KPMG

ESG Guide for Audit Committees

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Introduction

Environmental, Social and Governance (ESG) risks and opportunities, as well as their impact on long-term value creation for both public and private organizations, are top of mind for investors and other stakeholders. This is leading to increasing demands from stakeholders, investors, regulatory bodies, employees, and others.

There is an increased emphasis on the management of ESG-related policies and practices from stakeholders such as investors, employees, and customers.

C-suite and board buy-in

ESG has evolved from a topic that is primarily owned by sustainability experts and teams to a C-suite and Board concern.

Access to capital

Investors increasingly factor in ESG considerations when making investment decisions, pushing ESG expectations downwards to portfolio companies.

Regulatory developments

ESG-related compliance costs and disclosure requirements continue to evolve, as securities commissions, supervisors, stock exchanges, and governments tighten the rules.

Reporting standards

Measurement and reporting of ESG-related information is maturing rapidly, as investor-centric disclosure standards are making headway (e.g. TCFD, SASB, ISSB)*

Societal pressure

Stakeholders increasingly scrutinize companies' ESG performance and transparency affecting project approval, brand acceptance, and consumer demand.

Climate change

Companies now accept that climate change equals financial risks. KPMG's Global CEO Report and the World Economic Forum identify climate change as the single greatest risk.

Enhanced risk management and investing returns

ESG integration has become an investment norm, with 75 percent of institutional investors now consider ESG factors to be "material" to their investment analysis.

Workforce of the future

ESG has become a key factor in attracting and retaining top talent, as employees are seeking purpose from their work.

* TCFD: Task Force on Climate-related Financial Disclosures
SASB: Sustainability Accounting Standards Board
ISSB: International Sustainability Standards Board

With a shift from voluntary to mandatory ESG disclosures expected in the next 1-2 years, the role of the Audit Committee in overseeing ESG reporting will become more critical. As with public-facing financial reports, the Audit Committee may have a fiduciary duty to ensure that ESG reporting is complete and accurate.

Accounting and auditing standards setters have issued formal guidance on climate-related matters in the application of their existing standards to published financial statements. This means that certain aspects of the company's climate-related information sources and processes will increasingly need to meet more stringent internal controls over financial reporting (ICOFR) requirements. As such, Audit Committees may need to oversee the potential ESG impacts to a company's financial statements, paying close attention to ensuring data integrity.

For Boards where ESG reporting falls under the purview of the Audit Committee, one of the biggest challenges the committee will face is staying aware of rapidly evolving ESG standards and regulations. This means keeping abreast of what is proposed, what is out for comment, and what is due to be finalized for implementation. Audit Committees will need to ensure that management is closely monitoring developments and providing regular updates going forward.

The purpose of this guide is to provide a current analysis of the various elements of ESG reporting that may fall within the Audit Committee's mandate.

Key takeaways from the guide include the following:

- What is the current state of ESG reporting standards and regulatory requirements?
- What are the potential climate risk-related impacts on financial statements and internal controls?
- What forms of external assurance can be provided to stakeholders?

This guide is a compilation of information from KPMG sources around the globe, including the U.S., U.K., Australia, and Canada. We have collated and tailored this information to efficiently inform Audit Committee members in Canada. We thank all members of our KPMG network who have contributed to this guide, and we hope you find it useful.

CHAPTER 1

Applicable sustainability reporting standards

Chapter Summary

- The ISSB, SEC, and EU proposals should all be on an Audit Committee's radar
- The CSA is awaiting finalization of ISSB and SEC proposals before updating its own proposals
- All of the proposals have commonality but also key differences
- Credibility of ESG reporting has become a concern globally

ESG issues continue to rise on investor agendas, and lenders are becoming increasingly focused on companies' exposure to climate-related risks. Poor ESG management practices pose environmental, legal, and reputational risks that can damage the company and have a lasting impact on the bottom line. By contrast, firms with strong ESG performance tend to have a more stable investor base, lower cost of capital, and better overall access to financing.

Increasingly, companies report on ESG because they have become signatories to global ESG-related principles and initiatives or have otherwise made highly publicized commitments to certain ESG targets (e.g., net zero, Indigenous reconciliation, biodiversity, and human rights etc.). They now need to hold themselves publicly accountable for their progress against those targets. For example, banks that sign on to the UN Principles for Responsible Banking must publish a disclosure statement detailing how they are complying with those principles. Similarly, investors who are signatories to the UN Principles for Responsible Investment must agree to manage their portfolios in accordance with the principles and make disclosures around their adherence. ESG performance requirements are then cascaded down to the companies in their loan and investment portfolios.

KPMG's Survey of Sustainability Reporting 2022 found that 94 percent of Canadian companies surveyed report on their sustainability efforts (up from 92 percent in 2020). There are currently no legal requirements for companies to make ESG or climate-related disclosures in Canada, so this reporting is largely voluntary. But change is on the horizon and mandatory ESG disclosures are coming.

The upcoming regulations vary by jurisdiction and industry. The Canadian Securities Administrators (CSA) released draft climate-related disclosure guidelines in October 2021, followed by the U.S. Securities and Exchange Commission (SEC) in March 2022, and the International Sustainability Standards Board (ISSB) in the spring of 2022. The EU has moved forward with its own broader sustainability disclosure requirements, the Corporate Sustainability Reporting Directive (CSRD), with the Council of the European Union adopting the proposal in November 2022.

This chapter will discuss these proposed regulations and standards, starting with a key existing reporting framework (TCFD) that acted as a key input for each proposal.

Task Force on Climate-related Financial Disclosures (TCFD)

The Task Force on Climate-related Financial Disclosures (TCFD) was established in 2015, with a commitment to market transparency and market stability for climate-related disclosures. The TCFD's recommendations have been widely adopted globally as best practice by organizations in all sectors, as well as regulators, influencing the CSA*, SEC, ISSB, and EU climate-related reporting proposals.

The TCFD has been a primary reporting framework for voluntary reporting of climate-related disclosures since 2017, with over 3,000 supporters as of January 2022[1]. The framework has 11 recommendations grouped into four pillars.

* CSA: Canadian Securities Administrators

[1] https://www.fsb-tcfd.org/about/

Companies are expected to report on the following areas:

Governance	Strategy	Risk Management	Metrics and Targets
Describe the Board's oversight of climate-related risks and opportunities.	Describe the climate-related risks and opportunities the company has identified over the short, medium, and long term.	Describe the organization's processes for identifying and assessing climate-related risks.	Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
Describe management's role in assessing and managing climate-related risks and opportunities.	Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.	Describe the organization's processes for managing climate-related risks.	Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks.
	Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	Describe the targets used by the organization to manage climate-related risks and opportunities, and performance against targets.

In the TCFD's 2022 Status Update, it remains clear that companies are lagging in fully meeting all of the TCFD's qualitative and quantitative disclosure requirements. For fiscal year 2021 reporting, only 4 percent of companies' disclosures were fully in line with all 11 recommended TCFD disclosures. While 80% of companies' disclosures were fully in line with at least one of the 11 recommended disclosures[2], only 40% managed to be fully in line with at least five.

International Sustainability Standards Board (ISSB)

The ISSB was established in November 2021 to produce sustainability disclosure standards and operates under the International Financial Reporting Standards (IFRS) Foundation, with the aim of establishing sustainability reporting in mainstream reports on the same footing as financial reporting.

The ISSB launched consultations on its first two proposed standards in March 2022:

- IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*
- IFRS S2 *Climate-related Disclosures*

These standards are being developed at a much faster pace than accounting standards, with the 120-day consultation period having closed in late July 2022 and finalization of both Standards expected in early 2023.

ISSB standards are investor focused and follow the four-pillar TCFD structure (in both the proposed general requirements standard and climate disclosure standard). In addition to overall disclosures aligned with the TCFD recommendations, appendix B of the climate

[2] Task Force on Climate-related Financial Disclosures 2022 Status Report

disclosure standard discusses industry-specific topics and metrics that may need to be disclosed, derived from the Sustainability Accounting Standards Board (SASB) framework. This appendix may serve as a useful starting point for companies in performing or updating their climate-risk assessments.

Individual jurisdictions will have to decide how to adopt the ISSB standards. In some jurisdictions, the standards will provide a baseline either to influence or to be incorporated into local requirements. Others may adopt the standards in their entirety, similar to the IFRS accounting standards. In Canada, similar to how the Accounting Standards Board (AcSB) has the authority to establish accounting standards for use by all Canadian entities in the private sector, the Canadian Sustainability Standard Board (CSSB) was announced in June 2022. The CSSB is intended to be operational by April 2023, with a mandate to streamline the adoption of sustainability standards in Canada.

Canadian Securities Administrators (CSA)

The CSA was ahead of many other securities regulators with its proposed National Instrument 51-107 *Disclosure of Climate-related Matters* in October 2021.

However, the proposal appears limited in comparison to the subsequent SEC and ISSB proposals, with a comply or explain requirement for Scope 1 and 2 emissions and no consideration given to financial statement implications. The CSA is now re-examining its requirements and is monitoring the finalization of the SEC and ISSB proposals. One key consideration may be to better align with the final SEC rules to maintain the SEC's proposed exemption for Canadian Multijurisdictional Disclosure System filers. Although the CSA disclosure requirements are expected to become more stringent in the finalized national instrument, the CSA will strive to strike a balance between expectations for large filers and the significant majority of Canadian public companies that are much smaller in size.

Securities and Exchange Commission (SEC)

In March 2022, the SEC issued its proposed rule, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, with the aim of providing investors with more consistent, comparable, and reliable information about how climate-related matters impact a company's business and financial results over time. The initial consultation period ended in June 2022 but was reopened, with a revised comment period ending in November 2022. The proposal is comprehensive and complex and would affect nearly every SEC registrant and likely filter down to private companies that SEC registrants do business with.

Of particular note is the impact the proposed rule would have on financial statement disclosures, including:

1. Separate disclosure of the total negative and positive impacts on financial statement line items from severe weather events, other natural conditions, and transition activities if these amounts exceed 1 percent of the related line item.
2. The aggregate expenditures incurred, and the amount expensed or capitalized related to mitigating climate-related events and managing transition activities if these amounts exceed 1 percent of the total amount expensed or capitalized.
3. Disclosure of contextual information that explains the metrics in (1) and (2), including significant inputs and assumptions, and policy decisions in calculating the metric.

In addition, companies would also need to disclose exposures to risks and uncertainties associated with climate-related risks that impacted the development of

the estimates and assumptions used in preparing the financial statements.

Outside of the financial statements, Scope 1 and 2 GHG emissions would need to be disclosed in all cases and Scope 3 emissions would need to be disclosed if material or included in a reporting issuer's emissions reduction target or goal. The flexibility given to Scope 3 is reflective of the challenges that most companies still face in quantifying these types of emissions. While Scope 1 emissions are generated directly from sources owned and/or operated by the company and Scope 2 refers to emissions generated indirectly from the consumption of purchased energy, Scope 3 emissions refer to emissions not produced by the company itself, but by those in the company's upstream and downstream value chain. For Scope 3 emissions, proxies and estimates with varying degrees of reliability are often used as it can be difficult to get GHG emissions information from third parties such as customers, suppliers, and vendors.

Scope 1 and Scope 2 GHG emissions disclosures by accelerated filers and large accelerated filers would be subject to assurance requirements in fiscal year 2024 and 2025, respectively, starting with limited assurance and moving toward reasonable assurance in future years.

European Financial Reporting Advisory Group (EFRAG)

In November 2022, the European Financial Reporting Advisory Group (EFRAG) approved the final version of the European Sustainability Reporting Standards (ESRS). These set out the rules and requirements for companies to report on sustainability-related impacts, opportunities, and risks under the EU's upcoming Corporate Sustainable Reporting Directive (CSRD). The initial drafts of the standards were released in May 2022 and were finalized following a 100-day consultation period.

The standards are multi-stakeholder focused, including but not limited to investors, and include a significantly wider reporting scope compared to the ISSB and SEC proposals. In the context of identifying ESG topics and metrics requiring disclosure, double materiality is an important element of the CSRD, which has not been considered by North American regulators as yet. Double materiality refers to two dimensions of materiality – both 'financial' and 'impact' (on people or the environment over short-, medium- or long-term horizons).

There are 12 components of the ESRS:

- Two are cross-cutting standards setting out general principles and general disclosure requirements for strategy, governance, and materiality assessments; and
- Ten are sector-agnostic standards that cover environmental, social, and governance sub-topics.

The standards would apply to all large companies in the European Union, including subsidiaries of foreign parent companies, with phased introduction starting in 2024. Public interest entities with more than 500 employees would need to apply ESRS for 2024 year-ends (reporting in 2025), other large companies that don't fall into the former criteria would need to comply for 2025 year-ends (reporting in 2026), and an ultimate non-EU parent company under the non-EU parent scoping would need to apply the applicable ESRS for its 2028 year-end (reporting in 2029).

In general, a Canadian company should investigate further whether they and/or their subsidiaries fall within scope if any of the following applies:

- They have an EU subsidiary for which two of the following apply: >€40M revenue, >250 employees, >€20M assets
- Consolidated group earns >€150M in revenue in the EU annually
- They plan to grow their operations in the EU

The CSRD will eventually apply to both public and private Canadian companies with "significant" activity in Europe. Although the impact on Canadian companies with European subsidiaries is expected to be limited in the near term, companies should begin to assess the EU requirements to alleviate the burden of future compliance and avoid overlooking relevant additional disclosure considerations.

Comparing sustainability reporting proposals

As the CSA, SEC, ISSB, and EFRAG proposals have various dimensions where they are not fully aligned, this will create practical challenges for organizations trying to design coherent and consistent reporting that meets the needs of both global investors and local jurisdictional requirements.

Companies will need to carefully consider their broader value chain for at least some sustainability disclosures, and this may bring companies into the scope of multiple frameworks if they are part of sub-consolidations or consolidated groups.

The remainder of this chapter provides additional detail to the Audit Committee and management to help understand key proposed requirements on the following topics:

- Where and when would ESG and climate information be disclosed?
- What greenhouse gas (GHG) emissions reporting would be required?
- When would they be effective?
- What assurance would be required?

Where and when would the information be disclosed?

	CSA	SEC	ISSB	EFRAG
Required in the audited financial statements?	No	Yes, for financial impact and expenditure metrics, plus financial estimates and assumptions	No, but permitted via cross-referencing	No
Required in the annual report?	Yes, climate-related governance would be in the Management Information Circular or AIF (or MD&A if the company does not file an AIF) Climate-related strategy, risk management, and metrics and targets in AIF (or MD&A if the company does not file an AIF)	Yes, in a separate section or by reference from another section (e.g. MD&A)	Yes, with flexible location requirements	Yes, in the management report
Cross-referencing permitted?	Yes	Yes, within the annual report	Yes, to documents outside general-purpose financial reporting, subject to conditions	Yes, within the management report
At the same time as financial statements?	Yes	Yes	Yes[1]	Yes

[1] ISSB is deliberating a short-term transitional relief period to publish following the release of their financial statements
Source: ISSB - General Sustainability-related Disclosures (Agenda Paper 3)

What GHG emissions reporting would be required?

	CSA	SEC	ISSB	EFRAG
Scope 1?	Yes – Comply or Explain	Yes	Yes	Yes
Scope 2?	Yes – Comply or Explain[2]	Yes[3]	Yes	Yes
Scope 3?	Yes – Comply or Explain[2]	Yes, if material or included in targets	Yes	Yes
Basis for organizational boundaries	Consistent with the GHG Protocol	Consistent with the financial statements based on control and share of equity-method investees	Consistent with the GHG Protocol	Consistent with the financial statements, but expanded to cover the broader value chain (including associates)
Intensity metrics?*	Not included in the proposal	Yes, based on revenue and a unit of production for the total of Scope 1 and 2, and separately for Scope 3 (if included)	Yes, based on a unit of output for each of Scopes 1,2 and 3	Yes, energy consumption, based on net turnover for the *total* of Scopes 1, 2, and 3 in 'high climate impact sectors'
Disclose targets?	No	Yes, if used	Yes	Yes, based on Paris Agreement
Requirements for assurance	No	Yes	No	Yes

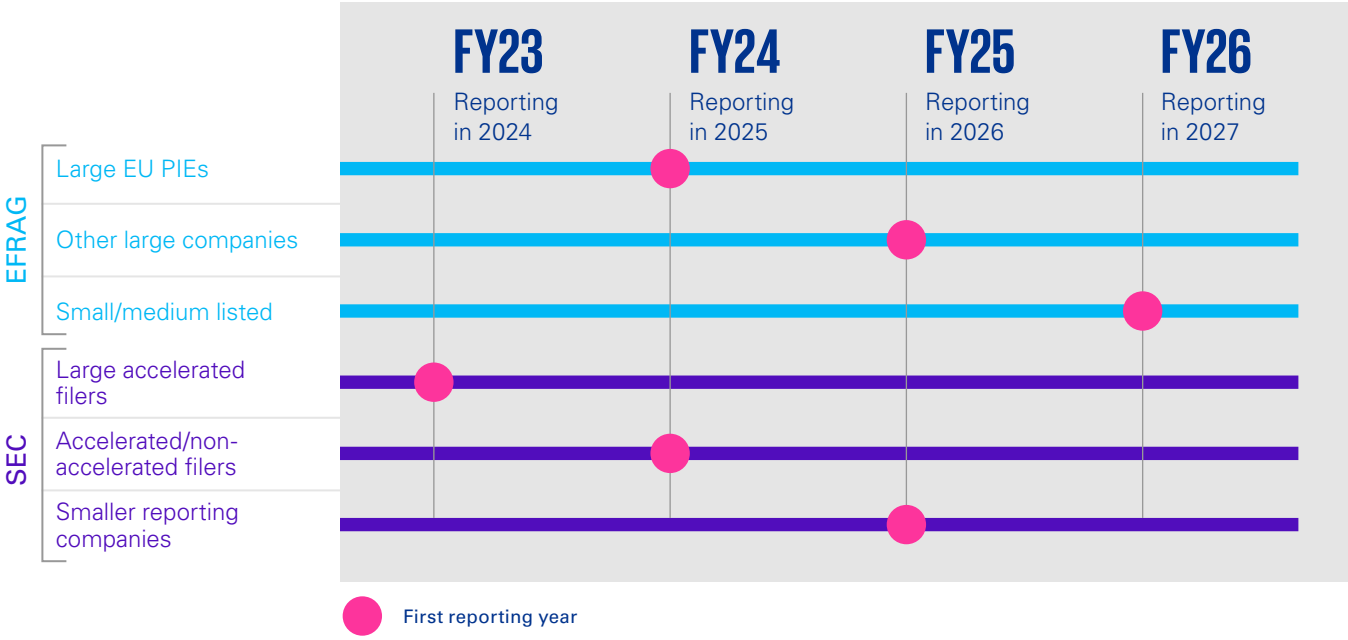
* Emissions Intensity is a ratio expressed as the volume of GHG emissions per unit of a specific activity, industrial production process or unit of economic output; for example *tonnes of CO2 per unit of product sold*.

[2] Scope 2 and 3 may be exempted using an "alternative approach" described in the proposed rule.

[3] Smaller reporting issuers would be exempted.

When would they be effective?

The following summarizes the proposed SEC and EFRAG effective dates:



Assuming that the CSA issues a revised proposal with an effective date of years commencing after December 31, 2023, these are the potential timelines for a Canadian reporting issuer:

	Financial Year	Filing Due Date
Non-venture issuer	December 31, 2024	March 2025
Venture issuer	December 31, 2026	April 2027

Both ISSB proposals will be effective from January 2024, with businesses beginning to collect information for the 2024 reporting cycle and publishing reports in 2025 – pending adoption by the various regulatory boards in each country.

What assurance would be required?

ISSB

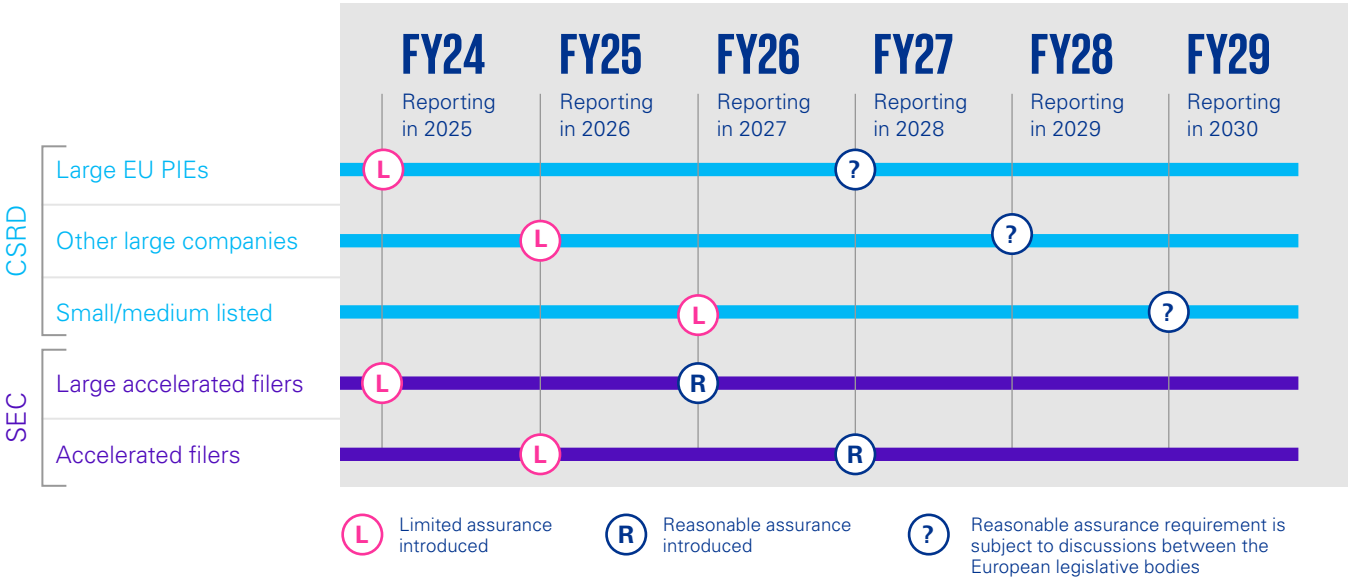
- Does not have the mandate to require assurance
- Instead, information is designed to be verifiable
- Local jurisdictions could chose to require either limited or reasonable assurance

EFRAG

- CSRD proposals would require assurance across all topics

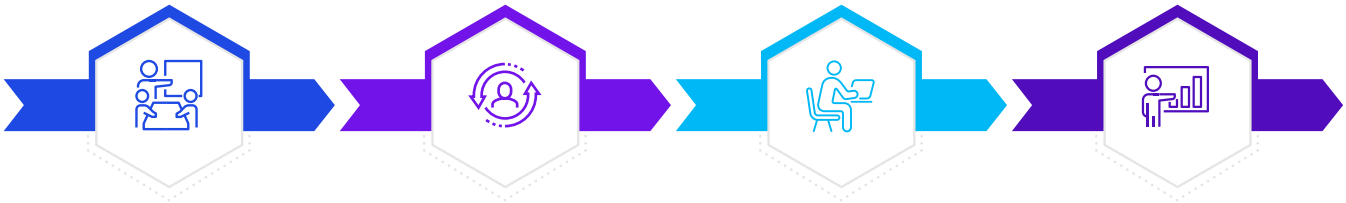
SEC

- SEC proposals would require assurance only on Scope 1 and Scope 2 GHG emissions



Considerations for the Audit Committee

Once the applicable standards and regulations above are finalized, the timelines for implementation will be short. Audit Committees should be proactively asking management about their implementation plans. These should include ensuring that everyone involved in the organization's external reporting receives the appropriate amount of training and education on ESG and climate-related priorities.



Educate your organization

... on the proposed requirements, including the people, processes, and technologies needed to accomplish what would be required across the frameworks.

Determine how ready you are

... by considering the impact of applying multiple frameworks across subsidiaries that would be subject to differing frameworks and how to apply the requirements at the most efficient level.

Develop your reporting readiness

... by taking stock of the differences between frameworks and how the various proposals would impact your disclosures and the need to enhance documentation, processes, systems, controls, and data quality of key disclosure.

Use data, technology, and analytics

... to foster better outcomes. Data can provide insights into market opportunities, leading practices, and large operating models. It can enable climate ambitions and enhance quality levers.

Credibility issues in ESG reporting

Against a backdrop of growing investor engagement on non-financial issues, organizations are ramping up their ESG commitments, especially those related to carbon reductions and 'net zero'. Some of these targets are linked to executive compensation. Amidst this trend, terms such as 'greenwashing', 'ESG washing' or 'carbon washing' are increasingly being used to refer to a growing risk of overstating ESG and climate commitments and performance. The consequences of exaggerating ESG efforts can be significant, including expensive litigation and reputational damage – and, potentially, the loss of social licence to operate. Audit Committee oversight of ESG reporting should include ensuring controls are in place to identify any instances where a company may be using unduly positive or misleading language to describe its ESG efforts.

It is also important for Audit Committees to insist on clear definitions and descriptions of the scope and methodology that is used to calculate ESG metrics that are disclosed. ESG-related metrics are likely to require significant assumptions and judgments, and, as generally accepted definitions may not yet exist, organizations may well define metrics differently from their peers. Clear disclosures will help readers understand what each metric represents and avoid misinterpreting the information provided.

CHAPTER 2

Climate-related impacts on financial statements and internal controls

Chapter Summary

- Certain industries are likely to have higher climate-related risks
- Climate-related risks can directly and indirectly impact financial statements
- Companies should be assessing the internal control environment for ESG reporting

Stakeholders are placing greater emphasis on the long-term success of companies and want to understand how ESG risks, including climate risks, may impact an entity and its operating environment, business model, and strategy. Disclosures will help inform the potential impact on enterprise value and the long-term prospects in a world transitioning to a low-carbon economy. Companies that do not have a mature climate strategy may increasingly see a negative impact on the valuation of their shares through higher risk premiums and/or less confidence in future growth.

An Audit Committee's mandate may include oversight of the entire Enterprise Risk Management (ERM) process, or this may be handled by a separate committee or the entire Board. This includes overseeing the integration of ESG in the ERM framework.

In all instances, Audit Committees need to understand the risks that ESG and particularly climate change could have on the judgments and assumptions used to make certain estimates in preparing the financial statements.

This chapter will discuss:

- key sectors impacted by climate-related risks;
- specific financial accounting and disclosure considerations; and
- climate-related risk impact on internal controls.

Key impacted sectors

Climate-related risks can either be physical or transition in nature. Physical risks pertain to the business' exposure to the possible acute and chronic physical effects of more frequent or severe flooding, storms, droughts, and sea level rise, while transition risks pertain to the business's exposure to policy, legal, market, technology, and other shifts that occur in mitigating climate-related risks. A summary of these risks is provided below.

Physical risks

Risk	Description	Potential financial impact
Acute	Event-driven, including increased frequency and severity of extreme weather events, such as hurricanes, cyclones, or floods.	– Loss of assets/operations – Reduced revenue from decreased production capacity (e.g. transport difficulties, supply chain disruption) – Increased operating costs (e.g. availability/cost of water) – Increased cost of maintenance and capital costs from damage to facilities – Increased insurance premiums/availability of insurance – Migration of growing areas
Chronic	Longer-term shifts in climate patterns (e.g. a sustained rise in temperatures) that may causes chronic heat waves and/or sea level rise.	

Source: The above content is based on information contained to *TCFD Recommendations of the Task Force on Climate-related Financial Disclosures*.

Transition risks

Risk	Description	Potential financial impact
Policy risk	Policy action that looks to constrain activity that contributes to adverse impact of climate changes or support adaptation.	– Increased operating costs (e.g. compliance costs, insurance premiums) – Write-offs, assets impairments, and early retirement
Legal risk	Increased likelihood of litigation associated with actual or potential losses associated with climate.	– Increased costs/reduced demand resulting from fines and judgments
Technology risk	Technological innovations or improvements that support the transition to a lower-carbon, energy-efficient economic system.	– Write-offs, asset impairments, and early retirement – Capital expenditures in technology developments – Loss of demand
Market risk	Varied and complex – includes shifts in demand and supply of products/ services.	– Reduced demand due to shift in consumer preferences – Increased production costs due to input prices (energy, water) and output requirements (waste treatments) – Abrupt and unexpected shifts in the cost of energy – Change in revenue mix and sources – Re-pricing of assets (e.g. fossil fuel reserves, valuations)
Reputation risk	Changing perceptions of an organization's contribution or detraction from the transition to a lower-carbon economy.	– Decrease in production capacity (e.g. delayed planning approvals, supply chain interruptions) – Reduction in capital availability – Decrease in productivity – staff quality/retention – Reduced demand due to shift in consumer preferences

Source: The above content is based on information contained to *TCFD Recommendations of the Task Force on Climate-related Financial Disclosures*.

The TCFD has identified the sectors, listed in the table below, that are expected to be the most impacted by climate-related risks. This list is not exhaustive and other sectors may be impacted as well. The nature and extent of risk to which an organization is exposed depends on its business model, the assets owned, services provided, and supply chains, among other factors.

Finance	Energy	Transportation	Materials and Buildings	Agriculture, Food and Forestry Products
Banks Insurance Companies Asset Owners Asset Managers	Oil and Gas Coal Electric Utilities	Air Freight Passenger Air and Transportation Maritime Transportation Rail Transportation Trucking Services Automobiles and components	Metals and Mining Chemicals Construction Materials Capital Goods Real Estate Management and Development	Beverage Agriculture Packaged Food and Meals Paper and Forest Product

It is important, particularly for organizations operating in sectors that are more significantly impacted by climate risks, such as those identified above, to consider the sufficiency of related disclosures made both inside and outside their financial statements.

Specific accounting and disclosure considerations for financial statements

Regulators and investors are increasingly expecting organizations to consider climate risk when preparing their annual reports, including both the MD&A and the financial statements. This places pressure on the often prevailing assumption among financial professionals that climate-related risks do not currently have a material quantitative impact on the recognition and measurement of assets and liabilities recognized in financial statements. For some organizations, this could lead to new disclosures relating to 'significant judgments' and 'sources of estimation uncertainty' regarding specific assets or liabilities in the notes to the financial statements.

Further, organizations need to consider how climate-related risks, including those disclosed outside the financial statements (for example, in the front section of annual reports or in sustainability reports), impact the amounts recognized and the disclosures included within the financial statements. Better connectivity between non-financial and financial reporting is key. Although the nature of the information provided outside the financial statements may differ, it needs to be consistent when appropriate. If key assumptions underlying the financial statements differ from those disclosed in the front part of the annual report – e.g. the potential outcomes from climate scenario analysis – then companies may need to explain that these outcomes do not represent best estimate assumptions. Similarly, if a company has made a 'net zero' commitment, the potential impacts on business segments and asset-carrying values will need to be addressed in preparing the financial statements.

For many organizations, there are a number of uncertainties when it comes to considering the potential climate impacts

on the recognition and measurement of assets and liabilities in their financial statements. Organizations will have to make judgments and apply assumptions to estimate the impacts of these risks on their financial statements by applying the requirements of existing accounting standards.

This chapter does not contain an exhaustive list of the potential financial reporting impacts of climate-related risks. Audit Committees should ask management probing questions regarding these and other potential ESG risks, and the materiality of these risks should be assessed.

Potential impact of climate-related risks on the financial statements

The following summary is focused on organizations reporting under IFRS. Management should be monitoring impacts of financial reporting on an ongoing basis, even when not yet identified as material.

Selected impacts of climate-related risks on the financial statements
Financial asset values – expected credit losses (ECLs)
Going concern
Impairment of non-financial assets
Provisions and contingent liabilities
Onerous contracts
Fair value measurement

Financial asset values – expected credit losses (ECLs)

Longer-term financial assets generally will have greater exposures to climate-related factors. Actual or expected adverse changes in the regulatory, economic, or technological environment of a borrower that are driven by climate-related risks could result in a significant change in a borrower's ability to meet its debt obligations.

The measurement of ECLs needs to consider information about past events and current conditions, as well as forecasts of future economic conditions. This is an area requiring significant judgment and measuring the impacts of climate risk continues to evolve in the calculation of ECLs.

Going concern

Entities in impacted sectors need to critically evaluate and reflect on cash flow forecasts developed to support a going concern assessment. Examples of how climate-related risks could impact cash flow forecasts include:

- Changing customer preferences and behaviour could reduce demand for goods and services.
- The sector could become stigmatized, in turn reducing or disrupting production capacity.
- Non-compliance with environmental regulations could result in significant fines and legal judgments.
- Costs could increase due to rising prices caused by carbon-pricing mechanisms.

Cash flow modelling needs to reflect any climate-related strategic plans approved by the Board.

Climate-related risks may impact a company's ability to obtain funding so that it can continue to meet its obligations. Lenders are increasingly focused on managing their exposure to climate-related risks and are starting to include environmental aspects in their credit pricing and their expected credit loss (ECL) decisions as follows:

- Lenders might consider environmental aspects when pricing a loan or even demand a premium or grant a discount on the interest rate when certain climate-related targets are missed or met (so-called 'sustainability linked loans').
- Asset managers might exclude bonds issued by companies in certain sectors from their portfolios or significantly reduce their exposure, driving up interest rates for affected companies.
- Covenants might include climate aspects – e.g. loan agreements may provide lenders with an opportunity to withdraw financing if the borrower exceeds a certain carbon emissions intensity.

As a result, companies in impacted sectors need to critically evaluate, and reflect in cash flow forecasts supporting their going concern assessment, their expectations of both:

- the cost of borrowing funds in the future; and
- any barriers to obtaining funding that could arise from lenders' climate risk management strategies, either announced or reasonably expected.

Impairment of non-financial assets

Additional developments in climate legislation or fundamental shifts in market demand for certain products due to climate concerns may impair non-financial assets. The cost of operating in a carbon-constrained world should be considered by organizations, particularly those in more emission-intensive sectors.

Provisions and contingent liabilities

Provisions are based on best estimates and key assumptions. New considerations include:

- Climate risks may speed up actions required under obligations for rehabilitation and restoration of sites, and, therefore, affect the amount of recognized provisions. Similarly, legislation or regulatory changes could increase the cost of decommissioning.
- Insurers may need to increase claims provisions for more immediate impacts of such acute – and more frequent – climate-related events as storms, fires, and floods.
- Organizations need to assess whether provisions for litigation or fines/penalties that have arisen from climate-related matters need to be recognized. This may also include cases where litigation is being brought by investors on the grounds of not appropriately considering climate risks.

If it is determined that no provision is required, the organization should also assess whether any disclosures relating to contingent liabilities need to be made.

Onerous contracts

Onerous contract provisions must be recognized where the unavoidable costs of meeting obligations under a contract exceed the economic benefits received. Climate-related risks may increase the costs of meeting contractual obligations and could give rise to onerous contracts that may need to be provided for.

Fair value measurement

Some assets that are measured at fair value may be heavily impacted by climate-related risks; for example, biological assets may be impacted by physical climate events such as droughts, floods, storms, and heat waves. These climate factors likely will influence a market participant's view of what they would be willing to pay for the asset given the risk uncertainties.

Other valuation considerations include:

- Inventory obsolescence: Climate-related factors may result in inventory becoming obsolete, selling prices changing, or inventory costs increasing. This may require inventory to be written down to its net realizable value.
- Recognition of deferred tax assets: The ability to generate future taxable profits may be impacted by climate-related factors. A reduction in an organization's estimate of future taxable profits may impact the recognition of deferred tax assets.
- Asset useful lives: The useful life of an asset represents the period of time the entity expects to derive benefit from that asset. Useful lives are an estimate that gets revisited each period. The useful lives of assets may be impacted by the decisions an organization makes today about the future of those assets, based on its response to climate-related risks and related commitments (e.g. 'net zero').

Disclosures of estimates and judgments

Organizations should consider any significant climate-related judgments and assumptions made that would impact the recognition and measurement of assets and liabilities that would be material to a user's understanding, and disclose this estimation uncertainty.

Internal controls

As organizations begin to articulate their goals and efforts to address ESG issues via public reporting, it is essential to build strong processes and effective internal controls. There is rapid change around ESG, which could make establishing the proper reporting environment challenging. Unlike internal control over financial reporting (ICFR), where the underlying financial statements have defined accounting frameworks, principles, and policies, ESG reporting outside of the financial statements is still largely in an evolving phase of identifying and applying the emerging standards and regulations discussed in Chapter 1. As such, many organizations' policies and processes around ESG reporting have not yet been fully developed. To prepare for mandatory ESG reporting, this control environment should be a key area for Audit Committees to focus on with management.

If organizations are disclosing information to investors about the steps they have taken to improve their ESG performance (e.g., reduce environmental impact and/or increase employee diversity), it is necessary for strong controls to be in place to ensure that the ESG data being communicated is complete, accurate, and governed by appropriate controls. Additionally, from a regulatory perspective, proposals by the CSA and SEC are expected to result in new disclosures in mainstream filings that will be subject to disclosure controls and procedure requirements (*National Instrument (NI) 52-109 – Certification of Disclosure in Issuers' Annual and Interim Filings* and the *Sarbanes–Oxley Act*, respectively). These certification programs are generally under the oversight of the Audit Committee.

The challenge with reporting on ESG metrics is that they are often non-financial in nature, are derived from multiple sources and systems within the organization, and to date have generally not been subject to rigorous policies and procedures that enable robust and consistent record keeping in the same manner as financial reporting data. The processes tend to be more manual and may differ among departments, business units, and geographical regions. This will inevitably pose challenges for implementing internal controls that can be applied consistently across the organization. Below are a few key

considerations for the Audit Committee to explore with management in this regard:

Defined policies and procedures

Organizations need documented definitions and principles for how their ESG reporting is prepared and presented. In some cases, there is an established standard that is accepted by almost all investors. For example, the GHG Protocol is widely recognized as a way to measure and report on emissions. However, there are many other metrics without established protocols that will require significant effort to define, measure, and control.

Support for estimates and assumptions

Particularly with ESG data, various estimates and assumptions are often used in preparing calculations. The rationale and support for such estimates and assumptions should be clearly documented and supported by reliable data.

Controls around key source reports

Appropriate controls should be in place to verify that source reports used for ESG data and calculations accurately capture information in a consistent, complete, and accurate manner.

Controls over third-party data

Even if data is from a third party, the company has responsibility for its accuracy and needs to ensure consistent measurement of data from third parties. Third-party data required for ESG measurement is often complex, especially climate-related emissions and risk data.

IT general controls

Systems used for ESG data need to have appropriate Information Technology general controls, including appropriate access, system development, and change management controls.

Homogeneity across processes, locations, and countries

Organizations should strive for processes and controls that are reasonably homogeneous and consistently applied across processes and locations. Arriving at common policies to define how data is defined, measured, captured, and controlled will be an initial challenge, particularly in larger, more global enterprises.

Evidence of secondary review and approval

ESG data and reporting should be subject to management reviews and approvals. Appropriate oversight by senior management is needed to validate the data, calculations, and presentation, as well as to challenge key assumptions and methodologies.

Governance over disclosures

A governance process needs to be established to define policies, oversee the entire ESG process – from the definition of strategy through to the disclosures being made – and ensure there are appropriate controls throughout. The Audit Committee and, ultimately, the Board are at the top of this governance process.

Finance functions, by their nature, have well-developed systems and processes designed to collect data across the organization. Additionally, because CFOs are experienced with regulatory and compliance filings, and associated governance and controls, they can provide valuable input into ESG reporting efforts.

Leading the ESG reporting efforts

Historically, the communication and reporting of ESG metrics were led by departments such as sustainability, investor relations, marketing, legal, and/or operations. However, with the expectation that regulatory proposals will result in extensive climate and human capital disclosures that will be covered by management certification programs and require the same level of rigor as financial reporting, many organizations are considering sharing this responsibility with the finance and accounting function.

CHAPTER 3

ESG external assurance

Chapter Summary

- Future mandatory assurance over ESG reporting is likely
- Limited assurance is the most common current form of opinion for ESG reporting
- Organizations should begin preparing for ESG assurance if not already doing so

Externally reported ESG information is increasingly material to understanding an organization's performance or financial position, including the impact of its activities on environmental and social matters. Assurance over non-financial ESG disclosures helps organizations build trust in the accuracy and reliability of what they disclose. External assurance can also provide Audit Committees and Boards with an added level of comfort concerning an organization's ESG performance against targets and commitments.

When Audit Committees are overseeing the management team's development of ESG reporting systems and processes, they need to be thinking about independent and objective assurance, and potentially seeking third-party advice on the adequacy and effectiveness of governance and risk management.

As discussed in Chapter 1, assurance is a growing part of the evolving mandatory ESG reporting standards. Leading companies are engaging early with their external assurance providers to ensure they are ready for assurance well before the assurance requirements become effective.

What assurance services can be provided?

External assurance for ESG data in Canada by assurance providers is typically performed following the Canadian Standards on Assurance Engagements (CSAE):

- CSAE 3000, Attestation Engagements Other than Audits or Reviews of Historical Financial Information
- CSAE 3410, Assurance Engagements on Greenhouse Gas Statements

The chart below describes certain types of ESG assurance an organization currently may obtain for voluntary purposes.

Type of assurance an organization may obtain	Description	Type(s) of information assured
Selected ESG metrics (e.g. within the Sustainability Report)	Assurance over historical non-financial information – including quantitative indicators – and alignment of policies and processes with principles-based frameworks.	Covers a wide range of ESG metrics included by an organization in its ESG reporting. Includes quantitative indicators in addition to alignment of policies and processes with principles-based frameworks. May include information over specific metrics included in ESG rating and ranking submissions* (e.g. CDP, GRESB).
Greenhouse Gas Emissions (GHG)	Assurance over Scope 1, 2, and/or 3 GHG emissions.	Reporting on carbon footprint of an organization. May include carbon neutral/net zero claims.
Green, social and sustainability-linked bonds or loans	Assurance over use of proceeds and/or impacts achieved via green, social, and sustainability bond issuances. Assurance over key performance targets for sustainability-linked loans.	Common loan/bond metrics: – Use of proceeds – Environment and / or social KPIs – Progress against targets

* A questionnaire or disclosure form submitted by an entity to a third-party rating or ranking agency to assess ESG performance.

Levels of assurance

Organizations can choose between two levels of external assurance: limited assurance and reasonable assurance.

Below is a comparison of Limited and Reasonable Assurance.

	Limited Assurance	Reasonable Assurance
Opinion	A negative assurance opinion is provided (e.g., 'nothing has come to our attention that causes us to believe that the information is materiality misstated')	A positive assurance opinion is provided (e.g., 'in our opinion, the information is presented fairly')
Relevant assurance procedures	Procedures performed can include: – inquiry – observation – analytical procedures – non-statistical sample testing (low sample sizes) – recalculations in certain situations	Similar procedures used in limited assurance in addition to: – test of the design and implementation and operating effectiveness of internal controls – statistical sampling (larger sample sizes) – extensive recalculations and reconciliations

Many organizations are not initially ready to obtain reasonable assurance on ESG disclosures in an efficient and cost-effective manner, due to a lack of maturity and formalization of systems relating to non-financial reporting.

Getting ready for assurance – what do organizations need to be thinking about now?

Audit Committees should be asking management how ESG data is being collected, measured, and reported. Many organizations have standalone ESG teams that are responsible for ESG-related reporting but lack expertise around design, implementation, and operation of internal controls over non-financial data. Finance may be able to offer advice and leadership to the broader organization given their knowledge of the control systems and processes used for financial reporting. This will become increasingly important as organizations start to seek assurance and/or start down the path toward integrating ESG information into their annual reporting.

Prior to committing to an assurance engagement, it is recommended that companies have a readiness assessment performed to determine which areas are ready for reporting and/or assurance and which areas need further improvement. This will involve Internal Audit or a third party looking at whether the organization's criteria for ESG measurement (the definitions of how aspects of ESG are measured) are specific and clear, and whether sufficient evidence is available and in line with the criteria expected to be used to measure underlying subject matter.

Understanding what these preconditions for assurance are and performing an assurance readiness engagement will help organizations reduce the risk of encountering issues in the future that may lead to a scope limitation or modified assurance opinion.

Audit Committees should work with management to identify which metrics would be considered material to stakeholders and the business, and therefore merit assurance. For example, labour conditions in the supply chain could be a key area in which a retail organization's customers may want assurance, while shareholders of a consumer goods organization may want assurance on claims of sustainable sourcing.

It is essential that what organizations report to the public is accurate, robust and credible. Aside from being a regulatory compliance requirement in some cases, assurance services will give organizations the opportunity to test any significant judgments they may have made in measuring ESG metrics, spur investor confidence, reduce exposure to risks, and support in securing access to better financing. This will be a key activity as you embark or continue to make progress in your organization's ESG reporting journey.

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