



**ACCOUNTANCY
EUROPE.**

ESG GOVERNANCE: RECOMMENDATIONS FOR AUDIT COMMITTEES

Position paper

VIEWS.

**CORPORATE GOVERNANCE
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HIGHLIGHTS

Audit committees play a crucial role in promoting strong corporate governance, through their involvement in risk oversight, internal controls, corporate reporting and audit.

New EU legislation is extending the mandate of boards and audit committees to include Environmental, Social, and Governance (ESG) matters. The European Commission proposal for a *Corporate Sustainability Reporting Directive* assigns a range of tasks for company sustainability reporting and assurance to audit committees. The EC proposal for a directive on *Sustainable Corporate Due Diligence* requires companies to implement a series of actions and policies to address adverse impacts on human rights and environment in their own operations and in their value chains.

This paper provides an overview of the expected role and responsibilities of audit committees, in light of relevant EU legislation and stakeholder demands. It includes recommendations for audit committees in relation to their ESG responsibilities with a focus on audit committee's:

- competencies and composition
- responsibilities for ESG reporting and assurance

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INTRODUCTION

Board committees often help the board of directors understand and act on complex or specialised matters. Committees' roles and responsibilities are determined by the tasks delegated to them by the board, as well as by EU and national legislation, and as defined in their terms of reference.

A typical governance framework for a large company will include, for example, an audit committee, a risk committee, a nominations committee, and a remuneration committee. Other committees may also exist, depending on board needs. It is not unusual for some committees' responsibilities to overlap.

OBJECTIVE

This paper provides an overview of the expected audit committee (AC) roles and responsibilities, when it comes to:

- sustainability reporting, as set out in the European Commission (EC) proposal for a [Corporate Sustainability Reporting Directive](#). This directive, which at the time of writing of this paper is still being negotiated, would expand the AC's mandate and responsibilities to include company sustainability reporting to enable them to support company boards
- the expected implications of the corporate sustainability due diligence duty for ACs as presented in the EC proposal for a [Sustainable Corporate Due Diligence Directive](#)

It includes recommendations for ACs regarding their Environmental, Social and Governance (ESG) responsibilities in light of these legislative requirements and stakeholders' expectations, with a focus on:

- AC competencies and composition
- AC responsibilities for ESG reporting and assurance

The paper first outlines the drivers behind corporate ESG transformation. It then looks at various governance bodies' roles – including boards¹, board committees and management – in driving the company ESG transformation. The paper then describes the ESG-related mandate, competencies and composition of ACs. A final section proposes questions that ACs should seek to address when fulfilling their ESG responsibilities.

WHY ARE AUDIT COMMITTEES IMPORTANT FOR STRONG CORPORATE GOVERNANCE AND THE ESG TRANSITION?

ACs are inevitably important in supporting boards with the company's ESG transformation necessary to respond to new strategic needs, societal expectations and regulatory requirements.

The audit committee is a board committee that supports the board of directors in executing their responsibilities. The board relies on the AC to safeguard the integrity of the financial reporting process, and to oversee statutory audits. Final accountability to shareholders and stakeholders remains with the board.

The AC can have many other responsibilities that are relevant to a company's corporate reporting, including sustainability reporting. These include overseeing company risk management systems, internal controls and compliance, external auditors or other assurance providers appointment and oversight, and auditors' or other assurance providers' independence monitoring.

¹ In this paper we are using the collective term 'boards' encompassing both management and supervisory boards as ESG oversight is relevant for both one-tier (unitary) and two-tier board structures. See De Moor, C. [Board effectiveness: one-tier versus two-tier boards](#), 2013-2014, University of Ghent.

ACs also play an important role overseeing financial risks facing companies, especially fraud and shortcomings risks in internal controls. As such, ACs provide confidence to investors, creditors, business partners, public authorities and the broader public.²

ACs are inevitably important in supporting boards with the company's ESG transformation as well given that their primary roles are overseeing risk and making sure that the appropriate internal controls are in place. The ESG transformation entails the shift to more sustainable business models, making sustainability concerns an integral part of company strategy and its governance. This transformation is necessary to ensure companies respond to new strategic needs, societal expectations and regulatory requirements.

DRIVERS BEHIND ESG INTEGRATION INTO CORPORATE GOVERNANCE

“Policymakers, investors and other stakeholders increasingly expect companies to have a comprehensive approach to ESG, integrating sustainability considerations into strategy, risk management, and the company's decision making and culture. Investors, for their part, increasingly measure business performance in both financial and sustainability terms.

The proposed EU [Corporate Sustainability Reporting Directive](#) (CSRD) would require companies to report how sustainability issues affect their business and their own impact on people and the environment. Companies would therefore need to provide information about strategy, targets, the boards' role in relation to sustainability, and adverse environmental and social impacts connected to the company and its value chain.

The CSRD would make AC responsible for overseeing company sustainability reporting and related processes to identify the information reported. The AC would need to submit recommendations to ensure sustainability reporting's integrity. It would have to inform the company's administrative or supervisory body about the outcome of the sustainability reporting assurance and explain how it contributed to the sustainability reporting's integrity.

The recent EC proposal for a [Sustainable Corporate Due Diligence Directive](#) (SCDD), meanwhile, introduces a duty for corporates to address any adverse impacts their operations and value chains may have on human rights and the environment.

Under this proposal, company directors would be responsible for setting up and overseeing the due diligence actions³, adopting the company's due diligence policy⁴, and integrating due diligence into corporate management systems. The company directors would have to report to the supervisory board in that respect. Directors would also have to adapt company strategy, taking into account actual and potential adverse impacts identified and any due diligence measures taken.

Directors would also be required to take into account the consequences of their decisions for sustainability matters, when fulfilling their duty to act in the best interest of the company. This includes human rights, climate change and environmental consequences in the short, medium and long term.

² Tapestry Networks, 2020, [Audit Committee Realities: Insights from Europe's leading boards](#)

³ Companies within the scope of the proposed EC [Sustainable Corporate Due Diligence Directive](#) would have to conduct human rights and environmental due diligence by:

- a. integrating due diligence into their policies
- b. identifying actual or potential adverse impacts
- c. preventing and minimising potential adverse impacts, and bringing actual adverse impacts to an end and mitigating their extent
- d. establishing and maintaining a complaints procedure
- e. monitoring the effectiveness of their due diligence policy and measures
- f. publicly communicating on due diligence

⁴ Companies within the SCDD Directive's scope would be required to have in place a due diligence policy detailing (a) the company's approach to due diligence, (b) a code of conduct, (c) the processes to implement due diligence, including the measures taken to verify compliance with the code of conduct. Companies would need to update their due diligence policy annually.

For many companies, the value chain is an important part of risk management and governance. As an important board committee, the AC would therefore have a central role to play in supporting sustainable corporate due diligence.⁵

INTEGRATING ESG INTO CORPORATE GOVERNANCE STRUCTURES

A full company ESG transition would require environmental, social, and governance issues to be made part of all corporate governance structures. This section outlines some possible features of a future-proof and resilient corporate governance system in line with ESG objectives.

ESG AS A STRATEGIC BOARD MATTER

Boards, including board committees, play a vital role in providing leadership to define a company's strategic orientation and overall risk governance.

It is the boards' duty to identify the most important risks facing a company, including impacts on its operations, resilience and viability⁶.

ESG risks such as climate change can have a material impact on a company's financial position and viability. This can in turn impact financial statements in areas of expected credit losses, asset valuation, fair value measurement or impairment, and going concern. Investors want to understand the company's strategy and how boards are addressing these risks. They are looking for reliable, high quality, and globally comparable information about how ESG will affect long-term business sustainability, as well as metrics showing progress against set targets and how this compares with similar companies.

It is crucial that boards and board committees fully integrate ESG risks, impacts and opportunities within business strategy and operations, supply chains and enterprise risk management⁷. This is why boards need to be properly equipped and supported by the appropriate governance mechanisms. Keeping board skills and composition up to date and ensuring that management establishes good internal practices and control functions, will be key to a comprehensive ESG approach for organisational decision-making.

ESG IN BOARD COMMITTEES AND COMPANY FUNCTIONS

Corporate governance of ESG risks, impacts and opportunities should be standard business practice. Led by the board, ESG risk management and oversight should be a central responsibility of both the senior management and supervisory board committees.⁸ These could include the audit, risk, and remuneration committees⁹.

As ESG affects sectors and companies differently, each company will need its own way of integrating ESG that is appropriate to its business model and circumstances.

A collaborative approach to ESG risk management is vital. Irrespective of committee structure, collaboration should lead to a comprehensive overview of ESG risk exposure for a business, thus facilitating ESG integration into the business strategy and culture. Shared membership in several board committees would promote such a collaborative approach, ensuring exchange of ideas and initiatives.

⁵ Accountancy Europe-ecoDa, 2021, Event Report [Driving the evolution of sustainable corporate governance Reflections on the future role of audit committees](#)

⁶ ecoDa, 2021, [Corporate Governance Guidance and Principles for Unlisted Companies in Europe](#)

⁷ ecoDa 2021, [A practical guide for boards and leadership teams on sustainability](#)

⁸ Ashley, J. et al., 2021, [ESG Governance: Board and Management Roles & Responsibilities](#), p. 4.

⁹ For example, the proposed SCDD Directive links the directors' variable remuneration to company's climate change obligations; hence, the role of the remuneration committee becomes particularly pertinent.

GOVERNANCE FIT FOR ESG NEEDS

Addressing ESG risks and impacts will require building capabilities, including at board and committee level. This means that terms of reference, competencies, expertise and work plans for boards and board committees must evolve to make ESG part of a broad strategy.¹⁰

This may mean reviewing the composition, diversity and profiles of boards and committees¹¹ to ensure members have the expertise, experience and mindset needed to respond to changing business realities and demands. Governance is a dynamic process, under which proactivity, innovation, capacity building, and a strong corporate culture are needed to help businesses withstand change and crises.

THE AUDIT COMMITTEE'S ROLE IN ESG GOVERNANCE

The main responsibility for a company's ESG transition lies with senior management and the boards. It is up to this top leadership level to focus on the journey towards a sustainable economy and determine how the company's vision, strategy and day-to-day operations can contribute to this transition.

In view of their corporate reporting and risk oversight responsibility, ACs will play a pivotal supporting role in this process, especially when it comes to reporting on issues related to ESG¹². For example, under the proposed CSRD the AC would have to:

- monitor company sustainability reporting and related processes to identify the information reported according to the relevant sustainability reporting standards
- submit recommendations for sustainability information integrity
- explain how it contributed to the sustainability reporting integrity and what its role in that process was
- monitor the effectiveness of the company's internal control and risk management systems, and of its internal audit function, particularly with regard to fraud or greenwashing
- monitor the assurance of annual and consolidated sustainability reporting
- inform the company's administrative or supervisory body about the outcome of the sustainability reporting assurance
- review and monitor the independence of statutory auditors and audit firms

ESG needs to become part of the terms of reference governing AC work because financial and sustainability reporting are interconnected. AC members' skill sets enable them to see the relationship between ESG matters, capital markets, and corporate finance. This will be crucial to identifying business relevant ESG risks, including emerging risks, and will help boards align an overall business strategy.

ACs are well placed to support boards with sustainability reporting and assurance, thanks to their oversight of business risks, risk management systems, internal controls, corporate reporting and audits. This responsibility means ACs must be able to show how ESG fits in with company strategy, purpose and stakeholder demands.

Below are recommendations to help ACs manage ESG responsibilities.

¹⁰ Tapestry Networks, 2022, European Audit Committee Leadership Network, [ESG Governance](#), p. 4-5

¹¹ Ibid

¹² Tapestry Networks, 2020, [Audit Committee Realities: Insights from Europe's leading boards](#)

RECOMMENDATIONS: AUDIT COMMITTEE ESG MANDATE, COMPETENCIES AND COMPOSITION

1. DEPLOY SOFT SKILLS TO TACKLE ESG CHALLENGES

Key soft skills will help ACs meet their ESG responsibilities. These include critical thinking, an investigative mindset, scepticism, an ability to challenge the status quo, moral courage to raise uncomfortable questions. Soft skills should allow ACs to challenge management and experts over ESG implementation across company systems and processes, as well as against related Key Performance Indicators (KPIs).

Enquiring if and how the catastrophic climate change impact is considered in a company's impairment testing, or whether the processes used to determine ESG-related KPIs are adequate, are examples of challenges ACs may face. ACs should be encouraged to explore climate change risks for the company together with management. This should also cover if and how material climate-related impacts on the company were incorporated into financial statements, what the estimates and assumptions are, and if any potential greenwashing risks are identified.

“ ACs need to be prepared to start difficult conversations [...] Building trust, relationships and open lines of communication with these parties will be crucial to investigating and resolving issues.

ESG-related challenges also mean ACs need to be prepared to start difficult conversations with boards, board committees, internal and external auditors and management, and, potentially, regulators and investors. Building trust, relationships and open lines of communication with these parties will be crucial to investigating and resolving issues. This is necessary for the AC work to be effective.

2. ENHANCE ESG EXPERTISE

ACs should proactively expand their knowledge of ESG matters through continuous learning

AC skills and expertise will also need to evolve to meet the realities of environmental degradation, as well as regulatory demands and stakeholder expectations. ACs should therefore proactively expand their knowledge of ESG matters through continuous learning. This may include calling on internal or external experts. It may also be appropriate to ensure that one member of the AC has experience with ESG measurement and reporting; similar to the requirement for knowledge of accounting or audit.

Professional accountancy institute qualifications and other tailored initiatives can also help executive and non-executive directors to enhance business-relevant ESG skills to lead boardroom discussions on these matters.

3. WORK WITH AUDITORS ON ESG

One responsibility of ACs is working with auditors. An effective working relationship between the two parties, while maintaining independence, is beneficial not only for the auditor and the AC but also for the company, investors, and the general public.

ACs will need to work closely with internal and external auditors to identify ESG risks and auditing processes involved with ESG reporting. This will help ensure sustainability information's integrity.

With investors increasingly focusing on ESG, sustainability is gradually being integrated within companies' governance, strategy, internal control and reporting. ACs, CFOs and finance groups are consequently taking an integrated approach to financial and sustainability reporting.

Connecting the financial and sustainability reporting is essential for companies to make better decisions and prevent the risks of inconsistencies and loopholes between the two reports. This will also facilitate better integration of sustainability considerations in companies' decision-making. The ACs too will therefore need to reflect on the interconnection between their sustainability and financial reporting responsibilities when deciding how to manage a company's assurance needs.¹³

When the sustainability reporting assurance is implemented, the AC needs to be involved in the assurance provider selection, monitoring their independence and work, including the audit report. The AC will need to make sure the assurance provider has appropriate ESG competencies and knowledge of relevant audit processes.

The AC should exchange with the external assurance provider information about company risks, including ESG-related risks. It should assess the compliance and internal audit functions' activities on ESG matters and report to the board.

AUDIT COMMITTEE CHAIR SHOULD FOSTER AN OPEN DISCUSSION ON ESG

“ *In the ESG context in particular, the AC Chair must show leadership to help AC members adopt ESG responsibilities. The Chair therefore also needs to show their own knowledge and expertise in tackling these issues.* ”

The AC Chair should aim to create an open-minded culture, in which AC members are comfortable asking difficult questions and feel free to speak up about ESG-related issues. The Chair should make sure AC members are fully engaged and have enough time for preparation and discussion.

Diversity of thought is critical to steer the organisation in the right direction. The AC Chair should seek all AC members perspectives on threats that may prevent the organisation from achieving its ESG objectives. This includes understanding how management prepares and deals with ESG challenges and opportunities, ensuring that the organisation is meeting stakeholders' changing needs and expectations. This also means that engaging with employee representatives can be particularly helpful for an AC.

ADDITIONAL TOOLS FOR AUDIT COMMITTEES TO FULFIL THEIR ROLE IN ESG

Companies should offer ACs training to increase their expertise in ESG matters, risks, reporting and assurance. Such training is particularly useful at the start of an ACs engagement with ESG. Input from both within the company and from external experts would add value to the training. AC members should also be encouraged to participate in specific training on how to integrate ESG in company strategy.

Management, for its part, should make relevant and up-to-date information and data available in a timely manner, to help AC members identify relevant ESG issues. This information should include a description of the management process used to develop and prepare sustainability information, along with the reference framework, risk management systems and control environment used, as well as any relevant related complexities, estimates and assumptions. The AC should have access to a system for reporting on how ESG KPIs are being monitored, as well as their evolution over time and progress towards meeting set objectives.

¹³ Accountancy Europe, 2020, [Setting up for high-quality non-financial information assurance in Europe](#)

KEY TOPICS: ENHANCED AUDIT COMMITTEE ESG RESPONSIBILITIES

This section proposes questions, divided into areas of responsibility, to help ACs adopt enhanced ESG responsibilities. These questions are intended to help guide the AC work.

INTERNAL CONTROL AND RISK MANAGEMENT SYSTEMS

Providing reliable ESG data means putting in place processes, systems, internal controls and risk management systems as for financial reporting. ACs will need to make sure that appropriate internal controls are in place, so that sustainability considerations are understood at all company levels and implemented throughout all business operations.

ACs should reflect on the following questions in order to monitor the effectiveness of a company's internal control and risk management systems:

Does the company have a robust system in place for identifying, collecting, analysing and reporting sustainability information, including its impact on financial risk and reporting?

Is the control environment for producing sustainability metrics and targets as strong as the control system for financial metrics, objectives and reports?

How does management ensure risk management and internal control effectiveness when it comes to ESG? Are there weaknesses and what is being done to address them?

Can the AC be sure that answers provided by management to the above questions are reliable?

Does the company implement comprehensive mitigation processes for adverse social and environmental impacts in their own operations and in their value chains?

How can the AC support compliance with new sustainable corporate due diligence measures companies will have to follow?¹⁴

RISK SCENARIO ANALYSIS

The AC may also help boards and management by overseeing ESG risks related resiliency planning given the potentially significant financial impact of ESG risks. To this end, the AC may consider the following questions:

What is management's understanding of company exposure to ESG risks – their likelihood and impact, in the short, medium and long term?

How does management assess the business-model viability, including data analysis and verification to ensure the integrity of the information feeding into the models?

What is management's assessment of physical¹⁵, human¹⁶, and transition¹⁷ risks, and their potential impact?

¹⁴ Companies within the SCDD Directive's scope will need to implement due diligence actions and have a due diligence policy detailing (a) the company's approach to due diligence, (b) a code of conduct, (c) the processes to implement due diligence including verifying compliance with the code of conduct. Company directors will be responsible for setting up and overseeing the due diligence actions and the due diligence policy and report to the board.

¹⁵ "Physical risks involve risks from climate change including risk to facilities and infrastructure, impact on operations, water and raw material availability and supply chain disruptions." IPCC report (2020), https://www.ipcc.ch/site/assets/uploads/2021/02/Risk-guidance-FINAL_15Feb2021.pdf

¹⁶ "Relevant adverse consequences include those on lives, livelihoods, health and wellbeing, economic, social and cultural assets and investments, infrastructure, services (including ecosystem services), ecosystems and species." IPCC report (2020), https://www.ipcc.ch/site/assets/uploads/2021/02/Risk-guidance-FINAL_15Feb2021.pdf

¹⁷ "Transition risks typically refer to risks associated with transition to a low carbon economy. Transitioning to a lower-carbon economy can entail extensive policy, legal, technology and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed, and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organizations.", IPCC report (2020), https://www.ipcc.ch/site/assets/uploads/2021/02/Risk-guidance-FINAL_15Feb2021.pdf

ESG DISCLOSURES

Corporate reporting is expected to help investors and other stakeholders understand how a company is run, its operating environment and how it addresses strategic risks and opportunities. ACs will play a crucial role in ensuring the quality of ESG reporting, as well as staying up to date with evolving sustainability reporting rules and expectations.

AC expertise and experience with ensuring the integrity of financial statements means they are well placed to assess ESG disclosures as well. They can help determine whether a company's internal controls, processes and procedures are robust enough to ensure the accuracy, reliability, consistency and quality of the information reported.¹⁸

ACs should reflect on the following questions to ensure ESG disclosures' integrity:

What policies and methodologies are used to develop metrics to ensure ESG information accuracy, reliability, and consistency?

Does the company management have the expertise necessary to determine which metrics are most appropriate to a sector of a company and its activities, its circumstances, and the risks faced? Are the KPIs set by management appropriate

How may the AC be sure that answers from management to the above questions are reliable? Is there any need for internal and/or external assurance

How does the AC assess the interconnectedness of ESG, non-financial and financial risks? Does management plan work accordingly? Are these interconnections reported accurately

Does the AC monitor senior management's adherence to the company's risk appetite How can the AC consider determination of relevant factors based on stakeholder engagement

Is there a potential fraud risk in relation to linking the directors' variable remuneration¹⁹ to the achievement of sustainability objectives

ESG ASSURANCE

Companies subject to the CSRD will be expected to seek external assurance of their sustainability information. The AC tasks related to this sustainability assurance will include:

monitoring the assurance of annual and consolidated sustainability reporting

assessing whether appropriate controls are in place to ensure reports are consistent

informing the administrative or supervisory body of the outcome of the assurance of sustainability reporting

reviewing and monitoring the independence of the statutory auditors or audit

ACs should reflect on the following questions related to their overall responsibilities on ESG assurance:

How does the AC keep up to date with relevant legal, regulatory or other developments regarding ESG assurance?

What factors does the AC need to take into account when selecting the appropriate service provider for sustainability assurance?

Where there is a role for external assurance, how will the AC oversee the relationship between the internal and external auditor or assurance provider and the execution of such assurance to the desired standard?

How can the AC be sure that these auditors have the necessary competence to provide assurance over ESG risk management and sustainability reporting?

What factors should the AC consider in monitoring the assurance of sustainability reporting? For instance, is there sufficient communication between the auditor and the AC?

How can the AC ensure the external audit's focus on key ESG risks?

How can the AC facilitate effective monitoring of a company's due diligence²⁰

²⁰ Companies within the SCDD Directive's scope would need to monitor the implementation and effectiveness of their due diligence measures.

How can the AC ensure the auditor's independence?
How can an internal audit provide additional insight and foresight?
Is internal audit adequately resourced to address additional ESG audits?
How can assurance ²¹ make company due diligence efforts more reliable and effective ²² ?

OTHER CONSIDERATIONS

How will the AC ensure that action follows up on the reporting? How can they communicate the mindset needed and set tone for culture from the top
How can ACs help boards to define and fulfil company's purpose? ²³
How and to what extent can the AC prevent greenwashing?
How can the AC help ensure that ESG risks related to the measurement of assets and liabilities are addressed?

COMMUNICATE FINDINGS TO THE BOARD

The AC should regularly communicate their findings and considerations in relation to ESG governance to the board, including any recommendations. This would allow the board to take the appropriate action.

The AC should also give an annual account of its work, how it completed its objectives, what challenges it encountered and how it addressed them.

CONCLUDING REMARKS

ACs will play a crucial role in helping the boards to steer companies along a sustainable pathway. In this paper we examined the enhanced responsibilities of ACs in the area of ESG and put forward recommendations to help them carry out this function. We hope that the paper sparks discussion and dialogue among key stakeholders.

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¹⁹ The proposed SCDD Directive links company's climate change obligations to directors' variable remuneration (see Article 15).

²⁰ Companies within the SCDD Directive's scope would need to monitor the implementation and effectiveness of their due diligence measures.

²¹ For example, the standards agreed by the International Organisation for Standardisation (ISO) could be used e.g. for the certification of management systems, to assess risks at supplier plants. For instance, [ISO 20400](#) provides guidance to organisations on integrating sustainability within procurement. Certification shows that specific requirements have been met.

²² Companies would have to conduct human rights and environmental due diligence by:

- a. integrating due diligence into their policies
- b. identifying actual or potential adverse impacts
- c. preventing and minimising potential adverse impacts, and bringing actual adverse impacts to an end and mitigating their extent
- d. establishing and maintaining a complaints procedure
- e. monitoring the effectiveness of their due diligence policy and measures
- f. publicly communicating on due diligence

²³ For example, the recent [ISO 37000: 2021 Governance of organizations – Guidance](#) provides organisations and their governing bodies the tools they need for good governance. The guidance considers purpose and sustainability at the heart of governance.



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