ESG audit and its fundamental concepts

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Abstract. According to the writers of the paper, ESG auditing is an innovative technique that is an important component in the chain of financial reporting for businesses. This strategy is founded on three pillars: environmental, social, and business risk management. The authors underline that ESG auditing is a business development tool that assists organizations in addressing environmental and social concerns as well as risk management. The article clarifies the reason why ESG auditing is essential, explores ESG audits as a way of enhancing businesses' capacity to function in compliance with emerging standards and requirements, and also diminish operational risks by managing issues.

1 Introduction

ESG audit has become ever more essential for the successful engagement of companies with society. Although some claim that aggregate ESG reporting is flawed, a thorough audit allows corporate strategies to be evaluated based on key environmental, social, and governance indicators. [1-20] The efficacy of a company's ESG program is dependent on taking a complete perspective of the information obtained from multiple sources. Case studies have demonstrated the significance of embracing ESG indicators, progress, and performance measurement in a single integrated report. [17, 21]

ESG audits emerged in the mid-2000s, when it became obvious that corporate social responsibility and environmental, social, and governance (ESG) factors were equally essential to investors and consumers, leading to a more sustainable global financial system. ESG auditing is now widely adopted in countries around the globe. ESG audits are required in the United States, Canada, the United Kingdom, France, Germany, Japan, and Australia for firms that wish to be included in sustainability indexes such as the Dow Jones Sustainability Index or the FTSE4Good. [15, 16]

An ESG audit is a critical component of a company's governance framework for assessing its social responsibility and sustainability. The audit facilitates in identifying the organization's strengths and weaknesses in these areas, as well as in developing strategies and action plans for enhancing its market position and satisfy the expectations of its stakeholders.

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ESG audit is performed by companies in various sectors that are committed to sustainable development and social responsibility. This particular type of audit tends to be especially prevalent among businesses active in the energy, transportation, manufacturing, and resource extraction sectors, as well as in financial institutions. Corporate and publicly responsible companies usually engage in ESG audits on a regular basis.

Simultaneously, an increasing number of small and medium-sized businesses are beginning to place a premium on social responsibility and are conducting ESG audits in order to establish an attractive borrower rating in times of limited financial resources.[12]

ESG auditing is also a tool for considering social concerns including equality, human rights, and labor relations. [10, 17]

2 Materials and methods

A literature research was done regarding ESG audit principles, which included academic articles, books, organizational reports, and other publications in the field of corporate responsibility governance and ESG investment. To put things into perspective with, data was obtained from widely accessible resources. Statistical data analysis, content analysis, and comparison with international standards and legislation were among the approaches employed in the research and data analysis process. Overall, the research approach allowed for a comprehensive analysis of ESG audit principles, drawing on a wide range of sources and analytical techniques to provide insights into best practices and areas for improvement in corporate responsibility governance and ESG investment [22-24].

3 Results and discussion

An ESG audit is the process of evaluating how an entity supervises its environmental, social, and corporate governance matters. That is to say, an ESG audit allows economic actors' subsystems to be assessed for compliance with sustainability norms and laws, to identify risks and opportunities, and to discover reserves for enhancing the performance of ESG-dependent subsystems.

Frequently an ESG audit is associated with an environmental or so-called socio-environmental audit.

ESG audits and environmental audits are similar in that both attempt to examine a company's environmental effect. However, an ESG audit, on one hand, is a review of a company's actions in terms of its environmental, social, and governance responsibilities. An environmental audit, on the other hand, is part of an ESG audit and focuses only on the company's ecological duties.

Thus, the distinction between an ESG audit and an environmental audit is that the former covers a broader range of a company's responsibilities, containing social and management aspects, whereas the latter only addresses environmental issues.

In fact, the social and environmental audit evaluates a company's social, environmental, and economic performance. Conversely, ESG audit is more strictly focused on examining environmental, social responsibility, and corporate governance risk and opportunity governance aspects.

Therefore, an ESG audit can comprise an assessment of multiple subsystems, which depend on ESG variables.
Table 1. ESG audit subsystems and their determinants

<table>
<thead>
<tr>
<th>Subsystem</th>
<th>Determinants</th>
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<tbody>
<tr>
<td>Environmental subsystem</td>
<td>Evaluates company's environmental impact, encompassing emissions, waste, resource consumption, and other ecological issues.</td>
</tr>
<tr>
<td>Social subsystem</td>
<td>Analyzes company's societal effect, such as social responsibility, labor relations management, employee health and safety, stakeholder interactions, and other social hazards.</td>
</tr>
<tr>
<td>Governance subsystem</td>
<td>Reviews management system, risk management, ethical standards, corporate responsibility, and other governance hazards.</td>
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ESG audit is carried out in stages, utilizing particular procedures and standards to analyze a company's social, environmental, and governance performance. (fig. 1).

Fig 1. Outline of ESG audit phases

Depending on the methodology and regulations used in the ESG audit, each step may have its own sub-stages and extra processes.

When ESG audit is carried out, it is critical to consider a number of key points that may possess a significant impact on the audit's results and the company's subsequent ESG transformation. The aforementioned are, according to our judgment:

1) Proper identification of relevant ESG-matters. The crucial ESG aspects and characteristics (environmental, social, and governance, etc.) affecting the company as well as its stakeholders should be identified.

The following aspects should be examined in order to determine the primary ESG criteria for a company: unique industry features, market demands, stakeholder interests, potential risks and opportunities.
Depending on a company's industry, certain ESG considerations may be more vital. Energy efficiency, operational safety, and waste management, for instance, may be crucial concerns for businesses in the oil and gas sector.

Companies must comply with a variety of environmental, social, and governance regulations and commitments. Compliance with the UN Global Compact guidelines, for illustration, is of paramount importance for multinational corporations.

There may be distinct ESG aspects that are more noteworthy regarding various stakeholder groups. Specifically, financial sustainability and social responsibility are essential factors for investors.

Hidden risks and opportunities related to sustainability issues may confront businesses. An entity, for example, may face risks relating to climate change or societal protests.

2) Data analysis. It is of the utmost importance to ensure that the data required to complete the audit is both available and of high quality. Financial reports, sustainability reports, social responsibility reports, and the results of environmental and social audits may all be reviewed.

Access to various data sources, such as financial reports, sustainability reports, social responsibility reports, results of environmental and social audits, and other documents containing information on the company's performance with regard to ESG factors, is required to audit ESG-dependent subsystems. This data analysis allows us to examine the current performance and hazards of ESG-dependent subsystems, as well as discover potential reserves for increasing their efficiency as an aftermath of ESG transformation. Data quality is an essential component of data analysis since erroneous or inconsistent information can lead to wrong conclusions and recommendations. As consequently, the data must be meticulously verified and verified for authenticity and accuracy.

3) Stakeholder identification. Stakeholder groups that are most material to the company should be targeted and their interests captured in the audit. Stakeholders are people, groups or organisations who may be affected by and/or have an impact on the company's operations. They may include customers, employees, investors, partners, competitors, regulators, civil society organisations, etc.

Prioritising the most strategic stakeholders for a company ensures that their interests and expectations are adequately taken into account in the audit and in the identification of relevant ESG drivers. For an upstream company, for example, the most important stakeholders may be environmental bodies and regulators who can pressure the company to reduce emissions and improve energy efficiency.

Stakeholder identification also facilitates the link between ESG factors and the company's business strategy, and reveals possible risks and opportunities associated with ESG issues.

4) Comparison with competitors. If the information is public, it is critical to compare the audit results with the results of similar audits conducted by the company's competitors. This will help to determine areas where the business may be trailing or leading in the adoption of ESG strategies, as well as possible opportunities for enhanced productivity within the ESG transformation. Regarding the comparison, a variety of information such as competitors' sustainability and social responsibility reports, news and media publications, analytical studies, and market research can be utilized. A comparison with rivals will be useful in determining how effectively the company is implementing its ESG strategy and in which areas its application can be improved.

5) Prioritising. Based on the audit results, the primary ESG issues and advancement objectives that can have the greatest impact on the business and stakeholders should be identified.

Prioritization is a crucial phase in the auditing of ESG-dependent subsystems, as it enables the identification of which areas require additional attention as part of a company's
ESG transformation. There are various approaches to prioritization, such as the priority matrix, stakeholder analysis, and industry standards analysis. These methods aid in determining the most critical ESG issues and advancement objectives that can have the greatest impact on the company and its stakeholders. By prioritizing these issues, companies can focus their resources on addressing the most pressing ESG concerns and improving their overall ESG performance.

A priority matrix reveals which ESG variables are the most significant and which have the greatest likelihood of having an adverse effect on the company's operations. A matrix is utilized for this purpose, with ESG elements highlighted on the X axis in descending order of relevance, and on the Y axis in declining order of probability of negative impact on the business as a whole. The research yields quadrants containing the most significant and dangerous ESG variables, which establish ESG transformation priorities. By using this approach, companies can make informed decisions about which ESG factors to prioritize and allocate resources accordingly.

Stakeholder analysis assists in determining which stakeholder groups are most essential to the organization and which ESG matters are most relevant to each of them. Investors, for example, may be particularly interested in aspects relating to the company's financial stability, employees in elements relating to safety and working conditions, and customers in factors relating to product quality and its impact on health. Companies may adjust their ESG strategy to suit the needs of their key stakeholders and establish stronger relationships with them by knowing the unique ESG goals of each stakeholder group.

Sector standards analysis enables the identification of the ESG factors that are most relevant to the industry in which a company operates. For example, for the energy production company, environmental and resource efficiency issues may be the most significant.

Furthermore, it is essential to consider the company's capabilities and resources when prioritizing ESG transformation in order to target those aspects that can be accomplished in the shortest possible time and at the lowest feasible cost.

6) ESG strategy development. On the basis of the audit results, a company's ESG strategy should be drafted, which would either enable the implementation of the identified potentials and improve the productivity of ESG-dependent subsystems or make adjustments to the company's existing one, which would also contribute to the achievement of maximum efficient performance.

4 Conclusion

To successfully implement an ESG strategy, specific activities that will assist in the achievement of the goals must be identified. These can include modifications to internal procedures and management systems as well as changes to the products or services the business provides. It is also critical to establish accountable personnel and timetables for completing each assignment.

When generating an ESG strategy, all stakeholder groups' interests must be considered, and a balanced development of all three areas - environmental, social, and governance - must be pursued. It is also necessary to take into account long-term prospects and forecasts of changes in society and the economy in order to be prepared for upcoming shifts.

To be effective, the ESG strategy should be fully integrated into the organization's overall strategy and business plan. This ensures that ESG considerations are not treated as a separate initiative, but rather as a fundamental aspect of the company's operations and decision-making processes. By embedding ESG considerations into the company's strategic planning, it becomes easier to align ESG goals with broader business goals and objectives,
and to prioritize ESG initiatives based on their potential impact on the company's long-term success. This integration can also help to drive greater accountability and transparency around ESG issues, and to enhance the company's reputation and credibility with stakeholders.

As consequently, auditing ESG-dependent subsystems is an essential tool for enhancing corporate social responsibility, raising environmental responsibility, and assuring profitability.

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