

Article

Methodological Approach Based on Risk Profiling in ESG Auditing and its Content

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Abstract: This article highlights a methodological approach based on risk profiling in ESG auditing in the context of sustainable development and provides suggestions and recommendations.

Keywords: Environmental Risk, Greenwashing, Social Risk, Management Risk, Risk Categories

1. Introduction

The ESG concept, in essence, represents a shift from the classical “profit maximization” theory to the “sustainable value creation” approach. That is, the value of a company is determined not only by current financial results, but also by the long-term consequences of its environmental, social, and management decisions [1], [2].

Embracing ESG helps businesses reduce risk, thereby creating efficiency and long-term value. Setting ESG goals is important for organizations because it demonstrates their readiness to meet the future demands of a changing business environment [3], [4].

The economic content of ESG is that it considers non-financial factors that shape the financial results of an enterprise as an object of economic analysis [5], [6]. These factors may not be directly reflected in financial statements, but they have a significant impact on the level of risks, cost of capital, investment attractiveness, and market stability [7].

Literature Review

B. Aceski and B. Traykoski gave the following definition of risk in auditing: “The auditor always plans adequate procedures that minimize audit risk and allow for the maximum detection of errors, fraud, and other irregularities in financial statements. In particular, the auditor should identify areas of high risk where errors are likely to recur. In determining the level of risk, the auditor should answer the following questions:

- Is there any incentive (from directors or officials) to manipulate information?
- Is it difficult to manipulate this type of information?
- Is it difficult to detect and prevent such manipulations?
- Were these type of errors intentional (accidental)?

According to Spencer Pickett, C.H, “Because it is difficult to assess the overall risk of a financial statement audit, it is important to remember that the risks of misstatement that may affect the financial statements can be divided into three groups:

- Identifiable risk (the risk of material misstatements in the reports);

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- Control risk (the risk that internal control will not detect or prevent such errors);

“Detection risk or under-detection risk (the risk that the auditor will not detect material misstatements).”

P. Nikolovsky in his works studied the following: “Audit risk arises in three ways during the audit process:

- Planned risk (i.e. the risk that arises when concluding a contract),
- Risk during the audit (risk unknown to the auditor until their work is completed),
- Estimated risk (which is known to the auditor during the audit).”

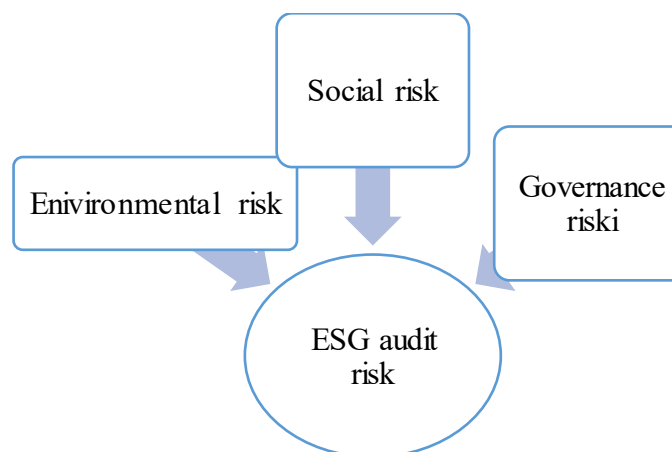
2. Material and Methods

The research used induction, deduction, systematic and comparative analysis, grouping, experimentation, adaptive methods, integrative approaches, and analysis and approbation of international experiences.

3. Results and Discussion

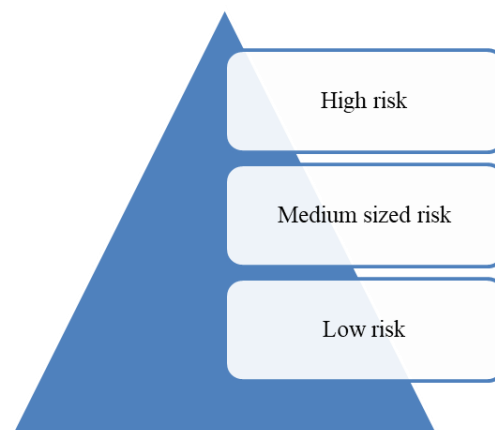
As mentioned above, risk assessment in the audit of financial statements is divided into three types: inherent, intrinsic, and non-detection risk, and these risk assessments are based on professional judgment.

However, when identifying risks in an ESG audit, it is advisable to divide them into three types: environmental, social, and governance risks [8], [9].



Source: Developed by the author

Figure 1. Classification of risks in ESG audits



Source: Developed by the author

Figure 2. Risk categories associated with ESG auditing

It is advisable for the auditor to assess these risks according to three categories: low, medium, and high.

The classification of risks into these categories is based on the auditor's professional judgment.

Low risk refers to the possibility of events occurring in the audited entity that have a relatively low level of risk and that do not affect the auditor's overall conclusion. As the name suggests, this risk is considered low and is not given sufficient attention by the auditor [10].

Medium risk is a type of risk that has a low to high level of severity and could affect the audit conclusion. This requires the auditor to consider the level of severity of the risk in relation to the extent to which it could affect users.

The above risk level is a high-stakes risk that is directly significant and can affect users. In this case, the auditor uses these types of risk to assess overall audit risk.

When organizing and conducting risk identification processes in an ESG audit, it is advisable for the auditor to obtain evidence from a variety of sources:

The first source is information obtained from the enterprise and organization itself, namely from management, the board of directors, and other key individuals who directly prepare sustainability information, as well as from internal auditors [11].

The second type of source is information obtained from outside sources, both directly and indirectly.

The third type of source is information obtained from the company's reports, which are directly covered in the media and announced at meetings of analysts and investor groups.

It would be useful to divide the potential risks in an ESG audit into three types.

The first type of risk, risks related to environmental issues, and information on their categorization are presented in the table below.

Table 1. Risks related to environmental issues in ESG audits and the auditor's approach to them

No.	Types of risk	Auditor's approach	Risk category		
			low	middle	high
1	The risk of not having a long-term strategy that is consistent with the company's business activities	In this case, the auditor should verify whether this type of strategy has been developed and whether management has been informed about it.			
2	The risk of not developing a roadmap for achieving this strategy	In this case, the auditor should check whether the strategy has been developed into a roadmap, and the roadmap should directly cover the strategy; It is advisable to confirm and determine the existence of intermediate goals that allow for any deviations.			
3	The risk associated with incorrect assessment of environmental problems	a) Verify that the company has incorporated climate risks into its risk management system; b) Verify that the company has a process for identifying and quantifying climate risks in its risk management process, including when making capital allocation decisions.			

4	The risk of Auditor: inadequate methodologies used to identify, quantify, and manage environmental problems	<ul style="list-style-type: none"> - The company should review the status of including environmental risks in its risk program; - should study the status of implementation of this environmental risk identification system; - should examine the development of incentive policies to reduce environmental risks.
5	The risk of environmental issues not being reflected in the company's investment process	In this case, the auditor must identify and assess whether the investment projects being undertaken by the company pose an environmental risk.
6	The risk of doing business that causes environmental problems	The auditor should first analyze the company's compliance with restrictions on businesses that may cause environmental problems.
7	The risk of incorrect reporting	The auditor must review the reports prepared by the enterprise on environmental issues and gather sufficient and appropriate evidence on them.
8	The risk of the enterprise's business activities being exposed to environmental problems	In this case, the auditor must determine and assess the extent to which the enterprise's business activities cause environmental problems and their consequences.

Source: Developed by the author

The above-mentioned will primarily help the auditor in identifying risks related to environmental issues and applying specific audit approaches to them. And through this, the auditor will be able to correctly assess and eliminate risks related to environmental issues [12].

The second major issue in an ESG audit is social issues, and the auditor may encounter several risks related to this issue during the audit process.

Table 2. Risks related to social issues in ESG audits and the auditor's approach to them

No.	Types of risk	Auditor's approach	Risk category		
			low	middle	high
1	The risk of lack of equality and fairness between workers and employees	In this case, the auditor should study and assess the existence of regulatory documents on the code of ethics, division of duties, determination of wages and incentives that ensure equality between workers and employees, and the extent to which they are being implemented.			
2	Problems related to hiring and firing workers and employees	In this case, the auditor should examine how transparently and correctly the hiring process is conducted, to what extent the requirements of the regulatory document on hiring are being complied with, and to conduct a thorough analysis of cases of unjustified dismissal and the factors that led to these cases.			
3	Risks related to worker and employee health and safety issues	In this matter, the auditor must study and assess the extent to which the enterprise's management complies with the laws and regulations on civil protection and labor protection of employees, as well as the extent to which the working conditions created comply with the requirements of these documents.			
4	Risks associated with employee and staff training	In this case, the auditor studies and evaluates the extent to which the process related to the professional development of workers and employees was conducted correctly and transparently, and whether there were any cases of corruption.			
5	Risks associated with the use of innovative technologies	In this situation, the auditor studies and evaluates whether the enterprise operates on the basis of labor or an automated system, and the attitude of the enterprise management towards the automation of labor activities.			

Source: Developed by the author

The above-mentioned will primarily help the auditor in identifying risks related to social issues and applying specific audit approaches to them. And through this, the auditor will be able to correctly assess and eliminate risks related to social issues [13].

The third issue is a management issue, and during the audit process, the auditor may encounter a number of risks related to this issue.

Table 3. Risks related to governance issues in ESG audits and the auditor's approach to them

No.	Types of risk	Auditor's approach	Risk category		
			low	middle	high
1	Risks associated with an inappropriate governance structure and accountability	The auditor should study and assess the extent to which the organizational structure of the enterprise and the established responsibilities are consistent with ensuring sustainable development.			

2	Risks related to stakeholder interests	In this case, the auditor should study and evaluate how well the company's relations with stakeholders are managed and the circumstances in which their interests have been harmed.
3	Risks associated with ESG strategy	In this case, the auditor studies and assesses whether the company has developed an ESG strategy, whether the strategy includes measures to prevent risks, and whether investment activities are properly organized.
4	Risks associated with incentives	The auditor should analyze and evaluate the extent to which the incentive system used by the enterprise in this case contributes to the achievement of the enterprise's goals.
5	Risks related to the internal control system	The auditor will need to examine and assess the effectiveness of the internal control system implemented at the enterprise.
6	Risks related to transparency of control and reporting	In this case, the auditor should study and evaluate the effectiveness of the control systems in place at the enterprise, and the transparency and appropriateness of the financial and other reports being prepared.
7	Risks related to fraud and corruption	In this case, the auditor must identify existing fraud and corruption cases in the enterprise, take appropriate action on them, and identify and assess the factors that could lead to the occurrence of these cases in the future.
8	Risks associated with tax evasion and non-payment	The auditor will need to examine and assess the tax liabilities arising from the business activities of the enterprise and the circumstances surrounding their concealment and non-payment.

Source: Developed by the author

The above-mentioned will primarily help the auditor in identifying risks related to governance issues and applying specific audit approaches to them. And through this, the auditor will be able to correctly assess and eliminate risks related to governance issues.

One of the most important risks in ESG auditing is the risk associated with "greenwashing."

Greenwashing is the act of making a company or organization's environmental, social, or sustainability performance appear more positive than it actually is. It is intended to mislead investors, customers, and regulators. Greenwashing is recognized as a significant risk factor in ESG auditing because it reduces the credibility of ESG reporting, damages corporate reputation, and delays the achievement of the Sustainable Development Goals [14].

The auditor's methodology for identifying the risk of "greenwashing" is carried out in four stages. The first stage is risk identification, in which the auditor identifies risks related to discrepancies between ESG reporting and financial results, inconsistencies between marketing materials and corporate activities, and the selection and incomplete measurement of ESG indicators.

In the next step, the auditor collects evidence related to these risks. This stage is called the "Evidence-Based Review" stage. In this case, the auditor compares the report with data obtained from production and service processes, collects independent expert

reports on environmental, social and governance (ESG) indicators, and analyzes the enterprise's internal control and risk management systems [15].

The final stage is called the "Auditor Approach" stage, in which the auditor performs analytical procedures (analyzing changes in ESG indicators over time), evidence collection (by comparing documents from production, financial and information systems), interviews and observations (interviews with internal auditors and management representatives, observing real processes), and comparisons (comparing corporate reporting with international ESG standards (ISAE 3000, ISSA 5000, GRI)).

4. Conclusion

In conclusion, it should be emphasized that the auditor's risk assessment requires the use of two important audit concepts: professional skepticism (applying a careful attitude to everything) and professional judgment (making decisions based on the acquired experience, knowledge, skills and abilities). These two concepts are not included in the audit code of ethics, but it is advisable for the auditor to conduct the audit based on them in the course of his work.

In conclusion, motivation, whether it is in material form or spiritual form, can directly affect the work system of managers.

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