KPMG

ESG Guide for Audit Committees

KPMG Board Leadership Centre

Contents

The KPMG Board Leadership Centre

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

Learn more at www.kpmg.com/uk/blc.

Introduction

Environmental, Social and Governance (ESG) risks and opportunities, as well as their effect on long-term value creation for both public and private companies, 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 level 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 stock exchanges, supervisors, securities regulators and governments tighten the rules.

Reporting standards

Measurement and reporting of ESG-related information is maturing rapidly, with the three main ESG reporting frameworks finalised (i.e., IFRS SDS, CRSD-ESRSs and the SEC Climate rule).[1, 2]

Societal pressure

Stakeholders increasingly scrutinise companies' ESG performance and transparency affecting brand acceptance and consumer demand.

Climate change

Companies now accept that climate change has financial risks. KPMG's Global CEO Report and the World Economic Forum identifies climate change as the single greatest risk facing the world over the next decade.

Enhanced risk management and investing returns

The use of corporate ESG information continues to increase, with investors including ESG-related factors in their investment analysis and decision making, as well as in their engagement with companies.

Workforce of the future

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

1 IFRS SDS: IFRS Sustainability Disclosure Standards, CSRD: Corporate Sustainability Reporting Directive, ESRS: European Sustainability Reporting Standards.

2 On April 4, 2024 the Securities and Exchange Commission (SEC) issued an Order to stay (or pause) its climate rule. The SEC believes the stay is warranted pending upcoming judicial review following legal challenges. Find more here.

Sustainability reporting is developing quickly, with new requirements from the ISSB, EU and the US SEC, on top of the recommendations from the Task force on Climate-related Financial Disclosures (TCFD) already in force in the UK.

Accounting and auditing standard 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 including sources and processes will increasingly need to meet more stringent internal controls.

For Boards where ESG reporting falls under the purview of the Audit Committee, the committee has a critical role to ensure that the reporting information is complete, accurate, and understandable. One of the biggest challenges the committee will face is staying aware of rapidly evolving ESG standards and regulations given the rapidly changing landscape. This means keeping abreast of what is now in force and ready for implementation, as well as what is on the horizon that should be taken into consideration now. Audit Committees will need to ensure that management is closely monitoring these developments and providing regular updates going forward.

Under the updated Financial Conduct Authority's (FCA) Listing Rules[1], companies listed on the UK main market are required to apply the UK Corporate Governance Code ("the Code"). The Code sets out that the Board should establish an Audit Committee whose roles and responsibilities, amongst others, include:

- Monitoring the integrity of the financial statements of the company and significant financial reporting judgements contained in those financial statements.
- Reviewing the company's risk management and internal control framework, unless handled by a separate board risk committee or the entire Board.

Although the Code does not specifically refer to ESG matters, given the increased focus and importance of this topic, the Board will need to ensure that that there are appropriate risk management processes and controls over ESG matters where relevant, and assess their impact on the financial statements.

For companies in the new transition category (previously known as the standard listed companies)[1], other listed companies (e.g. AIM companies) and certain large private UK companies[2] that may apply the Wates Corporate Governance Principles rather than the Code, those Principles also establish the need for formal and robust internal processes to ensure systems and controls are operating effectively.

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

Takeaways from the guide include the following:

- The current state of the main ESG reporting standards and regulatory requirements.
- The potential climate-related impacts on financial statements and internal controls.
- The different forms of external assurance that can be provided to stakeholders.

This guide is a compilation of information from KPMG sources around the globe, including the UK, EU, US and Canada. We have collated and tailored this information to efficiently inform Audit Committee members in the UK. I thank all members of our KPMG network who have contributed to this guide. I would also like to thank Almudena Cossio, Manisha Santchurn and Rachel Poole without who's help this guide would not have been possible. I hope you find it useful.

Timothy Copnell
Chair
Board Leadership Centre

1 The FCA has made significant changes to the listing rules which are effective from 29 July 2024. The Premium and Standard segments of the main market have been replaced by a single segment for commercial company equity shares. Companies listed on the UK main market are now required to apply Code. This will impact companies which would previously have been standard listed (premium listed were already in scope). Standard listed companies that choose to continue in the transition category are not required to comply.

2 Private companies that meet either or both of the following: (a) more than 2,000 employees; and/or (b) a turnover of more than £200 million, and a balance sheet of more than £2 billion.

Chapter 02

Applicable sustainability reporting standards

Chapter Summary

- The IFRS Sustainability Disclosure Standards, the European CSRD and ESRSs, and the SEC climate rule should be on an Audit Committee’s radar.
- All of the standards have commonalities but also key differences.
- Credibility of ESG reporting has become a concern globally.

ESG issues continue to rise on investors' agendas, as they become increasingly focused on companies' exposure to sustainability-related risks and opportunities. 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.

There is now a clear shift from voluntary to mandatory ESG reporting. Previously, companies were able to make highly publicised commitments (e.g. net zero, biodiversity, human rights, etc.) without holding themselves accountable or being held accountable for meeting those commitments. However, now with mandatory ESG reporting and increased stakeholder focus, companies now need to hold themselves publicly accountable for their progress against those targets.

In June 2023, the International Sustainability Standards Board (ISSB) released their first two standards, IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2 *Climate-related Disclosures*. IFRS S1 requires the disclosure of all sustainability-related risks and opportunities for a company and mandates the consideration of the sector-focused SASB standards when assessing the material information to report on. Jurisdictions around the globe are assessing whether and when to adopt them. In the UK, the Government aims to make a decision on endorsement in early 2025.

Furthermore, many UK companies are affected by the extraterritorial reach of the European Corporate Sustainability Reporting Directive (CSRD) and the European Sustainability Reporting Standards (ESRS), which have been in forced since January 2024 with different effective dates based on specific criteria and thresholds. These standards are detailed, complex and again cover all sustainability-related topics.

In addition, subject to a judicial review, the US SEC climate rule will be phased in for fiscal years beginning in calendar year January 2025. This rule applies to Foreign Private Issuers (FPIs) and, unlike IFRS SDS and CSRD/ESRSs, it focuses only on climate-related risks.

Despite the clear shift from voluntary to mandatory ESG reporting, the voluntary approach can still be a strategic way for early adopters to embed change in their organizations early. One such example would be the application of the recommendations from the Taskforce on Nature-related Financial Disclosures (TNFD) released in September 2023.

This chapter will discuss these current and emerging ESG reporting requirements, focusing on the mandatory requirements.

Task Force on Climate-related Financial Disclosures (TCFD)

The Task Force on Climate-related Financial Disclosures (TCFD) was established in 2015, as a framework for organisations to embed climate considerations into their business, and transparently report the actions taken to understand their exposure and how they are managing this. The TCFD's recommendations have been widely adopted globally as best practice and, in the UK, it is mandatory for companies listed on the UK main market.

The framework has eleven recommended disclosures grouped into the four pillars included below which have formed the basis for preparation of the sustainability-related disclosures required under the three new frameworks.

The recommended TCFD disclosures are as follows:

Governance	Strategy	Risk Management	Metrics / 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 company's processes for identifying and assessing climate-related risks.	Disclose the metrics used by the company 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 company's businesses, strategy, and financial planning.	Describe the company'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 company'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 company's overall risk management.	Describe the targets used by the company to manage climate-related risks and opportunities, and performance against targets.

In the TCFD's 2023 Status Update, it remains clear that while TCFD-aligned information continues to grow, companies are lagging in fully meeting all of the TCFD's qualitative and quantitative disclosure recommendations. The TCFD's 2023 Status Update highlighted that for 2022 reporting, only 4 percent of companies' disclosures were fully in line with all 11 recommended TCFD disclosures, while 58% of companies disclosed in line with at least five of the 11 recommended disclosures – up to 18% in 2020.

In the UK, the Financial Reporting Council (FRC) thematic review published on 26 July 2023 examined the quality of climate-related metrics and targets disclosures. The review analysed TCFD disclosures from 20 companies' 2022 annual reports across four sectors: materials and buildings, energy, banks, and asset managers. It identified areas of better reporting practice as well as opportunities for improvement. Key findings showed an incremental improvement in the quality of companies' disclosure of net zero commitments and interim emissions targets.

However, disclosures of concrete actions and milestones to meet targets were sometimes unclear, and that comparability of metrics between companies remains challenging. The review also found that explanations of how climate targets affect financial statements still need improvement. Boilerplate language on climate being 'considered' provides little insight on impacts.

IFRS Sustainability Disclosure Standards

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 released its first two Sustainability Disclosure Standards in June 2023:

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

These standards are investor focused and follow the four-pillar TCFD structure. In addition to overall disclosures aligned with the TCFD recommendations, the standards require industry-specific disclosures. They include industry specific guidance and reference the Sustainability Accounting Standards Board (SASB) standards.

The standards are effective from 1 January 2024, but it will be for individual jurisdictions to decide whether and when to adopt. With support from global bodies including the International Organisation of Securities Commissions (IOSCO), adoption is expected in several jurisdictions. 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.

Many jurisdictions around the globe are progressing their plans for the adoption of these standards, including Canada, Australia, Brazil, Japan, Hong Kong, Singapore and others. In the UK, the Governments has established two committees to assist with the assessment and endorsement of IFRS S1 and IFRS S2: 1) the UK Sustainability Disclosure Technical Advisory Committee (TAC), and 2) the UK Sustainability Disclosure Policy and Implementation Committee (PIC). The UK Government aims to make an endorsement decision by early 2025.

EU CSRD and ESRS

On July 31, 2023, the European Commission adopted the European Sustainability Reporting Standards (ESRS). These set out the requirements for companies to report on sustainability-related impacts, risks and opportunities under the EU's Corporate Sustainable Reporting Directive (CSRD).

The standards are multi-stakeholder focused, including investors and others. In the context of identifying ESG topics and metrics requiring disclosure, the so-called 'double materiality' approach is an important element of the ESRSs. Double materiality requires companies to make two separate materiality assessments – 'financial' and 'impact'.

Under ESRS, financial materiality requires disclosure of sustainability-related matters that (may) trigger material financial effects on a company's development, e.g., cash flows, financial position or financial performance. Impact materiality requires disclosure of sustainability-related matters that relate to a company's material actual or potential, positive or negative, impacts on people or the environment.

Companies will need to disclose information that is material from either a financial perspective or an impact perspective, or both.

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

The standards apply to all large companies in the European Union, including subsidiaries of foreign parent companies, with phased introduction starting in 2024, reporting in 2025. Furthermore, EU subsidiaries or branches of non-EU groups with a significant presence in the EU will be required to make additional 'reduced' ESRS disclosures for 2028 year-ends (reporting in 2029) of the global operations of the non-EU parent.

In general, a UK company should investigate whether they and/or their subsidiaries are within the scope of CSRD if any of the following applies:

- They have debt or equity securities listed on an EU Regulated Market.
- They have an EU subsidiary for which two of the following apply: >€50M revenue, >250 employees, >€25M assets.
- The consolidated group earns >€150M in revenue generated in the EU annually.
- They plan to grow their operations in the EU.

US SEC and State Climate Disclosure Rules

On March 6, 2024, the SEC issued its climate disclosure rule, SEC Release Nos. 33-11275; 34-99678, *The Enhancement and Standardisation of Climate-Related Disclosures for Investors.* In April 2024, the SEC issued an order to stay (i.e. pause) this rule given ongoing litigation.

While the outcome of the judicial review is uncertain, the rule as written requires nearly all SEC registrants, including FPIs, to provide climate-related disclosures in their annual report or registration statement.

There are two distinct components to the disclosures:

- Reg S-X financial statement disclosures, which will be part of the audited financial statements and therefore in the scope of the registrant's internal control over financial reporting (ICOFR).
- Reg S-K climate-related disclosures in the registrant's annual report or registration statement. These disclosures can be included in a separately captioned 'Climate-related Disclosure' section of the annual report or registration statement, or incorporated by reference from another section.

The Reg S-X financial statement disclosures relate to:

- Severe weather events and other natural conditions, which are not defined terms; and
- Carbon offsets or renewable energy credits or certificates (RECs).

For each financial statement effect disclosed, the registrant needs to describe appropriate contextual information, such as significant inputs and assumptions used, and significant judgments made.

The Reg S-K climate-related disclosures include information about:

- Scopes 1 and/or 2 GHG emissions, if material, for large accelerated filers and accelerated filers (except for smaller reporting companies and emerging growth companies), subject to phased-in assurance requirements;
- Governance, oversight and risk management processes of climate-related risks;
- Any climate-related risks that have materially impacted or are reasonably likely to have a material impact in the short-term (the next 12 months) and long-term (>12 months) – including on the registrant's strategy, results of operations or financial condition;
- Transition plans and climate-related targets or goals if certain conditions are met.

Disclosures about scenario analysis, internal carbon pricing, and offsets and RECs are also required if certain conditions are met.

The effective date is for fiscal years beginning in calendar year 2025 for large accelerated filers. Registrants will first be required to present the Reg S-X financial statement disclosures and most Reg S-K climate risk disclosures; other disclosures, including GHG emissions, follow one year later and assurance on GHG emissions three years after that. Other filers trail by one to two years to the extent requirements apply.

In addition to the SEC Climate disclosure rule, in October 2023 California became the first state in the US to adopt broad climate reporting laws that will require large businesses to report on GHG emissions and climate-related financial risk. These laws join a suite of sustainability reporting relative to GHG emissions and climate-related financial risks and may shape climate reporting in other states and/or nationally.

Comparing reporting standards

The IFRS SDS, the European CSRD/ESRSs and the SEC climate disclosure rule are not fully aligned. This will create practical challenges for companies trying to design coherent and consistent reporting that meets multiple jurisdictional requirements.

The remainder of this chapter provides additional detail to help Audit Committees and management understand the following:

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

Where and when is the information to be disclosed?

	TCFD	IFRS SDS	EU CSRD[1]	US SEC climate rule
Required in the audited financial statements?	No	No, but permitted via cross-referencing.	No	Yes, certain quantitative and qualitative information about severe weather events and other natural conditions, material effects on financial estimates/assumptions, and carbon offsets or renewable energy credits.
Required in the annual report?	No	Yes, with flexible location requirements.	Yes, in the management report in a sustainability statement.	Yes, in a separate section (climate-related disclosure) or incorporated by reference from another section (e.g. MD&A).
Cross-referencing permitted?	Yes	Yes, to documents outside general purpose financial reports, subject to conditions.	Yes, to a limited extent, within specific locations and subject to conditions.	Yes, within the annual report
At the same time as financial statements?	Yes	Yes	Yes	Yes, with some relief for GHG emissions.

1 Incorporates ESRS requirements.

.

What GHG emissions reporting is required?

	TCFD	IFRS SDS	EU CSRD[3]	US SEC
Scope 1	Yes	Yes	Yes	Yes[1], if material
Scope 2	Yes	Yes	Yes	Yes[1], if material
Scope 3	Yes	Yes, if material[2]	Yes	Not required
Basis for organisational boundaries	GHG Protocol – operational or financial control, or equity share.	GHG Protocol – operational or financial control, or equity share.	Operational control defined per ESRS.	Not prescribed
Intensity metrics?	Not required	Not required	Yes, based on net revenue for the total of Scope 1, 2 and 3 emissions.	Not required

	TCFD	IFRS SDS	EU CSRD[3]	US SEC
Disclose targets?	Yes	Yes	Yes, if used	Yes, if material
Requirements for assurance	No	Subject to local jurisdictions	Yes	Yes

1 Non-accelerated filers, smaller reporting companies and emerging growth companies are exempt.
2 The ISSB's climate standard gives reliefs for companies disclosing Scope 3 emissions to help address data availability and quality challenges.
3 Incorporates ESRS requirements.

When are they effective?

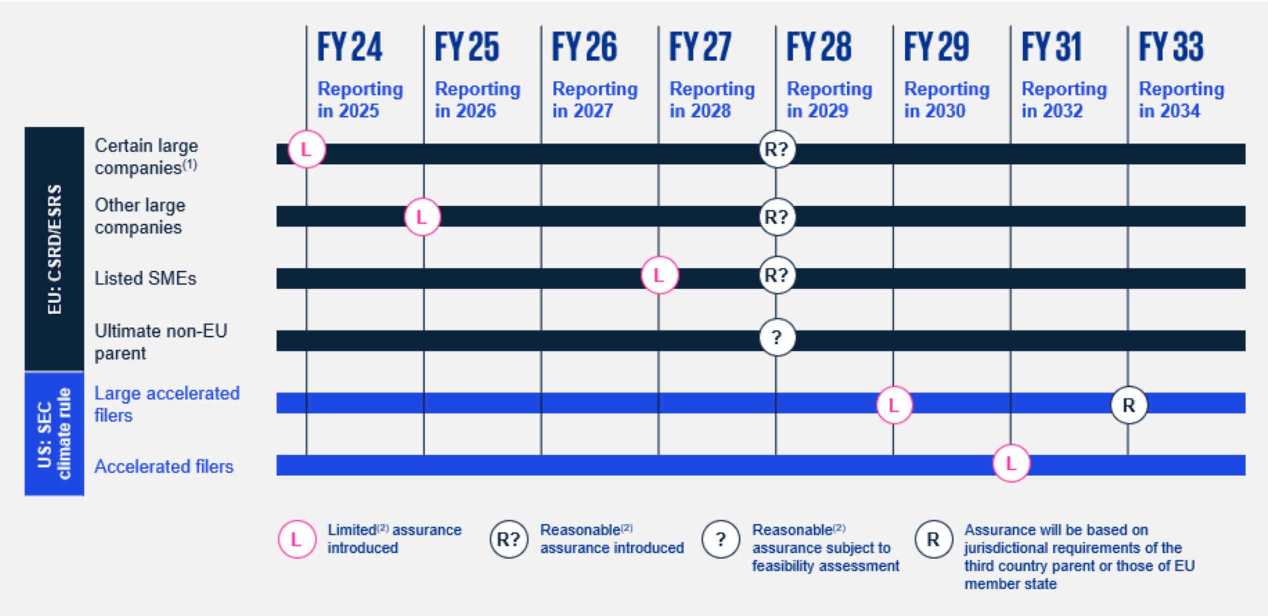
IFRS SDS	EU CSRD[2]	SEC[1]
• Effective date of 1 January 2024 – i.e. reporting in 2025. • However, local jurisdictions decide when the requirements will apply. • A climate-first option is available in the first year of reporting.	• Applies for years beginning on or after 1 January 2024 – i.e. reporting in 2025. • Phased introduction has started for certain EU PIEs or non-EU companies with securities listed on an EU Regulated Market.	• First applies for large accelerated filers for fiscal years beginning in calendar year 2025. • Disclosure of some information outside the financial statements (including GHG emissions) is deferred for at least one year.

1 On 4 April 2024 the SEC issued an Order to stay (or pause) its climate rule. The SEC believes the stay is warranted pending upcoming judicial review following legal challenges. Find more here.
2 Incorporates ESRS requirements.

What assurance is required?

IFRS SDS	EU CSRD[3]	SEC
• Local jurisdictions could choose whether to require either limited or reasonable assurance. • Information is designed to be verifiable.	• Requires limited assurance initially, moving to reasonable assurance over time. • Reasonable assurance standards to be adopted after feasibility assessment no later than 1 October 2028.	• Scopes 1 and 2 GHG emissions will be subject to assurance. • Limited assurance will be required three years after the disclosures are first required. • For large accelerated filers only, reasonable assurance will be required four years later (a total of seven years after disclosures are required).

1 Certain large companies with listed securities on EU-regulated markets and more than 500 employees.
2 The assurance requirements have no bearing on a company's responsibility to report accurate information from the first reporting year – i.e. limited assurance does not mean limited reporting.
3 Incorporates ESRS requirements.



See Chapter 3 for more information on assurance.

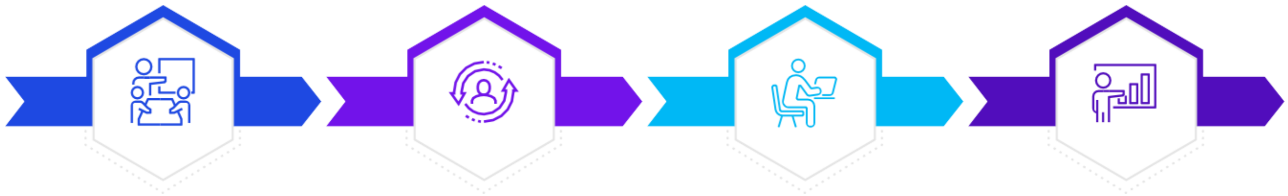
Audit Committees Considerations

With the ESG reporting frameworks finalised and ready to be endorsed or adopted, this is a trigger for companies to get ready to report. Audit Committees should be proactively asking management about their implementation plans. These should include ensuring that everyone involved in the company's external reporting receives the appropriate training and education on ESG and climate-related priorities and the reporting frameworks.

Going forward, there will be an increase in the volume of disclosures that need to be connected to the financial statements. IFRS SDS, for example, refers to the information disclosed as 'sustainability-related financial disclosures'; demonstrating that disclosures need to be connected with information in the financial statements, and is not a disconnected exercise.

Finance and sustainability teams will need to work closely together to ensure the information disclosed is complementary and based on the same facts and circumstances. Although the sustainability-related information may differ in nature from information presented in the financial statements, it needs to be consistent to the extent possible, for example period covered or reporting entity. This is required regardless of whether financial statements are prepared under IFRS Accounting Standards or other generally accepted accounting principles.

Companies will need processes and controls in place so that they can provide sustainability-related information of the same quality, and at the same time, as their financial statements.



Educate your organisation	Determine how ready you are	Assess your reporting and assurance readiness	Use data, technology, and analytics
... on the new requirements, including the people, processes, and technologies needed to accomplish what would be required across the applicable frameworks.	... to adopt the requirements in the most efficient way, particularly where multiple frameworks are applicable.	... by taking stock of the need to enhance documentation, processes, systems, controls, and data quality of disclosure.	... to enable optimal results. Data can provide insights into market opportunities, leading practices, and large operating models.

Credibility issues in ESG reporting

Against a backdrop of growing investor engagement on sustainability issues, companies are ramping up their ESG commitments, especially those related to carbon reductions and net zero. Some of these targets are now linked to executive remuneration.

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 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 when 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 companies may define metrics differently from their peers. Clear disclosures will help readers understand what each metric represents and avoid misinterpreting the information provided.

Chapter 03

Climate-related matters and impacts on financial statements and internal controls

Chapter Summary

- All companies are facing climate-related risks and opportunities; however certain industries are likely to be more affected.
- Investors, regulators and other stakeholders are increasingly demanding more transparency on the effects of climate-related matters on the financial statements.
- IFRS Accounting Standards do not refer explicitly to climate-related matters, but they implicitly require consideration of these matters and relevant disclosures in the financial statements when climate-related matters are material.
- Implementing an effective internal control environment around ESG should also be a top priority for companies.

Stakeholders increasingly want to understand how ESG, including climate risks and opportunities, may impact a company, including its business model, strategy and financial performance. Disclosure of this information will help investors and others understand the potential effect on enterprise value and the long-term growth prospects in a world transitioning to a low-carbon economy.

This chapter will discuss:

- The sectors most impacted by climate-related risks.
- Certain financial accounting and disclosure considerations.
- The need for effective internal controls over ESG matters.

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. Transition risks pertain to the business's exposure to changes in 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 on the *TCFD Recommendations*.

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.

Risk		Description	Potential financial impact
	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 a company'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, including 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 affected the most by climate-related risks. This list is not exhaustive and other sectors may be affected as well. The nature and extent of risk to which a company is exposed depends on its business model, the assets owned, services provided, and supply chains, amongst other factors.

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

It is important, particularly for companies operating in sectors that are more significantly affected by climate risks, to consider the effect on the business model, strategy and financial performance along with the adequacy of related disclosures made both inside and outside their financial statements.

Accounting and disclosure considerations for financial statements

Regulators, investors and other bodies[1] are increasingly expecting companies to consider climate risks when preparing their financial statements. This places pressure on the often-prevailing assumption among financial professionals that in many cases climate- related risks[2] do not currently have a material quantitative effect on the recognition and measurement of assets and liabilities recognised in financial statements.

Companies need to make materiality judgements when deciding what information about climate related risks to disclose in the financial statements. Under IFRS Accounting Standards, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that primary users of financial statements make on the basis of those financial statements.

Management will need to perform a detailed analysis before reaching the conclusion that there are no material impacts on the recognition and measurement of assets and liabilities affected by climate-related risks.

Management may still need to provide disclosures in the financial statements to note how they have considered the impact of climate-related matters and the conclusions reached. Such information could be qualitatively material to investors and other users of the financial statements.

Better connectivity between non-financial and financial reporting is critical. The financial statements should clearly explain how the discussion in the narrative section of annual report and accounts has been considered and reflected in the financial statements – for example, how the transition plans discussed in the strategic report or TCFD disclosures have been incorporated into cash flow projections used in impairment testing of non-current assets such as PPE and goodwill.

When information disclosed in the front half of the annual report and accounts differs from the assumptions used in financial statements - for example, when data and assumptions used in transition plans differ from those used in management's best estimate for impairment testing– companies may need to explain, in the notes to the financial statements, how they differ and what effect the different assumptions/data may have on the financial statements.

For many companies, there are a number of uncertainties when assessing the potential climate impacts on their financial statements. Companies will need to apply the requirements of IFRS Accounting Standards and make judgements and apply assumptions to assess and estimate the effect of these risks on their financial statements. The significance of the effect will vary by company and will depend on multiple factors, including its industry, geographic location, applicable laws and regulations and the goods/services it provides to customers.

As such, this chapter does not provide an exhaustive list of the potential financial reporting effects of climate-related risks. The chapter discusses selected financial statement effects considered to be relevant for companies and applicable to a range of sectors and highlights examples of other potential areas of effect. Audit Committees should use these or other relevant material to ask management questions regarding their consideration of the effect of climate-related matters on the financial statements.

[1] The International Accounting Standard Board (IASB) has issued educational materials to support the consistent application of requirements in IFRS Accounting Standards. In March 2023, the IASB also started a project to explore targeted actions to improve the reporting of the effects of climate-related risks in the financial statements. As part of this project, in July 2024, the IASB published an Exposure Draft proposing eight examples to illustrate how an entity applies the requirements in IFRS Accounting Standards to report the effects of climate-related and other uncertainties in its financial statements.

2 Whilst this discussion focusses on the impact of climate related matters on financial statements, management should also consider the impact of the other ESG matters.

Potential effects of climate-related risks on the financial statements

The following summary is focused on companies reporting under IFRS Accounting Standards.

Sources of estimation uncertainty and significant judgements

Climate-related assumptions could result in a significant risk of material adjustments to the carrying amount of assets and liabilities within the next financial year. Where this is the case, management is required to provide relevant information to help investors understand the assumptions that have been made. Those disclosures should include the nature of the assumptions, the carrying amounts of the assets and liabilities and sensitivity of the carrying amounts to reasonable possible changes in these assumptions, where relevant.

Where climate-related assumptions are expected to have a material impact over a longer timeframe than the next financial year, for example, a change in the estimated useful life of an asset as a result of physical risks. The FRC expects these estimates to be clearly distinguished from those that could result in significant risk of material adjustments in the next financial year.

In addition, disclosure about climate-related judgements (apart from those involving estimation) that management has made and has the most significant effect on the amounts in the financial statements need to be provided.

Impairment of non-financial assets

Climate-related matters may: (i) give rise to indications that an asset is impaired, for example, developments in climate legislation or changes in demand for products due to climate concerns, and (ii) affect the assumptions about future cash flows that management makes in estimating the recoverable amount[1] of the asset. Management may need to apply significant judgements in both respects. An example of significant judgement relating to future cash flows is the ability to pass potential carbon prices on to customers.

It may, however, not be possible for all climate-related expenditure to be included in the cash flow forecast when using value in use method for determining recoverable amount, as IAS 36 places certain constraints on this. For example, future climate-related expenditure that would improve or enhance the asset's performance have to be excluded from the cash flow forecast. However, when the recoverable amount is determined by reference to fair value less costs of disposal, such expenditure can be included if a market participant would be expected to incur them.

It is imperative that the disclosures in the financial statements communicate clearly how management has considered the effect of climate-related matters in impairment assessments, if relevant. Such disclosures may need to include the climate-related assumptions affecting the recoverable amount, management's approach to determining the key assumptions, the basis for including climate-related capital expenditure in cash flow forecasts, sensitivity analysis of the key assumptions and how the assumptions compare with the climate scenarios discussed in the TCFD disclosures or strategic report.

Useful economic lives of assets

Climate-related matters may affect the useful lives of assets, for example, legal restrictions may be introduced on carbon-intensive assets or carbon-intensive production assets may need to be replaced earlier than originally expected to meet net zero commitments.

When management performs its annual review of assets' useful lives, it should consider the company's climate-related plans, climate-related regulations and changes in the market. A significant reduction in the useful lives of the assets would accelerate the depreciation or amortisation expense charged to the income statement and could also indicate impairment of the assets and potential revisions to any related decommissioning provision.

Provisions and contingent liabilities

Climate change may impact the recognition and measurement of provisions, which are based on best estimates and key assumptions.

As jurisdictions and companies take additional actions to address climate-related risks, new laws or public commitments in relation to climate-related matters could result in new or changed provisions or disclosure of a contingent liability.

For example, legislation changes could speed up actions required with respect to obligations for rehabilitation and restoration of sites or increase

[1] An impairment arises when the carrying amount of an asset or cash-generating unit exceeds its recoverable amount, which is the higher the fair value less costs of disposal and its value in use.

the cost of decommissioning and, therefore, affect the amount of recognised provisions. New provisions may need to be recognised for levies imposed by the government.

IFRS Accounting Standards include specific requirements for determining if a liability exists and if this needs to be recognised in the financial statements.

Legal obligations related to climate matters cannot be recognised until the legislation is virtually certain to be enacted as drafted. When a company has made its own net zero commitments, it will need to assess whether its actions have created a constructive obligation (e.g., a valid expectation in the minds of stakeholders and the general public) that may require significant judgement. A provision would not be recognised in the financial statements for an identified constructive obligation if it relates to a future event or the outflow of resources is avoidable, or a reliable estimate of the amount needed to settle the obligation cannot be made.

When a provision is not recognised, information on potential costs to deliver these commitments may still be required in the financial statements if the information would be material to primary users[1].

In addition, new contingent liabilities may need to be disclosed in relation to possible obligations for climate-related matters, or for existing contingencies previously considered remote becoming possible.

Other potential effect of climate-related risks on the financial statements

Other (non-exhaustive) potential effects include:

- **Going concern**: Climate-related matters can lead to going concern issues. Although for many companies, climate-related matters are unlikely to be significant enough to cause a material effect on going concern, they may become increasingly significant for companies in sectors most impacted by climate change. In assessing whether the going concern basis of preparation is appropriate, all available information about the future—including those related to climate change—should be considered.
- **Segment reporting**: Companies may need to update their segment reporting to reflect the way management information is delivered in response to climate change. This may include identifying a new business segment that arises from the transition to a low carbon economy, or re-evaluating whether the current aggregation of operating segments remains appropriate.
- **Expected credit losses (ECLs)**: Actual or expected adverse changes in the regulatory, economic, or technological environment of a borrower that are driven by climate-related matters could result in a significant change in a borrower's ability to meet its debt obligations. As a result, management needs to consider whether it is necessary to increase the ECL provision associated with receivables and other financial assets the company holds, particularly those associated with customers in sectors most effected by climate change.
- **Onerous contracts**: Onerous contract provisions are required to be recognised where the unavoidable costs of meeting obligations under a contract exceed the economic benefits expected to be received. Climate-related matters 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 and liabilities that are measured at fair value may be effected by climate-related risks; for example, biological assets may be effected by physical climate events such as droughts, floods, storms, and heat waves. Since fair value focuses on what market participants would consider when pricing the asset or liability, climate change is likely to influence the assumptions management uses to measure fair value.
- **Inventories**: Climate-related matters may result in inventory becoming obsolete, selling prices changing, or inventory costs increasing. This may require inventories to be written down to their net realisable value.
- **Recognition of deferred tax assets**: The ability to generate future taxable profits may be impacted by climate-related matters. A reduction in a company's estimate of future taxable profits may affect the recognition of deferred tax assets.

[1] Primary users are existing and potential investors, lenders and other creditors as set out in the IFRS *Conceptual Framework for Financial reporting*.

Internal controls

As companies begin to articulate their goals and efforts to address ESG issues via in their external reporting, it is essential to build strong processes and effective internal controls. There is rapid change around ESG, which could make establishing 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 companies' policies and processes for ESG reporting have not yet been fully developed. To prepare for mandatory ESG reporting, this control environment should be a area for Audit Committees to focus on with management.

If organisations 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 performance data being communicated is complete and accurate.

The Board should ensure that the ESG information reported is fair, balanced and understandable. The Board's review and assessment of the risk management and internal control system should also cover ESG-related risks.

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 company, 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 organisation.

Below are a few key considerations for the Audit Committee to explore with management in this regard:

- **Defined policies and procedures:** Companies need documented definitions, principles and policies for how their ESG reporting is prepared and presented. In some cases, there is an established standard. For example, the GHG Protocol is widely recognised 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 on 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 collection and reporting need to have appropriate information technology general controls, including appropriate access, system development, and change management controls.
- **Homogeneity across processes, locations, and countries:** Companies should strive for processes and controls that are homogeneous and consistently applied across processes and locations. Arriving at common policies to establish how data is defined, measured, captured, and controlled will be an initial challenge, particularly in larger, 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 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 have well-developed systems and processes designed to collect data across the company.

  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, marketing or legal. However, as companies will need to apply the same level of rigor to sustainability reporting as financial reporting with upcoming regulations, many companies are considering sharing this responsibility with the finance function.

Chapter 04

ESG external assurance

Chapter Summary

- More companies currently not obtaining assurance are preparing for future assurance. Mandatory assurance over ESG reporting is already happening in the European Union.
- Limited assurance is currently the most common form of assurance for ESG reporting, but ultimately expected to move to reasonable assurance.

Assurance over ESG reporting helps companies build trust in the accuracy and reliability of what they disclose. External assurance also provides Audit Committees and Boards with an added level of comfort concerning the company's performance against ESG targets and commitments.

As discussed in Chapter 2, assurance is a growing part of evolving ESG reporting standards.

What assurance services can be provided?

In the UK, external assurance for ESG data is typically performed using the International Standards on Assurance Engagements (ISAE), including:

- ISAE 3000 (UK) Revised, Assurance Engagements Other than Audits or Reviews of Historical Financial Information for general sustainability reporting; and
- ISAE 3410, Assurance Engagements on Greenhouse Gas Statements for GHG emissions reporting.

Reflecting the rapid evolution of the sustainability assurance market, an exposure draft for a new assurance standard, ISSA 5000, specifically for sustainability assurance was published in August 2023 by the International Auditing and Assurance Standards Board (IAASB). The standard is intended to provide a new over-arching global standard for assurance on sustainability reporting that supports the consistent performance of quality sustainability assurance engagements and is suitable for use across all sustainability topics and reporting frameworks. It is expected to be approved by the IAASB in Sept-Dec 24 and effective in for periods beginning on or after 15 Dec 2026.

Types of ESG assurance relevant to sustainability reporting

Information that can be assured	Description	Key considerations
Quantitative information e.g. metrics	Assurance over company reporting on specific key performance indicators (KPIs) such as greenhouse gas emissions, diversity metrics, waste, water use. Sustainable financing is a significant driver for assurance as many credit institutions require limited assurance over the performance of the agreed sustainable performance targets.	Companies may use bespoke internal calculation methodologies, but increasingly metrics are calculated according to definitions provided in reporting frameworks to increase consistency and comparability between companies. The company always needs to provide a basis of preparation to be published alongside the KPIs explaining how the metrics were calculated. Assurance over estimates is possible provided there is a sound basis for the estimate that can be evidenced, and clear disclosure of the methodology, assumptions and proxy data used.
Qualitative information e.g. narrative statements	Assurance over narrative information (under the full-report assurance required under CSRD), processes (governance for eg) and compliance statements e.g. UN Principles for Responsible Bankingis set to increase.	Sufficient, appropriate evidence needs to be available to support all qualitative and quantitative statements. A basis of preparation describing how the information was compiled is expected to be published alongside the statement.

Levels of assurance

Companies can choose between two levels of external assurance: limited assurance 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 has not been properly prepared, in all material respects in accordance with the reporting criteria)	A positive assurance opinion is provided (e.g., ‘in our opinion, the information is properly prepared, in all material respects, in accordance with the reporting criteria’)
Relevant assurance procedures	Procedures performed can include: • Inquiry. • Observation. • Analytical procedures. • Non-statistical sample testing (low sample sizes). • Recalculations in certain situations.	In addition to the procedures used in limited assurance: • Test the design and implementation of internal controls. • Perform statistical sampling (larger sample sizes). • Perform extensive recalculations and reconciliations. • Perform enhanced procedures to evaluate information obtained from third parties.

Most companies start with obtaining limited assurance as the ESG data and reporting processes are not typically mature enough for reasonable assurance. Some leading reporters are moving to obtaining reasonable assurance over some ESG information, while still staying with limited assurance for some metrics.

Getting ready for assurance – what do companies need to be thinking about

Audit Committees should be asking management how ESG data is being collected, measured, and reported. Many companies have standalone ESG teams that are responsible for ESG-related reporting but may lack expertise around internal controls. Finance may be able to offer advice, leadership and resources such as process and control templates to the broader organisation given their knowledge of the control systems and processes used for financial reporting. This will become increasingly important as companies start to seek assurance and 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 company’s criteria for ESG measurement (the definitions of how aspects of ESG are measured) are specific and clear, and whether sufficient evidence is available to be used to measure underlying subject matter.

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

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

It is essential that what companies report to the public is accurate, robust and credible. Aside from being a regulatory compliance requirement in some cases, assurance will give companies 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.

Contact us

Hilary Eastman
Head of ESG Reporting
T: +44 (0)20 7311 1000
E: hilary.eastman@kpmg.co.uk

Timothy Copnell
Board Leadership Centre
T: +44 (0)7801 520802
E: tim.copnell@kpmg.co.uk

George Richards
Head of ESG Assurance
T: +44 (0)7919 110279
E: george.richards@kpmg.co.uk

Almudena Cossio
ESG Reporting
T: +44 (0)7776 498208
E: Almudena.cossio@kpmg.co.uk

www.kpmg.com/uk/blc

CREATE: CRT157390B | August 2024