Analyzing the impacts of the SEC's new climate disclosure rule on internal controls

In March, the US Securities and Exchange Commission (SEC) finalized its new climate-related disclosure rule. Today, companies are working to understand the rule, determining how it compares to similar reporting requirements from other jurisdictions, and identifying and implementing the appropriate measures necessary for compliance. The SEC's new regulation centers around enhancing and standardizing the way public organizations, including those seeking public offerings, handle and disclose certain climate-related matters, such as greenhouse gas (GHG) emissions metrics, the effects of severe weather events, and how climate risks influence their business strategies and outlooks.

Learn more » SEC mandates climate reporting and assurance (kpmg.com)

Prepare to comply: The path forward, from our perspective

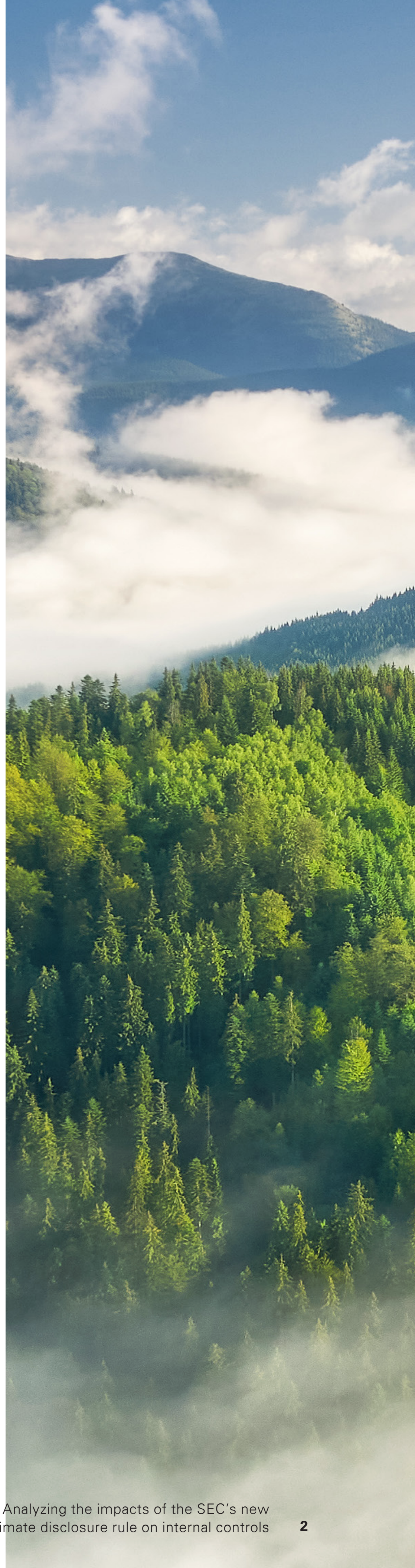
After releasing its initial proposal in 2022, the SEC received more than 24,000 comment letters to consider before finalizing its climate disclosure rule. Even after amending some key details, several legal challenges were filed almost immediately upon its finalization. On April 4, the SEC issued an order to stay the rule, arguing that it maintains its position as an authority to enforce laws against market manipulation, and intending to vigorously defend the rule's validity.

While the order to stay pauses implementation of the rule as the SEC defends it in court, there are several other regulators, such as the State of California and the European Union, that require similar GHG reporting, among other climate-related demands. That said, we recommend conducting an interoperability analysis to evaluate the scope of applicable requirements, including those of the SEC. Additionally, despite the legal stay, we recommend continuing to prepare for compliance as this may take some time.

Learn more » SEC stays its climate rule pending judicial review (kpmg.com)

What now?

First, your organization should review the rule and understand which disclosures you are required to report, paying close attention to the timeline and related audit and assurance requirements. Next, consider the appropriate internal controls and processes needed to ensure complete and accurate reporting, as well as adhere to an audit of internal controls over financial reporting (ICFR) and eventual assurance of Scope 1 and Scope 2 GHG emissions, as required. We believe that processes and controls should be evaluated and designed with interoperability in mind. Following a "build once to meet many needs" philosophy can support compliant reporting processes regardless of the reporting regime.



Here are our recommendations for how your company can prepare for the new regulation:

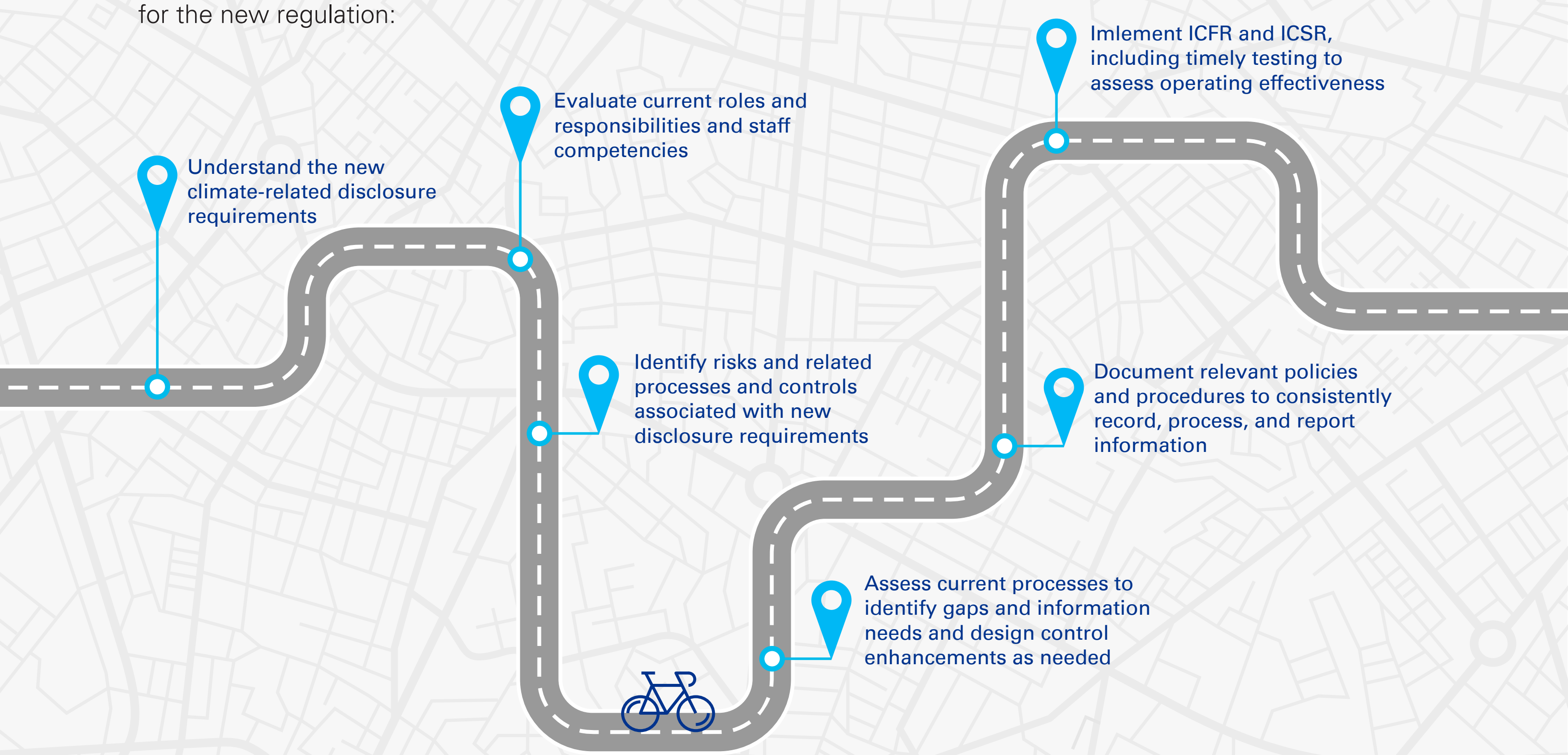


Figure 1 | An illustration of a high-level preparatory approach to support the new SEC climate disclosure rule.

1 Start with assessing and leveraging your existing control environment

Begin with an evaluation of your current control environment to determine where you can leverage or modify existing controls to expand coverage for the updated reporting obligations. Focus should be placed on entity level controls and overarching reporting and disclosure controls. You should consider the following:

- **Board and management structures**: Has oversight for climate-related risks been appropriately defined at the board and management levels? Do you have appropriate charters in place detailing responsibilities and reporting mechanisms?
- **Risk assessment and management**: Have climate-related risks been included in your enterprise risk assessment and management approach? Climate-related risks may be analyzed in functions such as business continuity or threat and resilience. Are these functions integrated with the enterprise risk function and does a feedback mechanism exist to inform the risk disclosures of your Form 10-K?
- **Disclosure committee**: Can your disclosure committee remit be expanded to include climate-related risks? Should changes be made so that the committee has the appropriate skill set to fulfill oversight responsibilities? Do existing certifications for committee members need to be updated?
- **Internal audit and assurance**: What will your internal audit function's role be over internal controls related to climate-related disclosures? This could include conducting periodic reviews and testing of controls to verify accuracy, completeness, and consistency prior to reporting.
- **Information technology (IT) data and security**: What new data will need to be considered for the new disclosure requirements and will it reside within your existing IT infrastructure and control environment? Will new IT applications need to be evaluated for compliance with your data security policy requirements? Many organizations use or are contemplating the use of third-party-hosted IT applications to capture and calculate GHG emissions. How will you incorporate any new IT applications within your existing third-party application control environment?

2 Consider the need for new controls and processes

The reporting requirements in the financial statements of the Form 10-K include the disclosure of material costs and expenses incurred due to severe weather events—a new process that requires definition and implementation for all public companies impacted by the ruling. Leverage existing operational processes from your business continuity and/or threat management functions to assist with the initial identification of these types of events. System changes may be needed to capture and track the relevant costs attributable to severe weather events, and management review of the amounts to be disclosed will be required.

While many companies already report Scope 1 and Scope 2 GHG emissions, some have yet to complete an initial inventory. Whether your organization needs to build a process from the ground up or evaluate an existing process, it is likely that internal control definition and enhancement will be required. Your business should consider where you currently stand with GHG metrics:

- ? Have you identified the activities, operations, and processes within the value chain that contribute to GHG emissions?
- ? Have you inventoried Scope 1 and Scope 2 emissions sources?
- ? Have you evaluated sources and accessibility of data to support Scope 1 and Scope 2 reporting and related quality of data?
- ? Are there measurement or tracking systems in place allowing you to quantify GHG metrics?
- ? Have you documented policies, procedures, and internal controls to consistently record, process, and report information?

3 Formalize and/or update policy and process documentation

Establish policy documentation for any new accounting policies required as a result of the regulation. For example, defining the term "severe weather event and other natural conditions" for your organization and also materiality considerations.

The SEC's new climate disclosure requirements are composed of three main categories that can be defined based on the location of the reporting (Regulation S-X versus S-K) and the level of audit or assurance required: ICFR, external assurance, or disclosure controls and procedures. Our view of the three categories and recommended documentation and control testing approach is illustrated in Figure 2.

Levels of SOX-ification

Figure 2

	Disclosure + Audit + ICFR Regulation S-X	**Disclosure + Audit + ICFR Regulation S-X**	**Disclosure + DCP Regulation S-K**
	Specified disclosures in the financial statements	**Scope 1 and 2 GHG disclosures**	**Climate risk disclosures**
Company internal control response	→ **Level 1: SOX Level required**	→ **Level 2: SOX Level recommended**	→ **Level 3: SOX-Lite recommended**
	• Documented processes and controls • Full control testing by management* • Testing by external auditor	• Documented processes and controls • Full control testing by management* • No/limited control testing by external auditor • Control testing may be required for reasonable assurance**	• Documented processes and controls • Risk-based control testing by management • No control testing by external auditor

DCP = Disclosure control procedures

ICFR = Internal control over financial reporting (SOX 404)

*Full control testing includes test of design and operating effectiveness

**Dependent on assurance standard applied

For all three categories, we recommend:

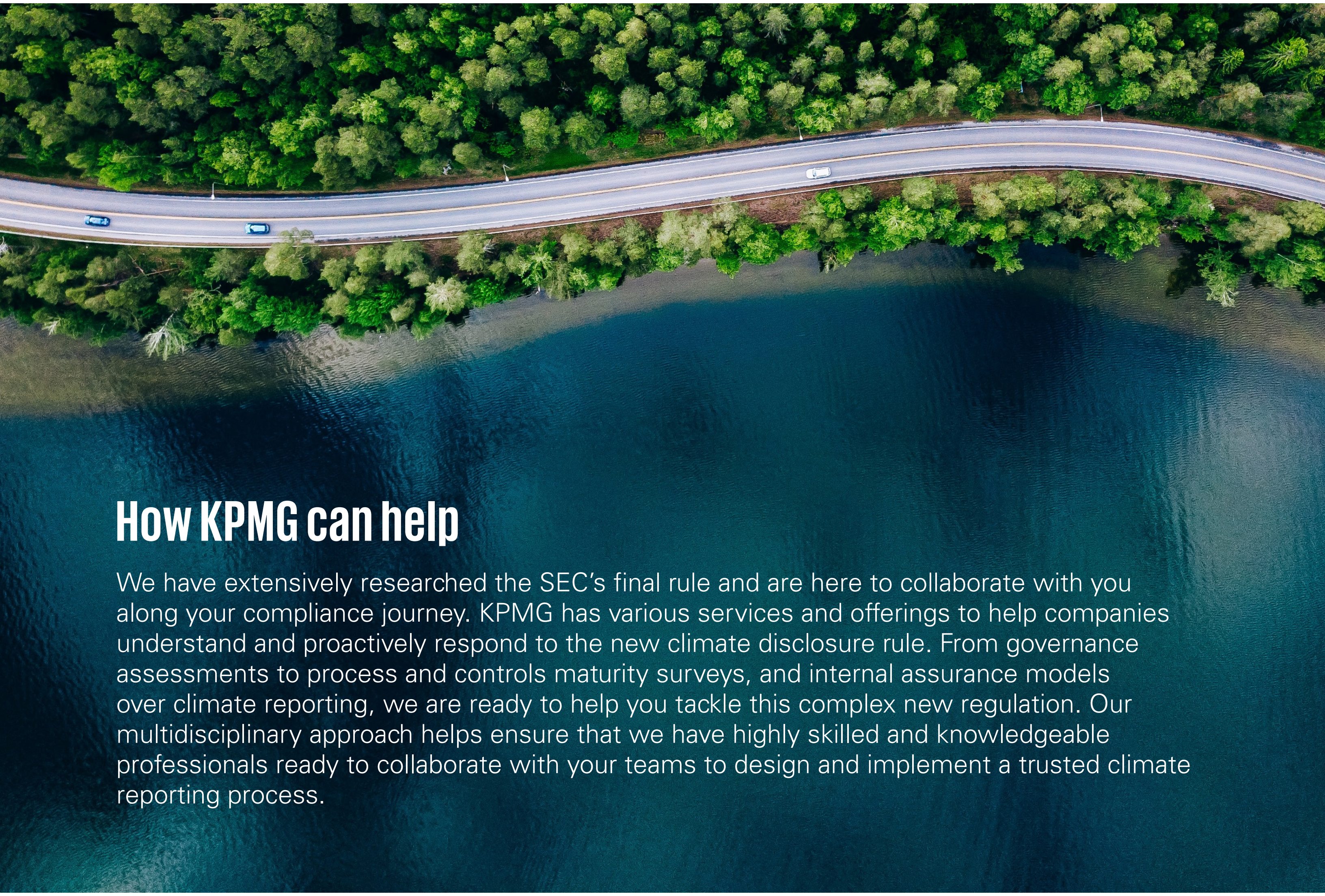
- **Preparing process and control documentation**—Detail the reporting process from initiation to reporting in a manner consistent with your existing control documentation. This may take the form of standard operating procedures, process narratives, or flowcharts and risk and control matrices.
- **Ensuring that roles and responsibilities are clearly defined across functions and that key criteria for controls are articulated**—Establish a standard for how controls are evidenced, what the procedures are for any exceptions identified during control operation, and review attributes for management review controls. IT general and application control considerations along with key reports should also be identified and included in the control documentation.
- **Aligning with your risk management, compliance, and internal audit functions early on**—This ensures that planned processes and controls align with the group's expectations. Additionally, determining roles for the development and review of new or updated process documentation is key. It may also be helpful to discuss your planned processes and controls with your external auditor and assurance provider (if different) during the design and implementation stage so that you can incorporate any additional considerations prior to the first year of reporting.

4 Integrate climate-related controls into your internal control testing program

Internal control testing teams should start to integrate climate-related controls into their existing testing programs. Those controls supporting ICFR disclosures (Level 1 in Figure 2) will require the same rigor of SOX testing as the full SOX testing program, including test of design and full populations for the test of operating effectiveness each year.

The approach to internal control testing for the GHG disclosures and climate risk disclosures can be risk-based and at the discretion of your organization. Our recommended approach (as outlined in Figure 2) is to complete design and operating effectiveness testing for controls supporting the GHG disclosures. These disclosures will be subject to assurance and will involve new processes and possibly individuals who are not as familiar with the rigor needed for effective internal controls over reporting. Operating effectiveness testing can support the control implementation process by identifying control gaps and providing learning opportunities to control owners on the adequacy of control activities and documentation.

You should integrate the climate-related disclosures into your existing testing approach for DCP. A risk-based lens should be applied when designing an internal control testing strategy. Factors to consider include how new these disclosures are, the skill set of control owners, the involvement and related necessary oversight of third parties, the level of expected scrutiny and reliance by your key stakeholders, and regulatory risk.



How KPMG can help

We have extensively researched the SEC's final rule and are here to collaborate with you along your compliance journey. KPMG has various services and offerings to help companies understand and proactively respond to the new climate disclosure rule. From governance assessments to process and controls maturity surveys, and internal assurance models over climate reporting, we are ready to help you tackle this complex new regulation. Our multidisciplinary approach helps ensure that we have highly skilled and knowledgeable professionals ready to collaborate with your teams to design and implement a trusted climate reporting process.

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Strengthen internal controls to navigate the "SOXification" of ESG reporting (kpmg.com)
SEC mandates climate reporting and assurance (kpmg.com)
Understanding the SEC's climate rule (kpmg.com)
Hot Topic: California imposes climate disclosures and assurance (kpmg.com)

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