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Embedding ESG and sustainability considerations into the Three Lines Model

The Institute of Internal Auditors

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Introduction

The world faces three main global challenges: the climate emergency, the loss of nature and growing inequality. Each of these challenges poses a threat to business, and the events of the past two years— a global pandemic, geopolitical instability, continued extreme weather events and the biodiversity crisis — have demonstrated the increasing interconnectivity of our operating environment.

There is a pressing need for a mindset shift within the business community to address these challenges, build more resilience and future-proof organizations.[1] Stakeholders' expectations on businesses are becoming increasingly demanding and developments in the regulatory landscape mean that business needs to respond with an actionable and practical approach. In this volatile and uncertain environment, there is a need for effective governance structures and processes to enable the achievement of objectives, which should include key sustainability topics.

While climate change remains firmly on the corporate agenda, business efforts toward nature-positive and equitable societies are growing in importance. There is no net-zero without nature.[2] When we speak with CEOs and CFOs, the question is no longer if they should act, but how and if their businesses should be part of the solution. For this, organizations need to embed practical and credible approaches into their business models and across their supply chains.[2] It is critical that material sustainability issues are embedded into business decision-making processes and that governance mechanisms are in place to ensure effective oversight of risk management and controls.

In 2020, The Institute of Internal Auditors (IIA) updated the Three Lines Model to include a principles-based approach that adapts to organizational needs.[3] The model is grounded in governance and amplifies the need for robust risk management and controls as a fundamental part of governance. It helps organizations to identify the appropriate structures and processes that best support the achievement of business objectives to create and protect value for the organization.

In 2021, the World Business Council for Sustainable Development (WBCSD) and The IIA established a collaboration to leverage each organization's knowledge and expertise.

The resulting collaborative guidance:

1. Considers how environmental, social and governance (ESG)-related risks and opportunities should be embedded into the Three Lines processes to ensure efficient and effective risk management and internal oversight; and
2. Offers practical suggestions and examples for integrating sustainability considerations into the key roles and responsibilities within the Three Lines.

   The intended audience of this guidance document includes corporate boards, C-suite representatives within large corporations, and senior management to provide information and understanding on the role of the respective lines in overseeing the effectiveness of risk management and internal audit processes.

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Executive Summary

In 2020, The IIA updated the Three Lines Model to guide organizations toward effective governance, risk management and internal controls. Since its launch, the Three Lines Model has helped organizations to identify the appropriate roles that could best support the achievement of business objectives while creating value for the organization, and its stakeholders.

The guidance in this document, jointly drafted by WBCSD and The IIA, highlights internal and external factors that are driving the integration of ESG and sustainability into decision-making. It provides suggestions on how to bring these considerations into the key roles and responsibilities outlined in the Three Lines Model, such as the governing body, management (first- and second-line roles) and internal audit.

According to the revised version of the Three Lines Model, presented in this guidance, to embed ESG and sustainability considerations, all roles need to work together to ensure good governance and make the business model future-proof.

- The **governing body** oversees and establishes governance mechanisms that integrate the strategic objectives with ESG and sustainability considerations. These governance mechanisms make the governing body more aware and actively involved in the company's ESG reporting strategy and the impact of the business operations on ESG issues. The governing body is also in charge of identifying and engaging with a variety of stakeholders affected by company operations.

- **Management** develops a multi-capital approach accounting for all the financial and non-financial capitals that the company business model requires to ensure the effective functioning of its operations. The management also oversees the delivery of the materiality assessment, which establishes the link between the operations of a company, their impact on ESG issues and relevance to key stakeholders.

  The outcome of the materiality assessment—the double-materiality matrix—shapes the ESG risk management strategy and helps the other roles understand the evolving context in which the business operates.

- **Internal audit**, independent from the governing body and the management, assures the reliability of internal control processes for ESG data disclosure and reporting.

Due to the diversity of governance models, roles and organizations, each company should decide how to apply this guidance according to its needs, strategic goals, culture, resources and business context. To make this guidance as widely applicable as possible, the recommendations provided were driven by insights from 12 companies, practitioners and regulatory bodies, who participated in interviews that have guided the content of this report.

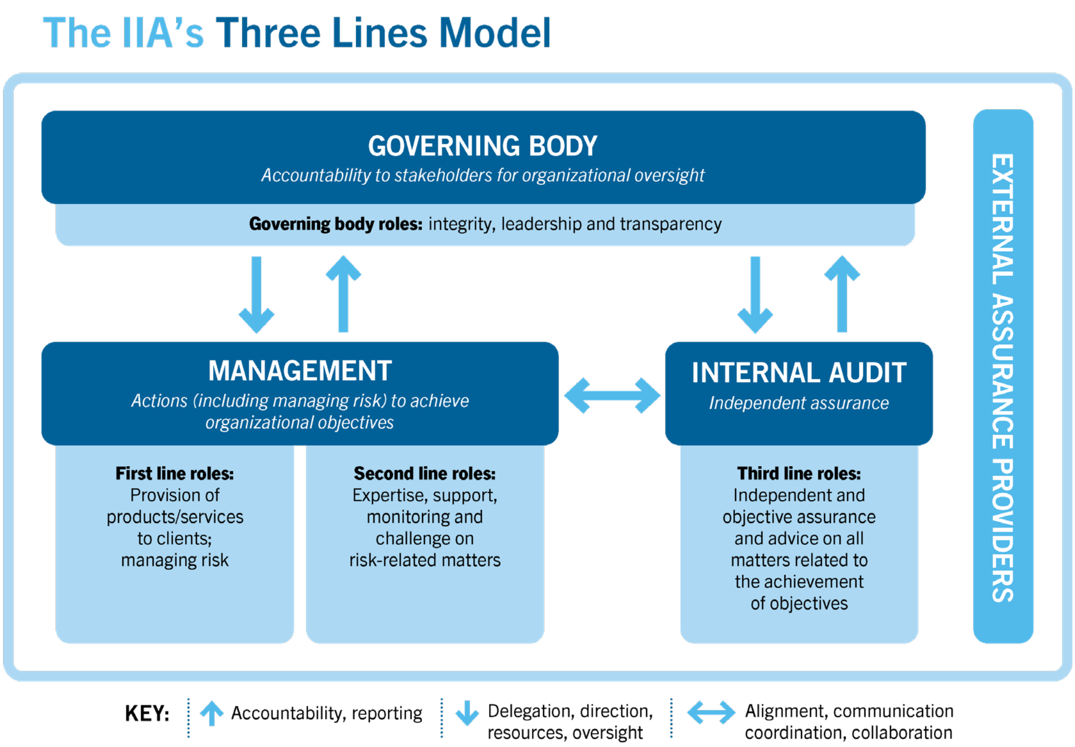
① The Three Lines Model: A timely update

The IIA's Three Lines Model is recognized globally as a critical resource in successful governance. It helps organizations identify structures and processes to best manage risks and achieve objectives, including an organization's ESG-related risks. The model establishes the three essential roles that define governance at its most basic: accountability, actions and assurance. It also identifies the three essential players in governance: the governing body, management and internal audit.

First-line responsibilities include providing products and services to clients or customers in compliance with the requirements and expectations set by the second-line, who provide oversight, advice and assess and perform risk management activities, challenging the first line where required. These roles and responsibilities are the fundamental components of governance supported by a governing body that is truly accountable for the actions it has asked management to perform.

It must have assurance from an objective and independent source that what has been asked has been accomplished. Without that assurance, there is no governance. The model identifies internal audit as the board's source for objective internal assurance, independent of management. The internal audit function can also play a key role in supporting external assurance through their reliance and coordination.

Figure 1: The Institute of Internal Auditors Three Lines Model



The Three Lines Model is an updated and enhanced version of the well-respected Three Lines of Defense.[3]

The model was renewed in July 2020 to clarify and strengthen some foundational principles, expand its scope, and explain how key organizational roles work together to facilitate strong governance and risk management. The name change reflects a clarified focus. Instead of acting as a purely defensive tool—as the old name might have implied—the model is intended to reflect how an organization's structures and processes should be designed to look ahead rather than simply reacting to circumstances. It also underscores how the internal audit function's role goes well beyond identifying concerns and encompasses forward-looking advice and consultation on key issues.[3]

The current model also better illustrates the board's and internal audit's integral roles in risk considerations and how all three lines interact. It includes an updated concept of risk and better defines responsibilities of management, internal audit and those charged with governance and their interactions.

These timely changes enhance the model's value to incorporate sustainability considerations, while guiding businesses toward becoming more resilient and future-proof.

2 The relationship between governance and future-proof businesses

In 2021, WBCSD updated Vision 2050, which sets a framework for action towards a world in which more than 9 billion people can live well, within planetary boundaries, by mid-century.[a] This vision is still within reach, but we have to act faster and, in the decade ahead, all businesses need to embed sustainability into all aspects of their systems, processes and practices to turn this vision into reality.

Governance is one of those key processes where significant evolution is required. Governance is defined as the set of processes that ensure the overall effectiveness of an organization,[4] and it must include oversight of risk management, controls and disclosure. In the context of Vision 2050, however, it must include governance of ESG-related issues, as well as broader sustainability considerations.

Effective governance builds stakeholders' confidence and trust that a company's decisions, actions, and outcomes can address priorities and achieve the organization's corporate purpose.[5] The purpose of business is defined by Professor Colin Mayer as "to produce profitable solutions to the problems of people and planet, and not to profit from producing problems for people or planet."[6]

Having a purpose and business model that demonstrates a company's contribution to people, profit and planet means that boardroom decision-making can support the long-term success of the organization.[7]

The Three Lines Model helps organizations consider the roles needed for effective governance and management of material ESG topics as well as broader sustainability reporting. It encourages a deeper understanding of these roles and how they work with each other to support organizational success. Organizations can better determine the most appropriate structures for their own needs, applying the model in conjunction with their particular considerations—goals, circumstances, culture, resources—as the foundation necessary to manage risk.

To make a business resilient and future-proof, those risks need to be managed against a continually evolving backdrop. A future-proof business strategy[8] connects to scientific and social consensus on progress towards a net-zero and nature-positive economy. An inclusive approach that considers value to all stakeholders is fundamental to a company's social license to operate. Failing to take into account ESG-related risks and opportunities may impact an organization's strategic resilience.

At the same time, business models need to reflect and account for a company's risk to and from ESG-related issues, adopting a double materiality approach (non-financial reporting in addition to financial reporting - see Figure 2).[9] To achieve this, companies need to consider the changes required within their existing business processes to better embed ESG into their operations.

In the context of the Three Lines Model, this means that all roles are working together to collectively contribute to the creation and protection of value when they are aligned with each other and with the prioritized interests of stakeholders.
The transition to a future-proof business will require new natural resource relationships as part of the business model. Nature must be considered alongside climate, and should be seen as business critical when it comes to managing risks and identifying opportunities for long-term equitable and sustainable growth.

Understanding these ESG-related risks and opportunities will require companies to have robust internal and external relationships and to ensure that the quality of those relationships supports a business in its value creation process. This guidance will support companies in this process, and illustrates how to embed sustainability and ESG considerations into business practices.

[a] "Living well" means that everyone's dignity and rights are respected, basic needs are met, and equal opportunities are available for all. And "within planetary boundaries" means that global warming is stabilized at no more than +1.5°C, and natural systems are protected, restored, and used sustainably. It also means that societies have developed sufficient adaptive capacity to build and maintain resilience in a healthy and regenerative Earth system.

Figure 2: Double materiality perspective

Double materiality perspective is an extension of the key accounting concept of materiality. The double materiality concept proposes that companies should consider reporting on sustainability issues (e.g. climate-related information, where they may affect the financial performance of the company AND information should be reported for an understanding the external impacts of the company).

Source: Graphic adapted from "Double materiality: what is it and why does it matter", Grantham Research Institute on Climate Change and the Environment, April 2021.[10]

3 Embedding sustainability and ESG considerations into business practices

Sustainability presupposes an inside-out lens as it describes how organizations impact society and the environment. Sustainability is used as an umbrella term for how an organization can operate within environmental thresholds and planetary boundaries. Sustainability initiatives can include a company's efforts to reduce its impact while creating value on the external environment (e.g., responsible sourcing or regenerative agriculture).

Environmental, social and governance (ESG) considerations presuppose an outside-in focus on how ESG issues (e.g., climate change) impact the company and its value by posing new risks, threats and opportunities. ESG considerations are data-driven and inform stakeholders on the value of a company by quantifying the impact of ESG issues on financial performance.[11] ESG is used when considering ESG-related risks and the integration of these material topics into key business processes.

To understand how ESG and sustainability considerations are currently embedded into business practices and the roles set out in the Three Lines Model, WBCSD and The IIA conducted a series of interviews with leading companies and experts. The insights from these interviews are included throughout this report and have informed the recommendations for companies to evolve their processes.

The interviews highlighted several factors that contribute to the extent to which a company integrates ESG and sustainability considerations in its decision-making processes. These factors are discussed in the following sections of the report and include:

1. Corporate culture and behavior change
2. The maturity of an organization
3. The evolving regulatory and voluntary disclosure landscape
4. Net-zero and nature-positive commitments
5. Pressure from investors and other stakeholders
6. Trust and reputation

Embedding ESG and sustainability considerations into business practices is also an opportunity. Leading companies have now realized that acting on nature is a chance to win trust with customers, civil society and investors. Major investors are also pledging to eliminate deforestation from their portfolios by 2025; nature action demonstrates mitigation against significant risk exposure and lowers the cost of capital.[12]

1. Corporate culture & behavior change

Corporate culture refers to the set of beliefs, behaviors and business practices that altogether establish how an organization engages with external actors, manages outside business transactions, and defines its attitudes towards ESG-related risks.[13]

Corporate purpose and culture are equally important, as they show leadership while characterizing the extent to which the leadership values and remunerates ESG performance within the operations of an organization. Changing an established corporate culture can be challenging from a governance perspective as it involves reviewing consolidated behaviors across different corporate roles and levels.

Insights from the interviews highlight that there are both internal and external drivers that can ensure the behavioral change necessary to develop a corporate culture rewarding ESG performance.[b]

[b] There are several behavioral change models available for organizations to implement. The most common push factors (resources, and internal and external triggers) are inspired by: Crawford Hollingworth and Liz Barker, "Behavioural Change Models: An overview of the two best behavioural change models and how to apply them", The Behavioural Architects, 2020.

Internally, the push towards behavioral change can be a top-down or a bottom-up process. It is a top-down process when the governing body directly leads the integration of ESG and sustainability considerations as part of the corporate strategy. For example, when an organization acknowledges that climate change is a key risk for its operations, managing material ESG issues becomes part of the corporate strategy, and sustainability part of the culture of the company.

The behavioral change process can be bottom-up, however, when management first- and second- line roles highlight new and emerging ESG-related risks and opportunities that should become part of the corporate strategy. For example, an organization might take a proactive approach to identifying ESG-related risks rather than reacting and managing them as they occur. Management has a role to play here in developing and implementing the necessary processes.

Externally, pressure can come from various sources, as outlined in the following sections. These factors external to the organizations continue to drive the need for behavior change within the organization, ultimately resulting in a corporate culture that values and promotes sustainability and ESG considerations.

These push factors, internal and external, are not mutually exclusive but can lead to the desired behavioral change supporting a corporate culture linked to ESG performance. The governing body can ensure that the corporate culture includes practices, resources and processes allowing management to challenge the status quo, highlight new ESG-related risk trends and ensure relevant skills, competencies and transfer of knowhow within an organization.

2. Maturity of an organization

For many companies, embedding sustainability and ESG considerations within their organizations presents both a challenge and an opportunity. This means that often companies are at different levels of maturity when it comes to integrated business practices. This maturity can be measured, for example, by identifying where responsibility and accountability for sustainability sits within the organization,[4] the alignment between ESG material topics and risk factors[14] (See Figure 3), quality of ESG disclosure[15] as well as governance mechanisms and processes to oversee and manage this integration.[7]

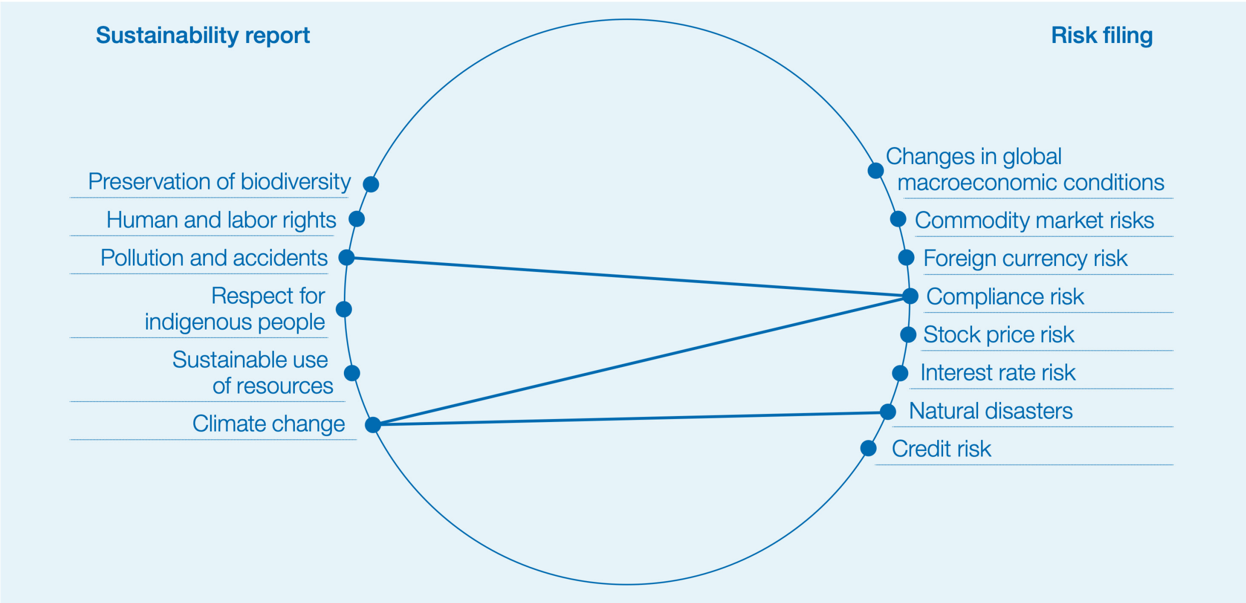
The interviews that we conducted with companies provided interesting perspectives on maturity levels:

1. According to some organizations, there is a perceived risk of first-mover disadvantage in integrating ESG and sustainability issues into governance, risk management and disclosure. For example, disclosure of impacts and dependencies on sustainability factors could present threats to competitive advantage. The extent to which companies choose to pursue these opportunities and mitigate risks will largely be determined by the corporate culture.

2. For complex organization structures, for example organizations operating across different regions and sectors with multiple business units, ESG and sustainability integration requires more complex governance processes and resources. More granular ESG disclosure and the skills to prioritize ESG-related risks will vary depending on the local contexts.

3. For companies that are more advanced on their sustainability journey, being a first-mover on ESG disclosure was seen as less of a concern because integrated strategies, governance processes and other internal decision-making systems were in place to ensure confidence and reliability of any ESG disclosure.[16]

Figure 3: The level of alignment between sustainability disclosures and risk factors is one way to assess the level of ESG integration



Source: Sustainability and Enterprise Risk Management: the first step towards integration. Full text available here

3. The evolving regulatory and voluntary disclosure landscape

The 10-fold increase in ESG reporting requirements between 1992 and 2017 has, unsurprisingly, led to calls from businesses and investors alike for greater alignment and consolidation of the ESG reporting space.[17] These calls for consistency and alignment have been heeded by global standards setters. In the past few months, the International Sustainability Standards Board has issued two exposure draft standards for consultation,[18] the United States Securities and Exchange Commission (SEC) has issued a proposed climate disclosure rule,[19] and the European Commission, through delegated responsibility to the European Financial Reporting Advisory Group (EFRAG), has issued interim drafts for public consultation on European sustainability reporting standards.[20]

Much of this activity draws on the existing work of voluntary reporting organizations such as the Task Force on Climate-Related Financial Disclosures (TCFD), the Sustainability Accounting Standards Board, the Global Reporting Initiative and others.

These new mandatory reporting standards are being driven by the increasing recognition by regulators and others for the need to build a common ground for disclosure to ensure effective communications of ESG-relevant information between corporates and investors. Capital markets need decision-useful and reliable information around companies' strategic sustainability risks and opportunities to understand their short, medium and long-term value creation.

In addition to climate-related financial disclosures, there is strong market momentum towards including "nature positive" in corporate disclosures through the work of the Taskforce on Nature-related Financial Disclosures (TNFD). The TNFD's beta framework requires disclosure of businesses' nature-related risks and opportunities using the same four pillar approach as the TCFD – governance, strategy, risk management and metric & targets – that has been widely accepted and adopted by business and financial markets.[21]

4. Net-zero and nature-positive commitments

Against this evolving regulatory landscape and the shifting operating environment, businesses are under pressure to set net-zero and nature-positive commitments. For example, WBCSD updated its membership conditions in 2021 to require members to set an ambition to reach net-zero greenhouse gas emissions no later than 2050 and create ambitious, science-informed goals that contribute to nature/biodiversity recovery by 2050.[22]

The United Nations Race to Zero campaign also urges companies to commit to science-based emissions-reductions targets, but net zero commitments will not be achieved without factoring in action on nature, too. A total of 70% of net-zero goals from governments and businesses are considered unachievable without ending deforestation[23] within the decade and protecting the marine life that absorbs up to 30%[24] of global carbon today. At COP26, the launch of the Glasgow Climate Pact saw all parties agreeing to focus on driving action across climate mitigation, adaptation, finance and collaboration.[25] In parallel, over 100 leaders reaffirmed their commitment to sustainable land use, and the conservation, protection, sustainable management and restoration of forests and other ecosystems.[25]

These increasing levels of scrutiny mean that it will not be sufficient to make net-zero commitments in isolation. Companies need to consider how to embed action on climate and nature into their business practices and drive action down their supply chains. Commitments must be supported by coherent strategies with interim targets to measure progress. Governance structures and board responsibilities will need to be reconfigured to include more complex ESG information and corporate ESG disclosures will need to be transparent and have high levels of external assurance.

5. Pressure from investors & other stakeholders

In his 2022 letter to CEOs, BlackRock Chairman and CEO Larry Fink focused on investment considerations when he said, "We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients."[26]

The demand from investors is clear. In a recent PwC Investor Survey, 79% of respondents highlighted ESG risks and opportunities as an important factor in decision-making, but only 33% believe that the current quality of reporting is on average good.[27] Ceres has urged corporate boards "to systematically and explicitly oversee environmental, social and governance (ESG) risks in order to keep their businesses resilient in the face of growing global climate and water crises."[28]

The board has a critical role to play in challenging management and should encourage the integration of financial and non-financial information so that stakeholders can be provided with investment grade data. But the board in its oversight role should look beyond the views of shareholders and consider its responsibility to understand stakeholder views firsthand to better inform boardroom decision-making.[25]

Research conducted by WBCSD and DNV highlighted that corporate culture is one of the key barriers to effective stakeholder engagement, as in many organizations the governing body does not consult directly with a diverse pool of stakeholders or does not engage with them at all. Management can support the governing body in this task; for instance, by establishing governance mechanisms to formalize operational relationships between the governing body and groups of stakeholders.[29]

6. Trust & reputation

Building and maintaining trust and confidence with stakeholders is necessary to ensure that business and investor decision-making can rely upon the information exchanges that take place. In Deloitte's *2022 CxO Sustainability Report: The Disconnect Between Ambition and Impact*[c], 97% of respondents said their companies had been negatively affected by climate change, including about half who saw impacts on operations such as disruptions to business models and supply networks.

[c] Full text available at: https://www2.deloitte.com/global/en/pages/operations/articles/deloitte-cxo-sustainability-report.html?id=mt:2or:3pr:4cxosurvey2022:GC1000053:6oper:20220118:pressrelease

They also reported feeling pressure to act on sustainability concerns from a variety of stakeholders, such as regulators, shareholders, consumers, and employees. The broad and complex nature of sustainability topics means that organizations need to raise awareness and build capacity to ensure that multiple departments understand how the business could be impacted.

Board members' personal liability is another important consideration that underscores the urgency in this area.

In its 2019 ruling in Marchand, the Delaware Supreme Court referred back to the pivotal Caremark case, stating that, "If Caremark means anything, it is that a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of duty of loyalty."[d]

Failure to uphold the board's duty of care can pose a wide variety of risks for not only the organization but also for boards, a risk that directors should be aware of.

There continues to be an increase in ESG-related litigation against both companies and in some cases directors, particularly on climate change matters and net-zero commitments, but also supply chain and human rights issues, and informal ESG disputes on disclosed information and allegations of greenwashing.[30]

Addressing sustainability is no longer a "nice to have", it is a critical business issue that should be rolled into the broader corporate governance, risk management, disclosure and accountability frameworks of the company. It is thus imperative that directors understand the nature of their fiduciary duties and take advice in circumstances where they are in doubt.[7]

[d] Marchand v. Barnhill, 2019 WL 2509617 (Del. June 18, 2019)

④ The Three Lines Model: Roles and sustainability responsibilities

The Three Lines Model identifies clear processes and roles to guide organizations towards good governance. An organization that relies on good governance can identify, assess and prioritize ESG-related risks to inform decision-making.

This section considers how sustainability and ESG considerations can be integrated and embedded across the three roles outlined in the model: governing body, management, and internal audit.

Within the Three Lines Model, ESG and sustainability considerations can be integrated as described in the visualization below.

Figure 4: Key actions for the Three Lines Model roles in sustainability and ESG considerations

Governing body	Management	Internal audit
Governing body roles: Establish governance mechanisms	**Management roles:** Develop multi-capital approach	**Internal audit roles:** Test internal controls and assure accuracy of ESG data
Oversee ESG reporting strategy	Undertake materiality assessment to inform ESG risk management	Anticipate ESG disclosure regulations
Engage with stakeholders	Oversee ESG data quality and reporting	Interact regularly with other lines

All roles, governing body, management, and internal audit, work in close collaboration to ensure feedback loops. Each role is described in detail below.

1. Role of the governing body: governance mechanisms

The governing body, including the board of directors, defines organizational objectives, as well as appropriate structures and processes for effective governance. The governing body aligns the organizational objectives with the ESG issues that stakeholders prioritize, setting the direction and defining a corporate purpose that includes broader sustainability considerations. Specifically, this can be achieved when the governing body oversees governance mechanisms that include sustainability and ESG considerations; ESG reporting strategy and engagement with stakeholders.

1.1 Establishing governance mechanisms that include sustainability and ESG considerations

Many companies have chosen to establish formal governance mechanisms to oversee sustainability and ESG considerations. This may be a dedicated committee, including members from the board, or placed under the responsibility of an existing committee; for example risk management or audit. There is a relationship between the internal audit function and audit committees which presents an opportunity to leverage the oversight responsibilities.

1.2 Overseeing ESG reporting strategy

The governing body also has responsibilities to oversee the ESG reporting strategy, make strategic integrated reporting decisions and adopt policies and processes that allow for strengthened governance through risk management and internal controls.[31]

The governing body has an important role in developing a narrative around ESG data and indicators in line with the corporate culture and purpose, to signal to stakeholders a strong commitment to ESG and sustainability considerations.

Sustainability management has the necessary ESG knowledge to integrate the right ESG indicators into the business strategy and convey evolving ESG-related risk trends to the governing body.

The Three Lines Model provides clarity on the roles and responsibilities of the different parties when it comes to executing an integrated approach to risk management, internal controls, disclosure and assurance to ensure that value is created and protected within an organization.[31] When the governing body understands and oversees how the three roles can contribute to a resilient business model, there are clear expectations on how each role can contribute to an organization's external reporting and assurance processes.

1.3 Engaging with stakeholders

Compared to other roles, management and sustainability departments are traditionally more engaged with an organization's stakeholders.[29] The relationship between the governing body and stakeholders may occur through annual general meetings, reports from management or through advisory groups, panels or forums. However, stakeholder engagement should be a crosscutting activity that percolates up to the governing body. When the governing body regularly engages with stakeholders, and vice versa, both have a mutual understanding of the expectations and the exposure of an organization to ESG-related risks.

The integration of ESG issues within a sustainable business model and a materiality assessment is therefore dependent upon stakeholder engagement. When engaging with stakeholders, the governing body should be aware of both the inclusivity and intersectionality of the stakeholders that are material to the organization.

1.3.1 Stakeholder inclusivity: Diversity between groups

The governing body should ensure that the pool of stakeholders is as inclusive as possible. An organization should first define and quantify the impacts that its operations have on different ESG issues (e.g., climate change, ecosystem degradation, water scarcity) and then map dependencies between each ESG issue and one or more groups of concerned stakeholders. Mapping these dependencies allows the organization to understand how ESG-related risks can propagate based on their level of interconnectedness. A stakeholder-inclusive approach may include NGOs, local communities, customers, employers and suppliers.

1.3.2 Stakeholder intersectionality: Diversity within groups

Stakeholder intersectionality can simultaneously encompass society, nature capital and actors from diverse cultural, regional, and socio-economic backgrounds that the operations of a company directly and indirectly affect.[32]
The intersectionality principle allows the governing body to ensure diversity within the same group of stakeholders.

For instance, when identifying NGOs impacted by the operations of an organization, a governing body can include both international NGOs as well as others advocating for the rights of local communities or operating in different socio-economic environments. In addition, to ensure intersectionality, the governing body can rely on stakeholder and advisory groups, such as trade unions or groups representing different local communities whose jobs rely on the operations of a company. Stakeholder groups selected under the principles of inclusivity and intersectionality allow an organization to have a more in-depth look at and understanding of the context in which it operates, minimizing and anticipating ESG-related risks.

An effective stakeholder engagement strategy, coordinated by the governing body, paves the way for the materiality assessment.

2. Role of the management: developing an integrated approach to ESG risk management

Management oversees the achievement of organizational objectives and can include both the first- and second-line responsibilities for specific ESG tasks. First-line management roles are directly aligned with the delivery of products, services and overall support to the organization to identify ESG-related issues that the operations of an organization affect.

Second-line management roles are responsible for specifically assisting in ESG-related risk management. Second-line roles can focus on certain components of ESG-related risk management, such as: compliance with laws or new ESG disclosure regulations; internal control; and ESG issues of quality assurance (internal and external).

Alternatively, in some organizations, second-line roles may oversee a broader responsibility for risk management, such as the development of enterprise risk management (ERM)[3] (pp.3-4).

Under the Three Lines Model, management oversees the following roles: i) developing a multi-capital approach; ii) developing a materiality assessment to inform ESG-related risk management; and iii) ESG data quality, internal controls and reporting.

2.1 Developing a multi-capital approach

Traditionally, management measures an organization's value through financial and economic capital. Financial and economic capital relates to easily quantifiable assets that the organization directly controls. In addition, the growth of financial capital can reassure current and potential investors on the stability of an organization. Financial and economic factors are not the only flows of capital that management should account for. Many organizations opt for a multi-capital approach, which accounts for "the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects."[33]

Under this multi-capital approach, the management of an organization defines, quantifies and establishes the relationships between physical and intangible capitals that the business model requires to ensure the proper functioning of the operations of an organization and their impacts on ESG issues. A multi-capital approach could also enable a company to assess their impacts and dependencies on stocks and flows of capital (e.g. nature), which in turn will help them to understand the effectiveness of their sustainability efforts.[34]

The IIRC (International Integrated Reporting Council)[e] developed a 6-capital integrated framework that helps management in this task.[4] Moving from traditional management processes to integrated ESG management requires good knowledge of management practices and a refreshed mindset based on integrated thinking. An integrated thinking mindset means that an organization moves from a narrow focus on the maximization of financial capitals and assets to basing business decisions on the relationships between multiple capitals, both tangible and intangible.[33]

Adopting an integrated thinking approach can support:

- An adequate identification of ESG-related risks
- A deep understanding of the macro-context in which the organization operates
- The value creation of an organization in the short, medium, and long term.

2.2 Developing a materiality assessment to inform ESG risk management

The materiality assessment prioritizes ESG issues against two aspects: 1) importance to stakeholders; and 2) impact on the organization. The double materiality matrix, the outcome of the materiality assessment, is a valuable tool to rank ESG issues and priorities in relation to key operations of the organization.

The more inclusive and diverse the pool of stakeholders is, the more reliable the materiality assessment is in capturing ESG-related risks, because it helps identify and prioritize ESG issues in terms of how a risk threatens the achievement of an organization's strategy and objectives.[4]

The materiality assessment process will also guide the disclosure of ESG data, as it helps to align relevant ESG material topics with the corporate strategy and should be considered an important crosscutting tool to which all roles in the Three Lines Model (governing body, management, internal audit) can contribute.

[e] Note: In November 2020, the IIRC and the Sustainability Accounting Standards Board announced their intention to merge into a Value Reporting Foundation which was officially formed in June 2021. In November 2021, the IFRS Foundation has announced the consolidation of the VRF and the Climate Disclosure Standards Board into the IFRS Foundation. The IFRS maintains the Integrated Reporting Framework under its responsibilities: https://www.ifrs.org/news-and-events/news/2022/05/integrated-reporting-articulating-a-future-path/

Best practices in materiality assessments

Materiality assessments are most effective and meaningful when they:

1. Indicate a clear purpose
2. Articulate time horizons and review cycle
3. Compare results over time
4. Articulate perspectives used
5. Include and consider a thorough analysis of stakeholders
6. Account for divisional and regional differences
7. Score topics on multiple aspects
8. Identify ESG risks associated with each material topic
9. Ensure high-quality information and support assurance

Adapted from: WBCSD, Erasmus School of Economics The Reality of Materiality: Insights from real-world applications of ESG materiality assessment, 2021. Full text available here

Traditional methods of assessing and prioritizing risks consider impact and likelihood criteria, but there are alternative quantitative and qualitative techniques to integrate ESG-related risks so that the most appropriate risk response is implemented. These techniques, such as risk scenario analysis, combine the likelihood of an ESG risk happening with future trends or expected environmental developments.[35] In addition to ESG scenario analysis, mapping the interconnectivities of risks and how they influence each other gives insights into the speed of their impacts, and the diffusion of risks across the different operations, upstream and downstream, that the organization manages.[36]

The interviews confirmed that good governance practices are critical in overseeing and ensuring that management understands the potential impacts of ESG issues and risks on the achievement of the organizations' strategic objectives.[4] During the interviews, some participants highlighted that this has been achieved by bringing together different management functions; for example, having sustainability and financial risk management work together to define an integrated risk management strategy, or to set the most appropriate financial and non-financial key performance indicators (KPIs) and key responsibilities areas (KRA).

Some companies have dedicated sustainability committees involving management roles (financial and non-financial), or involve members of the board or internal audit to provide oversight and direction on all ESG issues. The presence of these committees is usually welcomed by risk management roles, as these meetings allow for regular discussions on ESG issues and their integration within the corporate strategy.

When companies have clear procedures to identify, measure, control and report ESG-related risks, they can also become more resilient in volatile operating environments. For example, business units may have a more granular overview of the context in which the company is operating at a country level and be able to identify ESG-related risks and implement rapid risk responses. This vital risk information can roll up to the group level for inclusion and consideration in the enterprise-wide risk management process.

2.3 ESG data quality and reporting

The interview participants suggested that collecting high-quality ESG data can be difficult to achieve and the nature of ESG issues means that impacts and dependencies are often beyond the operating boundaries of the company. For example, Scope 3 emissions data may have to be provided by suppliers or industry averages.[37] Some companies also suggested a lack of confidence in the information collected as a reason why companies opt for lower levels of external assurance on their sustainability disclosures.

Ensuring a consistent approach to data collection, reporting and disclosure is necessary to ensure that information is decision-useful. Understanding the people, processes and systems within an organization and how they can be governed to ensure the validity and reliability of data is critical to improving the quality of ESG information.

ESG data disclosure and reporting should be a forward-looking exercise guiding the different roles towards ESG integration, effective risk management and stakeholders' engagement. ESG disclosure has to align with the financial statements and the sustainability report, because different groups of stakeholders will look for coherent and consistent information to make informed decisions.

Ensuring quality, validity and reliability in ESG data.

When determining which ESG data to use, how to collect and to aggregate them into indicators, it is important to consider three factors: quality, validity and reliability. This is particularly important for new or emerging ESG issues or risks. In assessing data quality, validity and reliability the management second-line should ask the following questions:

1. Are the data of high enough quality to produce reliable results? Are these ESG data measuring what an organization wants to measure (e.g., Scope 3 emissions, waste produced, electricity generated)
2. Are controls in place for internally collected data? Who oversaw the data collection process?
3. Are the data collected in accordance with an industry standard or an internationally recognized standard?
4. Are there other open-source secondary data to challenge the model assumptions or triangulate the results?

Management oversees these processes and may require regular training on ESG data disclosure, as well as training on the research design of indicators to understand biases and validity issues in measurement.

Source: COSO-WBCSD, Applying enterprise risk management to ESG-related risks, 2018. Full text available here.

3. Role of internal audit – internal controls and compliance

Internal audit is ideally placed to help companies evaluate opportunities, assess changes to operations and reporting, meet regulations, and be a catalyst for innovation and improvement for sustainability. While current practice is varied, internal audit does not routinely take the lead when it comes to ESG information. There is an opportunity for the governing body to recognize that internal audit can add value to the company and that integration with the sustainability function can move beyond compliance and take a more active approach to monitoring material sustainability topics.

The internal audit function also has close ties to the audit committee, which provides further opportunity for a more integrated approach at board-level. In light of evolving regulatory developments in the European Union, (the Directive on corporate sustainability reporting, and Directive on corporate sustainability due diligence) audit committees may be responsible for "overseeing sustainability reporting and related processes to identify information reported."[38]

The internal audit and sustainability functions have the opportunity to anticipate future ESG disclosure trends. For example, internal auditors can monitor the evolving regulatory landscape and level of harmonization between different regulatory frameworks.

Internal auditors can also test internal controls on ESG disclosure and assure that the ESG data are collected consistently to guarantee confidence in the data collection process. The internal control environment presents clear practices to ensure two-way communication and feedback loops between management and internal audit. The 2013 COSO Internal Control Integrated Framework[39] introduces practices to establish an effective internal control environment, a set of standards, processes and structures on which an effective system of internal control relies on. The internal control environment enables organizations to:
1) achieve strategic objectives,
2) provide reliable financial and non-financial reporting to internal and external stakeholders,
3) conduct their operations efficiently and effectively,
4) comply with laws and regulations, and 5) safeguard their assets' internal control across the organization.[39]

Internal audit is independent from management, to ensure its objectivity, authority and credibility. Internal audit provides independent and objective assurance and advice on effective governance and ESG risk management processes and structures. The internal audit function should be well-resourced and positioned to ensure integrity, trust, transparency, compliance and accountability. The IIA's International Professional Practices Framework (IPPF) includes globally recognized standards and authoritative guidance that drive high-quality internal audit work.[40]
It achieves this through the regular disclosure of sustainability and financial reports, guaranteeing disciplined data collection processes, and expertise on ESG indicators. Internal audit reports its findings to management and the governing body to promote and facilitate continuous improvement.[3]

A well-resourced, appropriately positioned internal audit function is:

1. Accountable to the governing body
2. Free from interference by management in its planning and operations
3. Empowered to access all people, data, and resources needed to undertake its work
4. Free from responsibility for executive decision-making
5. Thoroughly knowledgeable about all aspects of the organization
6. Compliant with the *International Standards for the Professional Practice of Internal Auditing*

Source: COSO-WBCSD, Applying enterprise risk management to ESG-related risks, 2018.
Full text available at www.wbcsd.org/erm

5 Recommendations and key questions

This table summarizes the recommendations for companies in integrating ESG and sustainability considerations into the roles set out in the Three Lines Model. The key questions are intended to stimulate conversation within and between the different roles on the extent that sustainability and ESG considerations are integrated into existing processes and practices.

	GOVERNING BODY	MANAGEMENT	INTERNAL AUDIT
RECOMMENDATIONS	• Consider a multi-capital approach to capital flows • Undertake stakeholder engagement to understand sustainability impacts and the link with the business model • Consider stakeholder diversity in any stakeholder engagement activities • Ensure the governing body oversees risk management • Ensure the internal audit function is well-resourced (ultimately may reduce costs of external assurance)	• Undertake a materiality assessment that informs enterprise risk management processes • Bring sustainability and finance functions together to define integrated risk management strategy • Establish ESG data quality and reporting alignment with financial reporting cycles	• Monitor reliability of ESG data collection and internal control processes • Build knowledge of sustainability and ESG impacts of the company • Ensure regular interactions between internal auditors and 1st, 2nd line roles
KEY QUESTIONS TO ASSESS LEVEL OF ESG/SUSTAINABILITY INTEGRATION	To what extent is the governing body overseeing ESG integration? How is the governing body currently engaging with the other functions on material ESG issues? And what could be improved? How is information on risks provided to the governing body? What are the current obstacles to integrating ESG risks? What role is corporate culture playing in the organization? Does it include ESG issues to achieve long-term sustainability?	How can management capture and measure the impact of the operations of a company on ESG issues? How can management ensure that the ESG data is complete and accurate? How is operational vs strategic management assessing and prioritizing ESG risks? What practices and policies ensure that first- and second-line management roles have a holistic approach to ESG risk management?	How can internal audit work with external auditors to provide assurance on the reliability and consistency of information? What role can internal audit play in helping the organization prepare for non-financial disclosures by advising and providing assurance on structures, systems and processes for decision-making and reporting? What controls ensure that sustainability data is collected, analyzed and reported in a way that is useful to decision-makers? What processes and policies are adopted to measure, monitor and report on progress towards company commitments? How can internal audit advocate for an organizational shift in mindset to integrate sustainability into governance and operations?

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DISCLAIMER

ACKNOWLEDGMENTS

With thanks to 12 WBCSD member companies and several IIA volunteers who kindly participated in the research interviews that have guided the content of this report.

This work was funded by the Gordon and Betty Moore Foundation's Conservation and Markets Initiative.

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Established in 1941, The Institute of Internal Auditors (IIA) is an international professional association with global headquarters in Lake Mary, Florida, USA. The IIA is recognized as the internal audit profession's leader in standards, certification, education, research, and technical guidance throughout the world. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

Globally, The IIA has more than 215,000 members in nearly 200 countries and territories. The IIA in North America comprises 159 chapters serving more than 70,000 members in the United States, Canada, the Caribbean (Aruba, Bahamas, Barbados, Cayman Islands, Curacao, Jamaica, Puerto Rico, and Turks & Caicos), Bermuda, and Trinidad & Tobago. The IIA's Audit Executive Center provides chief audit executives relevant and timely thought leadership and connections to peers for benchmarking and sharing best practices.

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WBCSD is the premier global, CEO-led community of over 200 of the world's leading sustainable businesses working collectively to accelerate the system transformations needed for a net zero, nature positive and more equitable future.

We do this by engaging executives and sustainability leaders from business and elsewhere to share practical insights on the obstacles and opportunities we face in tackling the integrated climate, nature and inequality sustainability challenge; by co-developing "how-to" CEO-guides from these insights; by providing science-based target guidance including standards and protocols; and by developing tools and platforms to help leading businesses in sustainability drive integrated actions to tackle climate, nature and inequality challenges across sectors and geographical regions.

Our member companies come from all business sectors and all major economies, representing a combined revenue of more than USD $8.5 trillion and 19 million employees. Our global network of almost 70 national business councils gives our members unparalleled reach across the globe. Since 1995, WBCSD has been uniquely positioned to work with member companies along and across value chains to deliver impactful business solutions to the most challenging sustainability issues.

Together, we are the leading voice of business for sustainability, united by our vision of a world where 9+ billion people are living well, within planetary boundaries, by mid-century.

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