG is not a new topic, the pressure for organisations to provide more ESG reporting continues to grow, and there are more calls for the underlying data in these reports to be scrutinised. Investors, for example now consider ESG information when making investment decisions. This shift in thinking is not limited to investors but to consumer and general public expectations as these now demand for ESG reporting.

The concept of ESG considerations is the bedrock of sustainable and responsible investment. The accelerating pace of change in both society and the climate is sharpening stakeholder focus on ESG risks that many organisations are facing. As the name suggests ESG considerations cover three broad categories:

(a) Environmental considerations

These generally examine how an organisation performs as a steward of nature. The aim is to make accountability for an entity's energy use and their overall environmental impact and responsibility. The risks and opportunities can include issues related to carbon emissions, waste management, raw material sourcing and climate vulnerability. Environmental considerations focus on both the inputs (the sustainability of the resources the organisation needs to feed its processes), the processes (actual usage of the resources) as well as the outputs (what and how much the organisation produces).

(b) Social considerations

Social considerations examine how organisations manage relationships with employees, customers and the wider community. Risks under this category include community support, employee relations, diversity, data privacy, general security, employee health and safety and customer interaction. Other key considerations here include working conditions of employees and third parties, fairness of wages or impact of entity's operations on the local community.

(c) Governance considerations

The Governance criterion is all about how the entity works internally. Governance considerations include variables such as business ethics, board and leadership, executive pay, audits, internal controls, intellectual property protection and shareholder rights. Governance considerations cover risks and opportunities around shareholder rights, board diversity and dynamism, ethical decision-making and deterring corruption and bribery. Investors are increasingly looking for organisations that make money while maintaining transparency and high ethical standards.

3.0 THE CASE FOR ESG REPORTING

With so many priorities competing for limited resources, organisations may question the need for enhanced ESG reporting beyond regulatory requirements. However, strong ESG performance is associated with many benefits and financial outcomes, including the following:

(a) Streamlined regulatory compliance

Since ESG is a way of going above and beyond the regulatory requirements, when companies focus on improving ESG performance then regulatory compliance will naturally fall into place.

(b) Improved Resource Efficiency

Improving ESG performance can help lower operating costs. For example, ESG often focuses on reducing energy consumption which can help companies save money on utilities. In addition, ESG emphasises strategies to reduce water and raw material usage. This helps in the elimination of waste and improving of resource efficiency.

(c) Better shareholder returns

Strong ESG performance also correlates with better investor returns by allocating resources to more promising and more sustainable opportunities. For example, a strong ESG proposition can help companies to avoid investments that may not pay off because of longer term environmental issues.

(d) Stronger customer loyalty

ESG performance is a major predictor of customer loyalty as customers generally prefer businesses that are good stewards of the environment. Customers are generally more loyal to entities that support social or environmental issues.

(e) Enhanced transparency to investors and financiers

Increasingly, Investors and lenders are relying on ESG transparency to manage investment risks. This is because ESG disclosures show investors how an entity mitigates risks and generates long-term sustainable financial returns. On the other hand, potential investors tend to overlook companies that do not provide ESG disclosures due to limited transparency about their operations. Disclosure of ESG information in today's business environment is thus essential to enhance the attractiveness of any organisation to potential investors.

(f) Higher employee productivity

A strong ESG proposition can help companies attract and retain employees, enhance employee motivation by instilling a sense of purpose and increased overall productivity[i]. This is because efforts to improve ESG performance contribute to employee engagement and higher employee satisfaction in the long run. A deliberate endeavour to improve ESG performance may make it easier for companies to attract and retain talent.

Ultimately, the case for ESG reporting can be summarised as being the need for sustainable practices in the management of organisations. Incorporation of ESG considerations in governance of organisations leads to the adoption of continually evolving policies and regulations that promote sustainable operations and corporate behaviour which in turn helps organisations to measure, understand and communicate their economic, environmental, social and governance performance.

4.0 ESG REPORTING

ESG reporting may include disclosure of both qualitative and quantitative metrics such as the measures of the entity's performance against ESG risks, opportunities and related strategies as indicated below:

(a) *Environmental component* encompasses how an entity is exposed to and manages risks and opportunities related to climate, natural resource scarcity, pollution, waste and other environmental factors as well as the entity's impact on the environment.
(b) *Social component* comprises information about the organisation's values and business relationships. Information disclosed here includes topics such as employee health and safety, employee diversity, recruitment and staff development.
(c) *Governance component* encompasses information about the entity's corporate governance. This could include information about the structure and diversity of the board of directors, executive compensation, critical event responsiveness and corporate resiliency.

Through ESG reporting, entities effectively integrate ESG considerations into their business strategy and risk management practices communicate the effects of such considerations on business operations and their effect on stakeholders.

ESG Reporting is a process whose magnitude, definition and recognition as a function within the organisation depends largely on the type of the organisation, its size and its maturity. The ESG Frameworks, generally do not assign responsibility to any one area. ESG reporting responsibilities and roles are cross functional but aligned to other stakeholder reporting roles.

4.1 ESG Reporting and the UN Sustainable Development Goals (SDGs)

The SDGs are 17 sustainability goals to be met by 2030 with 171 targets, which entities can use to integrate and align their business strategy and objectives. The SDGs allow for demonstration of commitment and disclosure of progress and performance towards meeting the 2030 goals.

Table 1: SDG Through the Lens of ESG[ii]

As indicated in the table above, the 17 goals that were adopted by the United Nations Member States in 2015 to end poverty, protect the planet and ensure peace and prosperity for all people include:

1. No poverty
2. Zero hunger
3. Good health and well being
4. Quality education
5. Gender equality
6. Clean water and sanitation
7. Affordable and clean energy
8. Decent work and economic growth
9. industry, innovation and infrastructure
10. Reduced inequalities
11. Sustainable cities and communities
12. Responsible consumption and production
13. Climate action
14. Life below water
15. Life on land
16. Peace, justice and strong institutions
17. Partnerships for the goals

Together, the SDG goals and ESG reporting provide a roadmap for a sustainable future in which all entities can thrive and not just survive. By incorporating SDGs into daily business operations, organisations can achieve success through the use of ESG factors which will eventually integrate with SDGs.

5.0 ESG REPORTING FRAMEWORKS

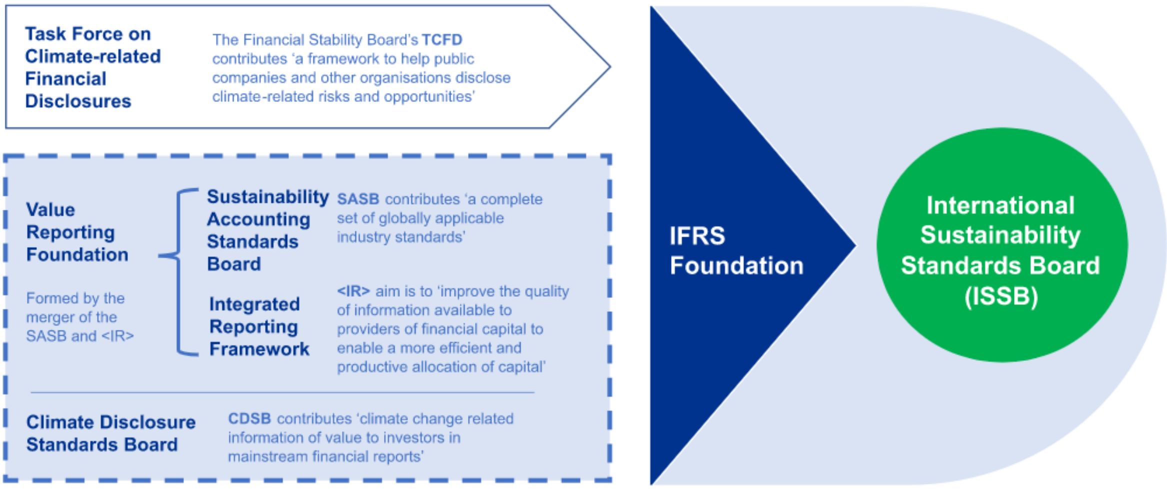
While there are no sustainability reporting standards, the current common practice is for entities to make ESG disclosures in accordance with prominent reporting frameworks such as the:

a) Global Reporting Initiative (GRI) standards – which help organisations report on significant impacts on the economy, environment and surrounding society.
b) Task Force on Climate- related Financial Disclosures (TCFD) for climate- related financial disclosures.
c) SASB standards which focus on the information needs of shareholders and are designed to produce information that is material, relevant and cost effective.
d) The International Integrated Reporting Council (IIRC) Framework which supports the development of integrated reports on an organisation's strategy, governance, performance and prospects in its external environment.

The choice of reporting framework and amount of information disclosed depends on individual organisational needs such as reporting requirements, company strategy, commonly disclosed industry information and intended audience needs. However, this voluntary and inconsistent application of sustainability reporting frameworks leads to inconsistent reporting due to the differing requirements of the sustainability reporting frameworks. Often, published ESG reports contain information that is not comparable between companies or industries.

Consequently, on 3 November 2021, the IFRS Foundation Trustees announced the creation of a new standard-setting board—the International Sustainability Standards Board (ISSB)—to help meet the demand for sustainability standards. At the same time, the IFRS Foundation Trustees announced the consolidation of the Value Reporting Foundation (VRF) and the Climate Disclosure Standards Board (CDSB) into the IFRS Foundation.

The ISSB will deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions.



The ISSB will benefit from the consolidation of global bodies (Climate Disclosure Standards Board (CDSB), Sustainability Accounting Standards Board (SASB) and International Integrated Reporting Council (IIRC)) – as well as the support International Organization of Securities Commissions (IOSCO), Task Force on Climate-related Financial Disclosures (TCFD), World Economic Forum (WEF).

Together they share the aim of enterprise value-focused sustainability disclosures[iii]. Until the full ISSB standards are released to streamline ESG reporting, companies are expected to continue using the existing ESG standards.

6.0 STATE OF ESG REPORTING IN UGANDA

The Institute of Certified Public Accountants of Uganda every year conducts the Financial Reporting (FiRe) Awards. These awards among other things seek to reward entities that have presented commendable reporting that captures aspects of the ESG. Analysis of annual reports submitted for the 2021 FiRe Awards shows that ESG Reporting in Uganda is still in the infancy stages as it is mainly evidenced in few entities such as listed and public interest entities which operate in industries that require such extensive ESG disclosures. Out of about 80 reports received, only half had some scanty elements of ESG reporting with only about 10 reports having well-structured sustainability reports for the ESG disclosures.

Entities with excellent ESG reporting exhibited provided a compelling value creation story by linking their strategic value drivers to their business model, key priorities and strategic outcomes. The reports also provided a useful and informative explanation of the specific risks and opportunities that affect the entity's ability to create value, and how they had been addressed. Overall, such reports described a number of issues that the reader would have expected and gave a reasonable account of the issues that are core to the operations of the entity and the impact entities' operations on the environment among others.

For the majority of entities reviewed, there was great concentration on CSR activity instead and limited efforts were put to ensuring appropriate ESG disclosures. In particular such entities lacked a clear demonstration of the impact of their operations to the environment; management of carbon emissions; water stress; opportunities in clean tech; product/service carbon footprint and the eventual opportunities for financing environmental impact. Other aspects intended to give the entities' perspective towards the social dimension, including human capital, product liability; stakeholder engagement and social opportunities not forgetting the governance aspects were equally not well addressed in some of these reports.

One of the major challenges identified for the limited disclosure of ESG information included regulatory limitations on Corporate Social Responsibility reporting for entities in consumer and industry and the Retirement Benefits sector. It was established that these entities only disclose information that was required by the respective legal regime such as the Uganda Retirement Benefits Regulatory Authority in the Preparation of Retirement Benefits Scheme Annual Report Guideline No.3 of 2020. Other reasons for failure to deliver effective and appropriate ESG reporting include:

- System issues beyond immediate control

- Balancing long-term value creation against the pressure of short-term financial requirements
- Inability to make ESG tangible and meaningful to all employees
- Inability to measure and attach value to some aspects.
- The need to implement operational changes throughout the organization
- Increased cross-functional collaboration and the complexity of a multitude of change initiatives

7.0 INTERNAL AUDIT ROLE IN ESG CONSIDERATIONS

While operating under the resource constraints, organisations are under tremendous pressure to show that their activities are not adversely impacting the environment. It is clear that strong governance over ESG considerations requires alignment among the key organisational players. The role of internal auditors thus becomes very relevant. Internal auditors are able to provide independent, objective assurance and advice over ESG reporting and ESG matters generally.

7.1 Assurance over ESG Reporting

Assurance over ESG reporting should include:

7.1.1 Evaluating Accounting and Reporting Procedures for Material ESG Matters

Internal audit can evaluate the design and operating effectiveness of internal controls around accounting and reporting procedures over material ESG matters. This can help ensure governance of financial reporting and disclosure controls which can lead to greater investor and stakeholder confidence.

7.1.2 Reviewing ESG Financial and Non-Financial Reporting Metrics

Internal auditors have a critical role to play in assessing the relevancy, accuracy, completeness and timeliness of management's ESG financial and non-financial reporting metrics used for public disclosures to avoid unsubstantiated claims that could adversely impact the reputation of their entities.

7.1.3 Monitoring consistency and comparability

The value of ESG reporting might be limited if there is no way to compare it. Internal auditors need to provide assurance about the consistency of their ESG disclosures against other entities in the industry as well as the established frameworks.

7.1.4 Evaluating the ESG Risk Management Framework

Internal audit can participate in the review the organisation's existing frameworks and standards, ranking, measurement protocols and reporting to ensure that they are reasonable, being followed, consistent with industry recommended frameworks, regulatory expectations and comparable with similar entities. ESG risk should form a cornerstone in any organisation risk management and the governance should fully understand this risk very well.

7.1.5 Assessing Controls

ESG reporting thrives well on strategically well mounted system of internal controls that explicitly an organisation's overall ESG efforts and value creation. Therefore, internal auditors need to understand what ESG measures are applicable to their organisations and concentrate the risk assessment process around ensuring the internal controls address those measures. The internal audit function should play an active role in providing assurance about the effectiveness of ESG-related controls and activities to help organisations manage those risks and foster resilience.

7.2 Advisory Services

If the board or senior management is uncertain about best practices in ESG reporting, internal audit (especially if well resourced) might be able to help by providing information to enable management and the board make more informed decisions about ESG reporting.

Internal auditors can:

(a) Assess whether risk strategy and risk appetite are consistently cascaded throughout the organisation and whether climate-related risks are being considered in new products and services;
(b) Advise on appropriate ESG governance framework and recommend the relevant ESG reporting metrics that resonate with the organisation's strategic direction.

The ultimate impact of all the above is for internal audit to advise on the development of internal controls and shape the organisation's ESG control environment.

7.2.1 Evaluate the Organisation's ESG Maturity

While it is important to consider where an organization currently sits in terms of these ESG profiles, it is also crucial to think carefully and strategically about the organisation's ESG ambitions and goals. These are key concerns which will arise in evaluation of an organisation's ESG maturity status.

Internal Audit can assess the maturity of the organization's ESG strategies by conducting a baseline assessment in comparison with other organizations to identify opportunities to improve it.

7.2.2 Assessing Governance Structure and Oversight

Internal audit can review roles and responsibilities to ensure that they are clearly established and understood throughout their organisation to monitor ESG issues, including the formation of an ESG committee or any other alternative committee tasked with the effective execution on ESG strategy, consisting of cross- functional executive members. Internal audit should ensure that appropriate structures and processes exist within the organisation that enable:

(a) Accountability by a governing body to stakeholders for organisational oversight through integrity, leadership and transparency.
(b) Actions (including managing risk) by management to achieve the objectives of the organisation through risk- based decision making and application of resources.
(c) Assurance and advice by an independent internal audit function to provide clarity and confidence and to promote and facilitate continuous improvement through rigorous inquiry and insightful communication[iv].

7.2.3 ESG Strategy

Internal audit also has a role to play in updating organisational plans to prioritise significant ESG risks so management can identify, assess and manage them more broadly and consistently throughout the organisation. Internal audit can assist in mapping ESG factors to the organisation's strategy and major risk categories to identify risks related to inadequately addressing ESG critical issues. In relation to measurement of progress, internal audit can ensure goals are realistic, measurable, included in the organisation's strategic objectives and are a regular item on Board meeting agendas.

All in all, internal audit's contribution to ESG efforts may be influenced by the organisation's strategy, programs and reporting.

7.2.4 Collaborating with other departments

Internal audit can work collectively with other departments such as legal and compliance to validate that ESG reporting disclosures comply with applicable regulations. This could necessitate creation of a checklist of ESG disclosure requirements to identify what disclosures are required, the regulatory agencies and the filing deadlines.

ESG reporting is a rapidly evolving area of reporting. Key stakeholders such as investors, regulators, customers and government will rely on internal audit to provide reliable assurance over ESG reporting and practices to meet their decision-making needs. Internal audit can meet this demand by providing assurance over the design and effectiveness of internal controls over the ESG programme, linking ESG risks to enterprise risks, and verifying completion and accuracy of data used in ESG reporting and disclosure.

8.0 CONCLUSION

ESG reporting is a rapidly evolving area of reporting. Key stakeholders such as investors, regulators, customers and government are increasingly relying on ESG reports and practices to make their business decisions. As such, many organisations now recognise the opportunities and risks ESG presents. Organisational wellbeing is dependent not only on financial strategies and metrics but also on the environmental, social and governance aspects. This holistic approach is important for long-term value creation. Therefore, any forward-looking organisation that desires to operate a sustainable business will need to incorporate ESG considerations in its business operations and business reports.

APPENDIX

RELEVANT IIA RESOURCES

1. Institute of Internal Auditors (2022) *Global Perspectives – The ESG Risk Landscape – Part 1-3*
2. Internal Audit Foundation (2022) *Prioritizing Environmental Social Governance: Exploring Internal Audit's Role as a Critical Collaborator*
3. Institute of Internal Auditors (2020) *The IIA's Three Lines Model*
4. Institute of Internal Auditors (2020), IIA White Paper – *Internal Auditor's Role in ESG Reporting – Independent Assurance is Critical to Sustainability Reporting*

---

[i] Henisz, W**. et al (2019):** Five Ways that ESG creates value, McKinsey and Company, https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Fin
value.pdf

[ii] Sætra, H.S. (2021), *A Framework for Evaluating and Disclosing the ESG Related Impacts of AI with the SD*, Østfold University College, N-1757 Halden, Norway

[iii] KPMG (2022), *New sustainability standards board* **-** *ISSB to address demand for global sustainability disclosure standards,*

[iv] "The IIA's Three Lines Model," The Institute of Internal Auditors, Lake Mary, FL, 2020, https://global.theiia.org/about/about-internal-auditing/Public%20Documents/Three-Lines-Model-Updated.pdf.