Building a climate-conscious organization: risk, reporting and net zero

How organizations can work toward standardized climate disclosures and net zero frameworks to manage risk

By Andrew Ross

As the global push toward decarbonization accelerates and the impacts of climate change are realized, stakeholders are demanding that organizations provide better climate-related disclosures. With ESG and climate change regulations on the horizon, audit committees should ensure their organizations are prepared for mandatory reporting, and are integrating climate risk into their operations, controls and governance.

Adopting a climate disclosure framework

Organizations looking for practical guidance on climate disclosures should consider the recommendations set out by The Task Force on Climate-Related Financial Disclosures (TCFD). It's voluntary, but regulators in jurisdictions including Canada, European Union, United States, and United Kingdom have made commitments to start mandating climate-related disclosures in alignment with TCFD, some as soon as 2022.

For additional guidance on adopting the TCFD framework, organizations can refer to the Carbon Disclosure Project (CDP), a not-for-profit charity that runs a global environmental disclosure system to help organizations measure and manage their risks and opportunities on climate change, water security and deforestation. TCFD and CDP are very much aligned in overall objectives, but the CDP takes a more detailed look at the oversight, responsibilities and incentives that should be in place within an organization's governance structure for managing climate-related risk. Audit committees should look to the CDP as a blueprint for the questions they need to be asking management, as investors are increasingly asking the same questions.

Net zero commitments are often vague. Organizations must have a strategy in place to define, measure, track and meet the corresponding emission reduction targets.

Andrew Ross
Senior Manager
Sustainability & Climate Change
KPMG in Canada

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The TCFD recommendations are also being formally incorporated in emerging reporting standards and regulatory proposals. At the recent COP26 conference in Glasgow, the IFRS Foundation announced the creation of the International Sustainability Standards Board (ISSB), a body tasked with developing sustainability disclosure standards that are focused on enterprise value. A prototype climate disclosure standard was released at the same time, which incorporates the four TCFD disclosure pillars of governance, strategy, risk management and metrics and targets. In October 2021, the Canadian Securities Administrators released their proposed mandatory climate disclosures for Canadian reporting issuers, which represent a slightly scaled-back version of the TCFD recommendations.

Audit committees will need to carefully monitor these developments as climate disclosures move from the realm of voluntary to mandatory, and more formal disclosure controls and procedures quickly become necessary.

Committing to net zero

Organizations are not just reporting on climate risks, they're taking steps to combat climate change—and many are making ambitious commitments to become net zero. But net zero can be a loosely defined term. Any organization making this commitment must clearly define how they are going to set and achieve their net zero targets.

Until recently, there was no global standard available for doing this but in October 2021, The Science Based Targets initiative (SBTi) released the world's first framework for corporate net-zero target setting in line with the Paris Agreement goals. SBTi is a partnership between CDP, the United Nations Global Compact, World Resources Institute (WRI) and the World Wide Fund for Nature (WWF), and is already working with more than 2,000 businesses around the world.[1] It helps organizations develop a clearly defined path to dramatically reduce emissions, provides technical assistance and expert resources, and assesses and validates the companies' 'below 2 degree' or '1.5 degree (net zero)' targets.

Questions audit committees should be asking:

- What has the organization communicated externally in terms of its net zero commitment, and have credible interim and long-term targets been established?
- How is the organization working to adopt the TCFD recommendations and determine if they're on track to meet upcoming TCFD-based disclosure regulations?
- How is climate risk being incorporated into the ERM framework and are mitigation plans being established?
- Does management have a plan for undertaking a climate scenario analysis exercise, and do the assumptions make sense, is credible external data being sourced and are the findings robust?

[1] Companies taking action - Science Based Targets

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Audit committees will need to understand what net zero commitments the organization has made and ensure that management has a robust plan and the resources needed to define, measure, track and report progress against those commitments (including setting credible interim targets).

Bringing climate into ERM

Moving to net zero as part of a future low-carbon economy creates transition risk for an organization and this, along with physical climate risk, needs to be incorporated into its enterprise risk management (ERM) framework. Traditionally, environmental risk has been seen as compliance risk with respect to environmental regulations. Climate risk needs to be treated as a more pervasive category within the risk register, with risk identification and assessment done in alignment with the TCFD framework.

To help with this, the TCFD has provided guidance on utilizing a climate scenario analysis approach to evaluate climate risk and quantify the potential financial impacts. It's essentially a stress testing exercise that looks at different future warming scenarios and different transition pathways, modelling how the economy will change in very low-carbon or very emissions-intense scenarios. Organizations are expected to use this approach to assess the resilience of their strategy across alternative scenarios, but unfortunately, most organizations don't have the teams or models required to undertake this potentially complex exercise—and there's no standardized way to then incorporate the scenario analysis results into strategic planning.

Many organizations will initially engage external advisors who, in addition to helping establish scenario sets, models and data sources, can also educate the risk management and finance functions on how to interpret the results and report to the Board and external stakeholders.

For organizations that have until now faced a myriad of ESG reporting frameworks, the move to standardized reporting under the ISSB and securities regulation marks a critical milestone starting with globally consistent climate disclosures. To prepare, audit committees should ensure that internal controls over models, data sources, analysis of results and adherence to standards are robust. And ultimately, third-party assurance over these disclosures may become the norm.

Contact

Andrew Ross
Senior Manager, Sustainability & Climate Change, KPMG in Canada
514-840-2249
andrewross1@kpmg.ca

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