Regulatory Changes and the Role of Sustainability Audits



Muhammad Ahmed, ACMA
Senior Executive,
Attock Petroleum Ltd and
Vice Chairman, Faisalabad
Branch Council, ICMA

Sustainability, encompassing social, corporate governance and environmental factors, has materialized the critical priority for organizations across the globe in the fast-changing business environment of today. Businesses are increasingly evaluated not solely on their economic performance, but also on their societal and environmental contributions. The growing significance of Governance, Environmental and Social is evident from the proliferation setting of standard activities that have emerged over the years. Notable examples include the ISO26000 standard on Social Responsibility, the Global Reporting Initiative, the implementation instructions created by the Sustainability Accounting Standards Board, and the universal sustainability development goals (SDGs) established by the UN Global Compact.

An audit is the process of scrutinizing and verifying evidence related to information in order to assess and report on the degree of compliance between the presented information and pre-established criteria or conditions. Within the realm of examination, audits are typically categorized into seven distinct types: financial statement audits, information system audits, compliance audits, forensic audits, investigative audits, operational audits and environmental audit. Since the dawn of civilization, the idea of sustainability has been linked to ecosystems that are influenced by human activity.

Sustainable development is based on three fundamental pillars: the environment, society and economics. Figure-1 illustrates the correlation between the three pillars, as indicated by reference.

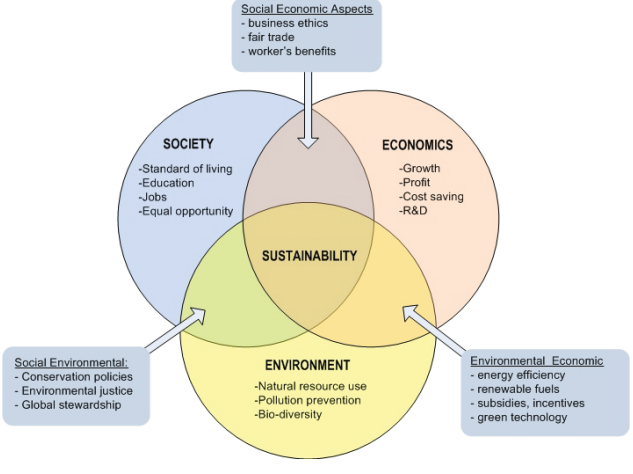


Figure-1

Environmental, social, and governance (ESG) reporting is defined by Rahman and Alsayegh (2021) as "a report issued by a business or organization concerning the ESG impacts." The environmental aspects encompass the magnitude of organization's operational influence on the natural environment, as well as the measures it has implemented to mitigate adverse environmental effects and promote environmental preservation. The social aspect pertains to the degree to which the organization's activities consider and address social and cultural concerns within the community. This includes the incorporation of inclusive practices into the company's business practices. Ultimately, the governance component pertains to the degree to which the organization's governance structures and protocols impede the execution of strategic initiatives and managerial oversight of business activities that bolster the organization's long-term viability.

Key Sustainability Reporting Frameworks

- **Global Reporting Initiative (GRI):** GRI, established in 1997, was the first to provide comprehensive rules for sustainability reporting. The GRI Standards offer a strong and comprehensive structure for reporting on the economic, environmental, and social effects.
- **Carbon Disclosure Project (CDP):** CDP, founded in 2000, specializes in climate-related disclosures, urging firms to assess and control their environmental effects, specifically with greenhouse gas emissions.
- **Sustainability Accounting Standards Board:** SASB, established in 2011, creates industry-specific guidelines for disclosing financially significant sustainability data to investors.
- **International Sustainability Standard Board-ISSB:** At the 26th United Nations Climate Change conference (COP26) in November 2021, IFRS announced the creation of the ISSB, which subsequently introduced the IFRS Sustainability Disclosure Standards.

These standards outline fundamental principles for organizations to disclose sustainability information that is relevant to their financial aspects. On March 31, 2022, ISSB released two preliminary versions of sustainability exposure documents (S1 and S2).

Emerging developments that are influencing the future of sustainability reporting and audits encompass like, Standardization and Harmonization, Impact Assessment and Regulatory integration.

Regulatory changes and Sustainability Audit

Regulatory changes are essential in influencing the framework of sustainability and sustainability audits, compelling firms and organizations to comply with more stringent standards and reporting obligations.

A. Environmental Regulations

Several nations have implemented rigorous environmental legislation to address climate change, minimize pollution, and conserve natural resources. As an example, the Green Deal project of the European Union establishes high goals for achieving carbon neutrality and conserving biodiversity. This effort encourages firms to embrace sustainable practices, such as the IFRS emphasize the significance of conducting sustainability audits like,

- **IAS 16 Property, Plant, and Equipment:** In industries such as oil and gas, where there are rules for environmental restoration and rehabilitation, corporations may be required to include decommissioning expenses in their financial statements.
- **IAS 36 Impairment of Assets:** Assets can be impaired as a result of environmental causes.
- **IAS 37 Provisions, Contingent Liabilities, and Contingent Assets:** Companies must record expenses related to environmental cleanup or potential regulatory fines and penalties.
- **IAS-1 Presentation of Financial Statements:** if there are environmental liabilities or assets that have a substantial impact, they should be accurately represented in the financial statements.
- **IAS 38:** Firms have the option to capitalize intangible assets related to the environment, such as carbon credits.
- **IFRS-6 Exploration for and Evaluation of Mineral Resources:** This standard focuses on the environmental rehabilitation requirements associated with the process of prospecting for and evaluating mineral resources.
- **IFRS-13 Fair Value Measurement:** The environmental condition and associated costs of an asset or obligation can impact its fair value.

"Environmental considerations have evolved into strategic imperatives surpassing mere regulatory compliance. Consequently, the integration of environmental accounting into core corporate financial practices is imperative."

B. Corporate Governance Regulations

Regulatory bodies are placing increased emphasis on corporate governance frameworks that give priority to ESG (Environmental, Social, Governance) aspects. The Task Force on Climate-related Financial Disclosures (TCFD) offers rules for disclosing climate-related risks and opportunities, which have a global impact on reporting methods developed under the IFRS S1 and S2. This innovative idea represents a significant turning point, where the fields of economics and environmental awareness converge, allowing investors to,

- Assess the impact of sustainability disclosures (S1 and S2) on the overall value of the company, considering both the associated risks and opportunities.
- Determine the firm's strategy for addressing emerging threats, risks, and opportunities.
- Evaluate the company's readiness to adjust its strategy, operations, and business model in response to sustainability-related risks and opportunities.

Regulations Impact on Sustainability Audits

- Auditors are required to verify compliance with changing reporting standards and regulations, which means they need to conduct thorough reviews of ESG performance.
- Imposing more stringent requirements fosters accountability and transparency, motivating organizations to carry out more thorough sustainability audits and reveal pertinent information to stakeholders.
- Auditors are required to incorporate ESG factors into their risk assessments and assurance methods, recognizing the interdependence between sustainability and company operations.

Key Steps for an ESG Audit

Implementing ESG objectives, conducting an ESG materiality assessment, and undertaking an ESG audit necessitate the participation of multiple leaders and departments within an organization. The procedure consists of multiple steps (Bhatnagar & Anastas, 2022). Essential measures involve the subsequent actions:

- Conduct an ESG materiality evaluation to determine, comprehend, and rank the issues that pose the greatest risks and opportunities affecting the organization's operations and performance.

- Establish the structure or standards that the organization will employ for ESG evaluation, reporting, and auditing. "The audit will be influenced by anything that has a significant effect on the company, as that is what will be examined," stated Beers.



- Enumerate the specific measurements necessary for reporting the environmental, social, and governance (ESG) risks and strategies of the organization. This includes the metrics mandated by regulators and desired by stakeholders.

- Establish robust controls to verify the integrity and completeness of the data used for measuring and reporting on ESG concerns. Ensure that these controls are effective and well-documented, allowing for easy demonstration to auditors. "Implement robust governance measures to ensure accurate reporting of that information," said McGowan.

- Establish board supervision of the information being disclosed, considering the increasing interest in ESG information from investors and authorities. "Board oversight enhances rigour and discipline," stated McGowan.

- Conduct an audit readiness evaluation to evaluate the adherence to processes, procedures, and governance, as well as to verify the effectiveness of controls.

Conclusion

ESG audits are crucial in promoting sustainability and responsible business practices. Organizations can improve transparency, reduce risks, and attract responsible investors by integrating ESG factors into their operations. To achieve effective ESG audits, one must comprehend the fundamental principles, set explicit goals, gather and authenticate data, evaluate risks, and measure performance. In addition, the use of efficient reporting and communication tactics promotes the involvement of stakeholders and ensures that ESG factors are in line with the overall company plan. By adopting optimal methodologies, organizations can generate a beneficial influence, establish confidence with stakeholders, and contribute to a more enduring future.

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***About the Author: Mr. Muhammad Ahmed** is an Associate Member of ICMA, currently serving as a Senior Executive at Attock Petroleum Ltd. He is an active member of the ICMA Research and Publication (R&P) Committee and the Technical Evaluation Committee for the Best Corporate & Sustainability Report Awards of ICMA and ICAP. Additionally, he serves as Vice Chairman of ICMA's Faisalabad Branch Council (FBC). Mr. Ahmed holds degrees in LLB, M. Com, ACMA, and M.Phil., and is presently pursuing a PhD in banking and finance.*