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Original Paper

The Importance of the ESG Factors and Their Potential Impact on an Audit of a Financial Statement

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Abstract

This review paper aims to determine the potential impact of Environmental, Social, and Corporate Governance (ESG) factors on an audit of a financial statement. For this reason, a triangle of implications has been proposed, i.e., for: (1) audit clients whose business activity is reflected in a financial statement; (2) a financial statement; and (3) audit firms which perform an audit. The evidence represents a collection of a) scientific articles, b) publications offered by professional accounting bodies and consulting firms, and c) relevant standards and legal regulations. The paper finds that ESG has become a factor which must be considered, and the financial world will face multiple changes. For audit clients, the critical aspect will be ESG integration with a business model. Financial reporting will evolve under Exposure Drafts IFRS S1 and IFRS S2. A financial statement will require in-depth knowledge about existing accounting standards to reflect the financial implications of ESG-related products and transactions. Moreover, there is a distinction between "financial audit" and "ESG assurance" in audit and assurance services. However, some ESG-related risks and matters may be considered in the financial audit cycle. The paper's findings are significant from the scientific research perspective as only a few studies contribute to ESG and auditing. The article also provides some practical implications that might be important for audit clients, firms, and regulators.

Keywords

ESG, financial statement, financial audit, sustainability reporting, auditors

1. Introduction

Considering climate change and a greater need for sustainable growth, the European Union (EU) set a goal to make Europe the first climate-neutral continent by 2050 by delivering the European Green Deal. To execute this ambitious goal, the EU works on and promotes different activities and proposals, such as the EU taxonomy for sustainable activities, guidelines on climate-, ESG-, and sustainability-related disclosures, or the European green bond standard. They all indicate not only the importance of climate change and a direction toward climate protection but also social and governance implications, which should lead to greater sustainability.

Hence, the concept of ESG, which stands for *Environmental, Social, and Corporate Governance*, is significantly gaining in popularity in terms of (1) the public attention, awareness, and commitment, (2) the involvement of regulatory and institutional bodies such as the EU or the OECD, and (3) the visible activity of the professional bodies and consulting firms, offering practical guidelines, ESG audits, ESG interpretations, and ESG-related publications.

As ESG represents a global trend, it is expected to have some critical consequences of different nature. Among them, it is worth considering the potential impact of ESG on an audit of a financial statement. A financial audit evolves in the wake of changes happening in the audit profession itself and changes in the audit client's environment and reporting framework.

An attempt to determine the potential impact of the ESG factors on a financial statement audit is challenging because we discuss a complex service. Therefore, a perspective for this review paper should be broad. Considering external audit specificity, we can assume a potential impact of ESG at three levels: (1) an audit client whose business activity is reflected in a financial statement; (2) a financial statement; and (3) an audit firm which performs an audit. This initial scope creates a triangle of implications, as shown in Figure 1 below.

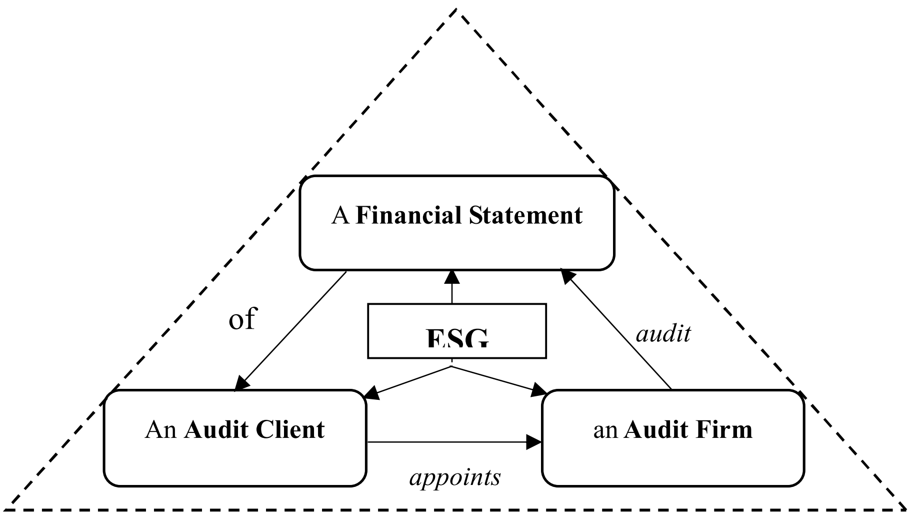

Figure 1. ESG and a Triangle of Implications for a Financial Statement Audit

Source: Own elaboration.

For this reason, Section 2 addresses the potential impact of ESG on an audit client's business activity. Section 3 is devoted to implications for a financial statement, whereas Section 4discusses changes from the audit firm's perspective. Finally, Section 5 presents conclusions.

The paper demonstrates a great interest in and demand for various ESG-related solutions and activities, including ESG-related business activity, disclosures, reporting, investment, assurance, etc. From the audit client's perspective, it turns out that ESG may be the trigger point for changes which, in the end, will be reflected in a financial statement. The corporate environment will change. For some companies, ESG will act as a factor which drives value. At the same time, some entities will be at risk of business discontinuity or will face a transition risk. However, the essential aspect of ESG for audit clients will be ESG integration with a business model. This integration assumes board oversight, risk management including ESG risks, integrated reporting, and a vital role of governance mechanisms: internal audit, an audit committee, and external audit.

The paper shows that various financial statement users consider financial data and ESG (non-financial) information. There are several research studies which discuss ESG investing or ESG scores. What is more, some ESG disclosures may be correlated with earnings quality. The biggest challenge may be seen in the upcoming ESG integration into financial reporting, which two Exposure Drafts have addressed: IFRS S1 and IFRS S2. Assessing the financial exposure of ESG-related risks and opportunities will require in-depth knowledge about existing accounting standards to reflect the financial implications of new products and transactions, such as sustainability-linked debt and energy service agreements.

ESG may have a direct impact on auditors and audit firms. Obtaining assurance on ESG data is not currently part of a financial statement audit, but it is an excellent opportunity for audit firms to offer ESG assurance services under ISAE 3000. However, the current form of the EU Corporate Sustainability Reporting Directive (CSRD) proposal raises many questions, especially about the interpretation and application of various requirements (e.g., limited and reasonable assurance).

ESG matters may also influence an audit of a financial statement. The existing publications indicate that climate-related/ESG-related risks may be captured and considered in an audit cycle as part of risk assessment if they are treated as business risks or may have implications for risks of material misstatement. Moreover, auditors are required to consider "the other information" according to ISA 720; therefore, ESG information (despite not being in the scope of a financial audit) may be necessary. Finally, the role of auditors may be seen as an effective communication channel on ESG matters (e.g., through Critical Audit Matter).

2. ESG and Implications for an Audit Client

The first question should be: Do ESG factors impact the audit client's business performance reflected in a financial statement? The existing literature systematically proves a positive financial relationship (e.g., Friede, Busch, & Bassen, 2015; Zhao, Guo, Yuan, Wu, Li, Zhou, & Kang, 2018; Dalal & Thaker, 2019). An interesting remark was pointed out by Whelan, Atz, Van Holt, and Clark (2021), who examined more than 1,000 ESG studies published between 2015-2020. Among different conclusions, the authors draw attention to (1) improved financial performance more observable in the long term and achieved due to mediating factors such as improved risk management and more innovation; and (2) ESG disclosures which do not drive financial performance themselves.

It might be implied that some ESG disclosures have an informative value only, and some ESG-related activities act as value drivers. Henisz, Koller, and Nuttall (2019) indicate the following five ways that ESG creates value: (1) top-line growth, (2) cost reductions, (3) regulatory and legal interventions, (4) productivity uplift, and (5) investment and asset optimisation. In general, we should expect value-added from the ESG-related activities, such as better and sustainable management, innovative technologies, new product development, innovative solutions, changes in the supply chain, better waste management, better transparency, etc.

On the other hand, it is also reasonable to expect that some sectors, current technologies, and business models may be at some point in the future at risk of becoming obsolete. S&P Global Ratings published the ESG Risk Atlas (2019), which comprises a Sector Risk (measuring environmental and social exposures) and a Country Risk (measuring corporate governance, regulations, and exposure to natural disasters). In terms of a Sector Risk, the ESG Risk Atlas (2019, p. 3) highlights the following sectors as the riskiest ones: Oil and Gas, Metals and Mining (Risk Score 11), Power Generation (coal) (Risk Score 10), Refining and Marketing, Chemicals (Risk Score 9), Technology Hardware and Semiconductor, Power Generation (excl. coal), Autos and Auto Parts, Agribusiness and Commodity Foods (Risk Score 8).

It should be underlined that the ESG concept goes beyond a simplified view which quite often reduces ESG to a climate risk or the reduction of a carbon footprint. We are talking about a sustainable way of management which includes: (1) business risks and their mitigation, (2) effective allocation of the entity's assets, (3) fair treatment in employment, and (4) more robust corporate governance.

Deloitte (2020) proposes the ESG maturity model, which distinguishes three evolutionary stages of ESG: (1) responsive, (2) enhanced, and (3) integrated (see Figure 2). The discussed model does not treat ESG as a group of isolated activities but as a set of deliberate actions that change their character from compliance-driven, performance-driven to value-enhancing. Moreover, the model proposes obtaining reasonable assurance from the external auditor at the "integrated" stage.

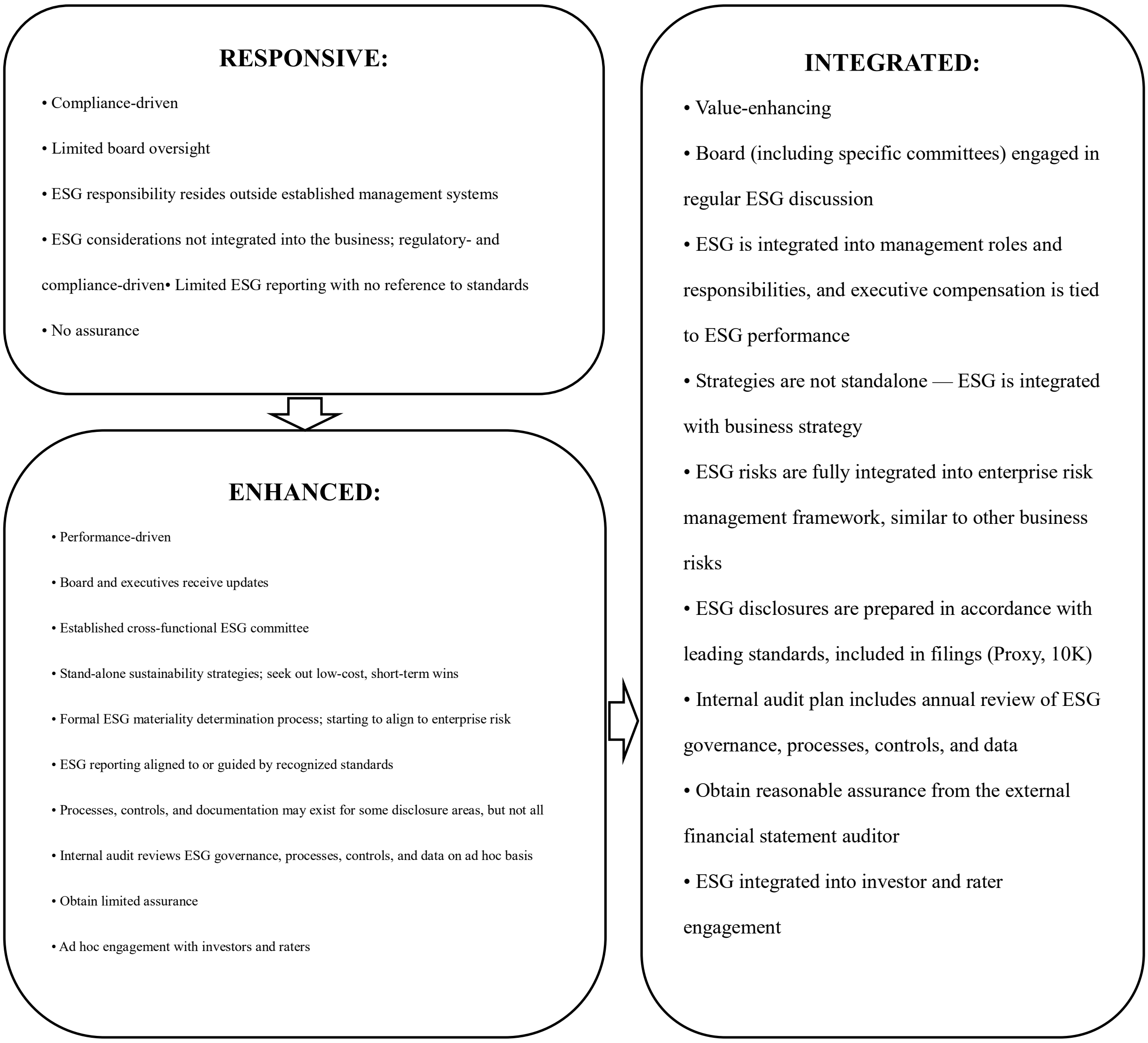

Figure 2. Deloitte ESG Maturity Model

Source: https://www2.deloitte.com/content/dam/Deloitte/us/Documents/center-for-board-effectiveness/us-defining-the-role-of-the-audit-committee-in-overseeing-esg.pdf, p. 2.

To ensure such evolution, solid and long-term commitment should be demonstrated by the board and executives with support from internal control bodies such as (1) an audit committee (e.g., Bravo & Reguera-Alvarado, 2019; Arif, Sajjad, Farooq, Abrar, & Joyo, 2020; Chouaibi, Chouaibi, & Zouari, 2021) and (2) internal audit (e.g., Bonrath, Eulerich, & Lopez-Kasper, 2022; Soh & Martinov-Bennie, 2015).

Moreover, PWC (2021, p. 4) proposes the audit committee's framework for overseeing ESG, which consists of three steps and questions: (1) Disclosures: Are the ESG disclosures investor grade? Which ESG frameworks or standards is the company using? (2) Processes and controls: Are there processes and controls in place to ensure ESG disclosures are accurate, comparable, and consistent? and (3) Assurance: Should independent assurance be obtained to ensure ESG disclosures are reliable?

Taking all the above into account, the upcoming changes, which audit clients may face, will require acute awareness from auditors. Altogether, ESG should lead to more efficient management, a more robust corporate and internal control environment, and more meaningful reporting.

3. ESG and a Financial Statement

An intense discussion takes place about ESG disclosure requirements. This discussion reveals several gaps in ESG understanding and interpretation, ESG standardisation and taxonomy, and a general problem with ESG comparability between companies. A key question is: Is it possible to create a linkage between financial and non-financial reporting? To answer this question, it is essential to look at various aspects.

3.1 Are ESG Disclosures Relevant for the Users of a Financial Statement?

There are several arguments for ESG disclosures. Firstly, some research studies discuss the so-called ESG investing, which aims to consider financial factors and also non-financial ones, i.e., ESG-related (e.g., Van Duuren, Plantinga, & Scholtens, 2016). Many factors may impact ESG investing and returns, including the type of a fund, methodology used, ESG factors, ESG measurement, etc. (cf. Hill, 2020; Giese & Lee, 2019). For this reason, the researchers have not yet concluded about ESG investing results. For example, Giese, Lee, Melas, Nagy, and Nishikawa (2019) confirm that ESG has affected the valuation and performance of companies, both through systematic and idiosyncratic risk profiles. Verheyden, Eccles, and Feiner (2016) report an unequivocally positive contribution of ESG to risk-adjusted returns under specific circumstances presented in their article. On the other hand, Halbritter and Dorfleitner (2015) do not confirm a relationship between ESG ratings and returns, indicating the impact of a rating provider, a company sample, and a particular subperiod. Similarly, Cornell (2021) justifies lower expected returns for investors.

Secondly, there is a common approach among managers and investors to use ESG ratings, which sometimes provokes controversy. For example, Dorfleitner, Halbritter, and Nguyen (2015) warn about deficiencies in ESG measurement concept sand that different ratings neither coincide in distribution nor risk. Thus, extended ESG disclosures could shed light on details in terms of ESG activities. What is more, ESG-related news may act as a factor which triggers stock market reactions (cf. Wong & Zhang, 2022; Capelle-Blancard & Petit, 2019).

Thirdly, ESG disclosures may be correlated with earnings quality (cf. Rezaee & Tuo, 2019). However, it is essential to be aware of the phenomenon of green washing, i.e., when firms disclose a large quantity of ESG data that does not correspond to actual ESG performance (e.g., Yu, Van Luu & Chen, 2020).

3.2 How to Integrate ESG Disclosures into Financial Reporting?

The biggest problem with the potential integration of ESG disclosures into financial reporting is that most ESG disclosures are non-financial and descriptive. In addition, various organisations individually approach ESG disclosures. We can distinguish: the EU taxonomy, the Global Reporting Initiative, the Task Force on Climate-related Financial Disclosures (TCFD), the Streamlined Energy and Carbon Reporting (SECR), etc.

It is not a problem to "describe" ESG activities. The question is whether it is possible to distinguish ESG activities with a financial effect, i.e., which could be traced back to a financial statement. Thus, the problem relates to the general integration of ESG data into financial reporting (cf. Tomlinson, Whelan, & Eckerle, 2021).

The International Sustainability Standards Board (ISSB) has offered a solution, i.e., two Exposure Drafts: IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*. Among various disclosure proposals, both exposure drafts include in their current form (as of May 2022) that *an entity shall disclose how significant sustainability-related risks/climate-related risks and opportunities have affected its most recently reported financial position, financial performance, and cash flows* (IFRS S1, p.27; IFRS S2, p. 37). A similar approach was proposed on 21 March 2022 by the US Securities and Exchange Commission (SEC). Among different proposed rules, the SEC concentrates on the material impact of climate-related risks on business and consolidated financial statements (Note 1).

All proposals suggest that financial reporting will evolve soon. The trend aims at better and meaningful ESG reporting (both in financial and non-financial measures). It should be underlined that proposed standards and rules are risk-based, i.e., an entity should identify relevant risks and then reveal their exposure and financial consequences. Therefore, it is not all about disclosures but about ESG being a part of risk management (cf. Antoncic, 2019).

Assessing the financial exposure of ESG will be challenging and require in-depth knowledge of existing accounting standards. The Financial Accounting Standards Board (FASB) published the FASB Staff Educational Paper (2021) on *the Intersection of ESG matters with Financial Accounting Standards*. The paper comments on Going Concern, Inventory, Intangibles, PPE, and Fair Value Measurement. What is more, ESG matters will require special attention. For example, Knachel and Porter (2021) point out that the company's activities and even announcements about carbon footprint reduction may create, under particular circumstances, a liability to be recorded in a financial statement. The authors also mention two trending transactions: sustainability-linked debt and energy service agreements which require a specific accounting treatment.

It should be highlighted that all proposals and reporting requirements will mean additional costs for companies regarding time, human competencies, and technical resources. Despite widespread attention, ESG seems to be at an initial stage in actual implementation. According to the EY and the Financial Education & Research Foundation (FERF) survey, only 8% of respondents claimed to have a complete and robust set of ESG policies and procedures. On a scale of 1 to 10 (where one means fully manual and ten fully automated), ESG reporting received a score of 3.5. It also turned out that ESG information is currently stored in various software applications and spreadsheets (EY & FERF, 2022, pp. 9, 14-15), suggesting the absence of relevant reporting systems.

4. ESG and Implications for Auditors and an Audit of a Financial Statement

The previous sections showed that ESG is a challenge. Auditors should be prepared for changes in the audit client's business environment and new standards that will affect financial reporting. For this reason, we can assume that ESG will also have some direct implications for auditors. Two exposure drafts issued by ISSB and expectations raised by consulting firms led to a discussion about reasonable assurance and the role of an external auditor. We can ask here two questions: (1) Should reasonable assurance be obtained from the external auditor? and (2) What are the direct consequences of ESG for a financial statement audit?

4.1 ESG and Reasonable Assurance Provided by a Financial Auditor

Firstly, there are several reasons why a company may seek third-party assurance on ESG data. The Center for Audit Quality (CAQ) discusses some of them, for example, (1) boards of directors may want to ensure a high quality of ESG information; (2) third-party assurance can enhance the reliability of ESG data, especially when investors are interested in understanding a company's long-term value creation strategy; and (3) third-party assurance may provide another perspective on ESG reporting and processes (cf. CAQ, 2021a).

The critical problem here relates to an entity which may be appointed to verify ESG data. According to the survey mentioned earlier, 42% of respondents use a non-financial audit firm to assure and validate ESG data, 22% use an external auditor to assure some data, whereas 23% use Internal Audit (EY & FERF, 2022, p. 11). It raises questions about the methodology and general comparability of these services.

Obtaining assurance on ESG data is not currently part of a financial statement audit. As discussed by Deloitte (2021), ESG engagements may be classified under International Standard on Assurance Engagements (ISAE) 3000 (i.e., engagements other than audits or reviews of financial statements). As mentioned by Dingle (2021), financial auditors are already prepared in terms of ESG assurance as they: (1) adhere to strict ethics and independence standards, (2) can understand and interpret frameworks; (3) have resources and expertise; and (4) are familiar with compliance reporting engagements. According to Schrank (2022), the assurance of ESG reports spills over to financial reporting, especially in the combined case of a tight auditor liability regime, imprecise accounting system and ESG assurance provided by a financial auditor.

ISAE 3000 assumes two types of assurance which may be provided: (1) limited or (2) reasonable (which is the same level as in financial statement audits).Regardless of the assurance level, some activities will be the same in both cases, for example, planning or materiality assessment. The main difference is the extent of evidence collected, sample sizes, and test coverage adopted. Thus, it is not possible to express the same degree of confidence (Note 12).

Obtaining reasonable assurance is challenging regarding non-financial data, such as ESG. A subject matter may be less defined and more difficult to verify with other sources (e.g., carbon footprint) (Note 3). The EU regulators have considered it. The EU Corporate Sustainability Reporting Directive (CSRD) proposal *will require all companies within the scope to seek limited assurance for reported sustainability information while including an option to move towards a reasonable assurance requirement at a later stage* (CSRD, 2021, p. 10).

At the same time, a discussion paper issued by Accountancy Europe (2022) raises concerns about sustainability assurance under the CSRD, especially about the lack of clarification. The authors appeal for more details in several aspects, such as (1) the scope of both: limited and reasonable assurance engagements, (2) the approach towards forward-looking information, or (3) ensuring high quality among different sustainability assurance service providers.

4.2 ESG and an Audit of a Financial Statement

Considering upcoming sustainability standards and ESG disclosure requirements, we can expect that an audit of a financial statement will evolve. The IAASB has issued the Staff Audit Practice Alert: *The Consideration of Climate-Related Risks in an Audit of Financial Statement* (2020). Similar practice aid has been prepared by the AICPA & CIMA (2021) regarding ESG-related matters. The publications review audit standards and briefly interpret how climate-related/ESG-related issues may be included in various audit aspects. Understandably, professional judgment from auditors will be required in many cases. In general, climate-related/ESG-related risks may be captured and considered in an audit cycle as part of risk assessment if they are treated as business risks or may have implications for risks of material misstatement.

What is more, ESG should be considered in respect of ISA 720 *The auditor's responsibilities relating to other information and related conforming agreements.* According to this standard, an auditor must read and consider the other information. Despite not being in the scope of a financial audit, a material inconsistency between the other information and a financial report may indicate that there is a material misstatement (either of a financial statement or the other information) which, in the end, may mislead the users of a financial statement (cf. ISA 720, p. 6).

Finally, the role of auditors may evolve into an effective communication channel on ESG matters (cf. da Silva & Imoniana, 2021). A unique way of communication may be seen in the so-called "Critical Audit Matter" (CAM), which *is any matter communicated, or required to be communicated, to the audit committee that relates to an account or disclosure that is material to the financial statements and that involves especially challenging, subjective, or complex auditor judgment* (PCAOB AS 3101.11). The CAQ admits that climate-related risks do not represent financial statement accounts or disclosures. However, depending on the nature of an entity's business, such considerations may be included in a CAM in the auditor's report (CAQ, 2021b).

5. Conclusions

This review paper aimed to discuss the potential impact of ESG on an audit of a financial statement. The article proposed a broad view in the form of a triangle of implications, i.e., for (1) audit clients whose business activity is reflected in a financial statement; (2) a financial statement itself; and (3) audit firms which perform a financial audit.

The paper demonstrates a great interest in and demand for various ESG-related solutions and activities, including ESG-related business activity, disclosures, reporting, investment, assurance, etc. From the audit client's perspective, it turns out that ESG may be the trigger point for changes which, in the end, will be reflected in a financial statement. On the one hand, ESG may act as a factor which drives value. It is not all about informative disclosures but about a sustainable business strategy which considers innovative technologies, eco-friendly solutions, effective resource management, and greater transparency. On the other hand, some sectors will be at risk of business discontinuity or transition risk. Management boards, stakeholders, and auditors will have to consider this perspective. Finally, the essential aspect of ESG for audit clients will be ESG integration with a business model which assumes board oversight, risk management including ESG risks, integrated reporting, and a vital role of governance mechanisms: internal audit, an audit committee, and external audit.

The second group of implications for a financial audit relates to a financial statement. Firstly, it should be emphasised that ESG (non-financial) information is considered and respected by the users of a financial statement. There are several research studies which discuss ESG investing or ESG scores. What is more, some ESG disclosures may be correlated with earnings quality. Secondly, the biggest challenge is the upcoming ESG integration into financial reporting, which two Exposure Drafts have addressed: IFRS S1 and IFRS S2. Thirdly, assessing the financial exposure of ESG-related risks and opportunities will require in-depth knowledge of existing accounting standards to capture ESG-related products and transactions, such as sustainability-linked debt and energy service agreements. Finally, ESG is still at an initial stage when it comes to a system similar to an accounting system with document and data workflow. ESG reporting process is highly manual, with data in multiple locations and spreadsheets.

ESG may have a direct impact on auditors and audit firms. Firstly, obtaining assurance on ESG data is not currently part of a financial statement audit, and various sustainability assurance service providers may offer this service. However, it is an excellent opportunity for audit firms to provide ESG assurance services under ISAE 3000, especially considering audit firms' experience in attestation services. Secondly, ESG assurance may offer reasonable or limited assurance. The EU CSRD proposal will require all companies within the scope to seek limited assurance, possibly transitioning to reasonable assurance later. The current form of the CSRD proposal raises many questions, especially about the interpretation and application of various requirements. At the same time, it stimulates discussion about ESG assurance and the role of auditors.

ESG matters may also influence an audit of a financial statement. The existing publications indicate that climate-related/ESG-related risks may be captured and considered in an audit cycle as part of risk assessment if they are treated as business risks or may have implications for risks of material misstatement. Moreover, auditors are required to consider "the other information" according to ISA 720; therefore, ESG information (despite not being in the scope of a financial audit) may be crucial. Finally, the role of auditors may be seen as an effective communication channel on ESG matters (e.g., through Critical Audit Matter).

Overall, this review paper showed the variety of ESG aspects that may directly or indirectly influence audit clients, financial statements, audit firms, and financial statement audits. Undoubtedly, ESG has become a fundamental factor that must be considered. As of now, many question marks and aspects require greater clarification. What is more, annual financial reporting and sustainability reporting, if needed at the same time, will raise further questions about: (1) audit timelines; (2) possibly extended scope of an audit, (3) potential overlapping of procedures or potential cooperation between audit and ESG assurance teams; and (4) the auditor's independence if the same audit firm will provide ESG assurance. It creates an opportunity for further research studies and opens a discussion about costs for audit clients and firms, which the ESG revolution will bring.

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Notes

Note 1. cf. https://www.sec.gov/news/press-release/2022-46

Note 2. https://www.icaew.com/technical/audit-and-assurance/assurance/process/scoping/assurance-decision/limited-assurance-vs-reasonable-assurance

Note 3. ibidem.