KPMG

The SOXification of ESG

SEC Climate Proposal, Internal Controls, and the Technology Ecosystem

The Future of SOX Insights

The SEC released a proposed rule that requires companies to significantly increase their reporting on climate risk to make climate disclosures more transparent and enable investors to make informed decisions.

Based on the implications of the SEC's climate disclosure proposal on internal controls, organizations are looking for best practices around ESG governance and understand the emerging trends in technology ecosystems to support ESG reporting.

Specifically, organizations need to understand:

- SEC climate proposal
- ESG technology ecosystem
- Internal controls and governance
- Top five things to get started now

SEC climate proposal

With the proposed rule—Enhancement and Standardization of Climate-Related Disclosures for Investors—the U.S. Securities and Exchange Commission (SEC) is seeking to provide investors with more consistent, comparable, and reliable information about how climate-related matters impact a company's business and financial results over time.

- **Scope:** It applies to nearly all SEC registrants. The scope is determined by both the type of business you are in and your position within the ecosystem. The focus is on climate risks that impact the company (outward-in pressures) as well as GHG emissions (inward-out pressures).
- **Disclosures:** One of the biggest requirements in the climate proposal is that certain disclosures need to be filed, not furnished, which means they are required to be included in the actual footnotes of the financial statements and covered by an external audit. The SEC proposed financial statement disclosures required are:
  - Separately for each line item in the financial statements–and separately for physical risks and transition risks–disclose total negative impacts and total positive impacts
  - The cost related to both physical risks and transition risks
  - Bright-line one percent materiality of each line item in the financial statement.
- **Timeline:** For large-accelerated filers, the SEC's climate disclosure requirements loom in FY23, which gives them reduced time to assess gaps and be compliant until the SEC adopts the final rules. Litigation will play a crucial role here. Businesses contemplating an IPO need to consider how this proposal could impact their timing or approach while there is still time to act.

It is crucial to understand that disclosures must be based on comprehensive ESG perspectives rather than only climate-specific data to support investor-grade information.

Gearing up for evolving ESG regulations

Different levels of SOXification

In these webcasts, we have drawn a parallel to our experiences from the implementation of SOX when it was released in the early 2000s. We learned hard lessons then that should be leveraged in this new era of ESG controls that we are entering. By saying "SOXification", the intent is not to duplicate all aspects of SOX around ESG disclosures but rather leverage the assurance methodology developed for internal controls over financial reporting for internal controls over non-financial reporting. This gives companies flexibility in their control response to ESG reporting

- The control response to ESG climate controls could have many options. It is understood that a robust, well-defined process supported by efficient internal controls is the key to navigating successfully across the levels of SOXification. KPMG shared what an ESG control response could look like for the four categories of the proposed SEC climate disclosures:
  - **Level 1** involves full control testing by management and the external auditor
  - **Level 2** involves full control testing by management and no/limited control testing by the external auditor
  - **Level 3** involves limited control testing by management and no control testing by the external auditor
  - **Level 4** involves documentation only. No control testing by management or external auditor. **This option could also be to do no documentation.**
- As companies build their ESG process and control documentation, many of the old SOX guiding principles should be included:
  - Identifying the key personnel as the control owners
  - Evaluating the key systems and data inputs
  - Having policies and procedures governing the process
  - Seeking automation or other process improvements up front
  - Prioritizing controls that are truly key and critical to an effective process
  - Considering the delivery model for the process including 3rd party sourcing, shared services, etc.

This can ultimately help you to visualize where all the different controls and data pieces are located.

ESG technology ecosystem

Technology has emerged to be the key enabler of ESG. Data and analytics-driven approach to ESG strategy can help at all stages of your sustainability journey: from disclosures and climate risk assessments to governance and enhanced decision-making.

The importance of data and technology in ESG programs

Data and technology are critical to the success of ESG programs. There are several current state pain points such as lack of the data infrastructure to aggregate data from disparate sources, inability to harness environmental data to drive strategic and operational decisions, and significant challenge to producing on-time reports due to manual data collection and verification process. Leveraging technology to drive data integrations across multiple ESG stakeholder data sets can help businesses move away from these pain points to a better, future state by:

- Introducing a single-pane-of-dashboard to visually enable real-time performance management and data-driven decisions and moving to a global inventory of primary ESG data can help improve data analysis and operational activities
- Provide a single point of view to provide oversight for ESG leaders and to drive accountability across business stakeholders
- Streamlining metric generation with a robust methodology to calculate emissions confidently can help enhance data governance and quality
- Decreasing manual excel calculations with API-based data ingestion, increasing automated data collection, and establishing data ownership can help facilitate better workflow management and build automation capabilities.

You do not need to focus on building an entire ecosystem. Start by assessing where your organization stands now and where you want to be in the future. Conduct a gap analysis across people, processes, data, and technology. Identify the technologies you have in-house and if they could be leveraged to start streamlining your process and activities. And seek assistance in navigating the nuances of technology to understand how it fits into the ecosystem.

The KPMG ESG risk framework

KPMG has developed a target operating model framework that organizations can use as a guide to understand how to structure and effective ESG framework

Governance	Control Framework	Data Management	Reporting
Appropriate documentation of policies and procedure to ensure processes for aggregation of ESG reporting is consistent and sustainable.	Inventory of controls necessary for ESG reporting including mapping to existing controls used for compliance	Data governance is in place to help ensure data linage for ESG metrics and reporting exists.	Disclosure must be clearly defined in reporting including timing of reporting, scope and comparability, as well as reporting principles.
Oversight from senior management and committee\board levels to help ensure the appropriate focus and challenge is taking place.	Test of design and operating effectiveness of control framework necessary for ESG	Data integrity controls exist to help ensure accuracy and completeness of reporting	Approval and signoff by senior management for ESG reporting to help ensure material topics, disclosures, impact, and omissions are appropriately documented
	External independent review of controls to ensure verifiability of processes and reporting	Understanding of third-party data usage with a goal to have data integrity controls as well as the ability have comparable data points	

Elements of ESG programs

1. **Set targets:** identifying the reporting targets and mapping frameworks to these targets; locating the inventory of targets; and identifying the target owners and due dates
2. **Measure:** calculating and aggregating against your targets; automating data collection and calculations; and having capabilities to visualize data and produce dashboards
3. **Report:** drawing up "last mile" reporting process and publishing and filing reports in line with standards bodies and SEC requirements
4. **ESG governance:** managing internal controls and practices and the overall governance over the program
5. **ESG program management:** having policies and procedures in place to navigate the ESG journey.

These elements are important strategic components that ultimately help drive business value. There is data everywhere. Organizations need to make sure they are thinking about managing their ESG program in a consistent manner that is streamlined, and technology-enabled.

Disclosure-focused reporting technology ecosystem

Technology vendors such as Workday, Appian, Unqork, Salesforce, ServiceNow and Workiva are targeting ESG reporting and offering an enterprise-wide to help organizations manage their efforts, starting from defining requirements and standardizing data collection to setting data quality controls and disclosure reporting. The diverse capabilities that each of these technologies offers can help build a robust ecosystem with the right tools to enable different parts of the ESG program to effectively provide oversight and reporting goals. These tech providers are playing a key role in helping businesses improve the robustness of their sustainability reporting, drive SEC reporting readiness, provide metric data governance support, and help transform their ESG journey.

Navigating from Measure to Report: environmental spotlight

There are eight major components of a scalable and robust platform for climate data reporting:

1. **Define the data sources:** Gather data from various emissions sources such as electricity and fuel use.
2. **Security:** Manage data privacy, access controls, and SSO integration.
3. **Ingesting and Processing:** Configure communication channels for batch, on-demand, or real-time pulls. Aggregate and apply transformations.
4. **Data storage:** Map ingested data to common data model. Incorporate industry-specific functions and connect to climate goals.
5. **Calculation Methodology:** Calculate carbon emissions according to chosen methodology.
6. **Data Integration:** Prepare structured data for analysis in the carbon accounting process and generate reports.
7. **Insights & Analysis:** Dashboards to visualize carbon footprint trends & create stakeholder reports such as SASB, TCFD.
8. **External Integration:** Integrate with systems such as ESG governance, reporting engine, energy efficiency, REC & offset management.

The capabilities that enable the above steps from "Measure" to "Report" consists of:

- Centralized environmental data to obtain asset-level insight into decarbonization performance
- Regular assessment of impacts on your carbon baseline and areas for operational improvement
- Preparation of climate data for ESG reporting with the auditability required by stakeholders.

The technology ecosystem consisting of cloud, platform, and SaaS providers such as AWS, Microsoft, Google, Oracle, and SAP can make the ESG computing and reporting process automated, more efficient, and auditable for investors and regulators. However, it is equally important to prioritize the information required and validate if the system is the right fit for achieving your organization's ESG goals.

Critical underpinning components of the ESG program

- ESG governance involves components to make the program more integrated such as setting and managing controls; establishing governance for how ESG metrics are constructed; identifying ways to trace and verify data; aligning your ESG risk and control information to existing risk and compliance program; and storing evidence of metric validation to provide reporting.
- ESG program reporting involves capturing the most granular and accurate data possible from ESG projects; tracking performance towards targets; fetching real-time progress and updates on performance of the program; and identifying key people and necessary timelines for targets.

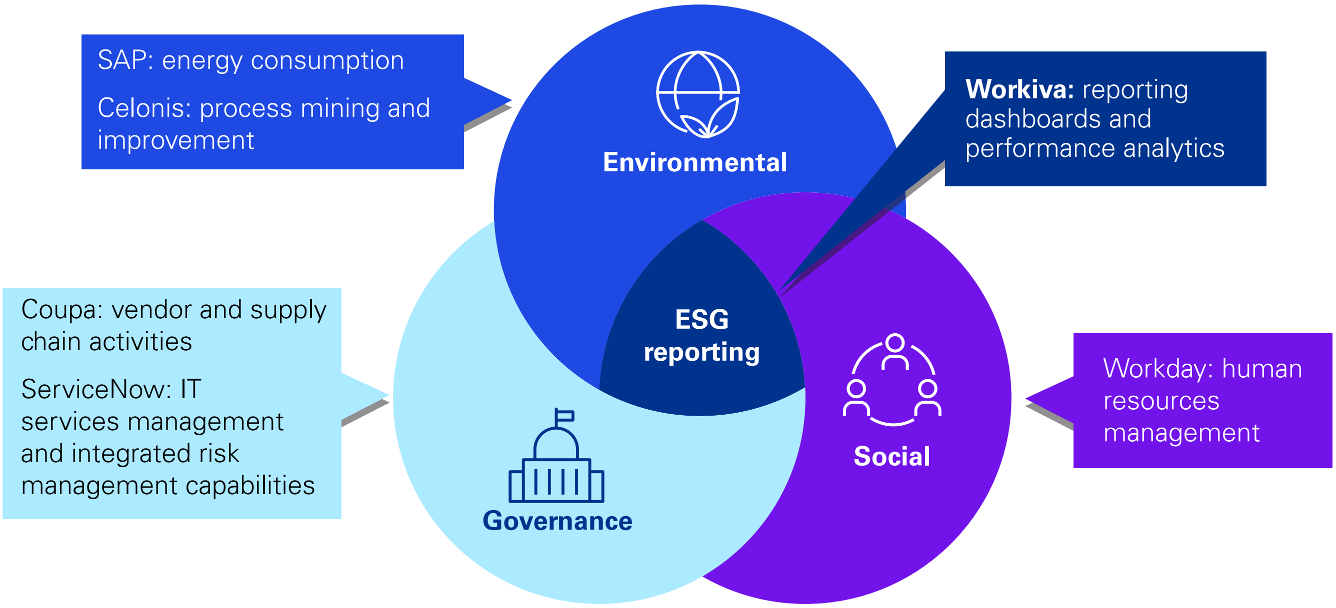
Technology has a critical role to play in both components, such as ServiceNow, that are in scope from a Sarbanes-Oxley (SOX) perspective. This can be leveraged to build more integrated workflow capabilities resulting in an efficient ESG program.

Governance-based technology ecosystem

- A governance-based technology ecosystem starts by pulling in external data that needs to be captured. It focuses on operationalization, the external and internal calculations, and third-party information that you may need. There are various tech-enabled applications that need to work together in conjunction with one another so that the computations can ultimately help you evaluate the robustness of control points and enhance confidence and accuracy from an investor and auditor standpoint. It further moves to ESG management, which takes care of your frameworks, metric mapping of your risks and control matrices, documentation and attestations, and process flows. This enables you to finally aggregate the information, look at the integrated information, export it, and do your "last mile" reporting.
- It is important to understand that there is no one-size-fits-all when it comes to tools. All the leading technology vendors are really maturing their capabilities in the ESG space, and it can be quite overwhelming with so many features and capabilities at your disposal. But it's good to know where these providers are playing. Before choosing a technology platform an organization should assess it's ESG goals to understand which technology would help them best meet them.

- Organizations are increasingly embedding technology in their ESG journey to streamline their processes and get insights faster. The following are some of the top providers and areas where companies are investing:

How technology platforms can help enable an organization's ESG program efficiencies



Internal controls and governance

With the SEC indicating that accuracy of climate risk disclosures will be examined, companies are now considering how robust their internal controls are related to their ESG disclosures. The internal controls help minimize risks, ensure accuracy and adherence to regulations, and result in operational efficiency.

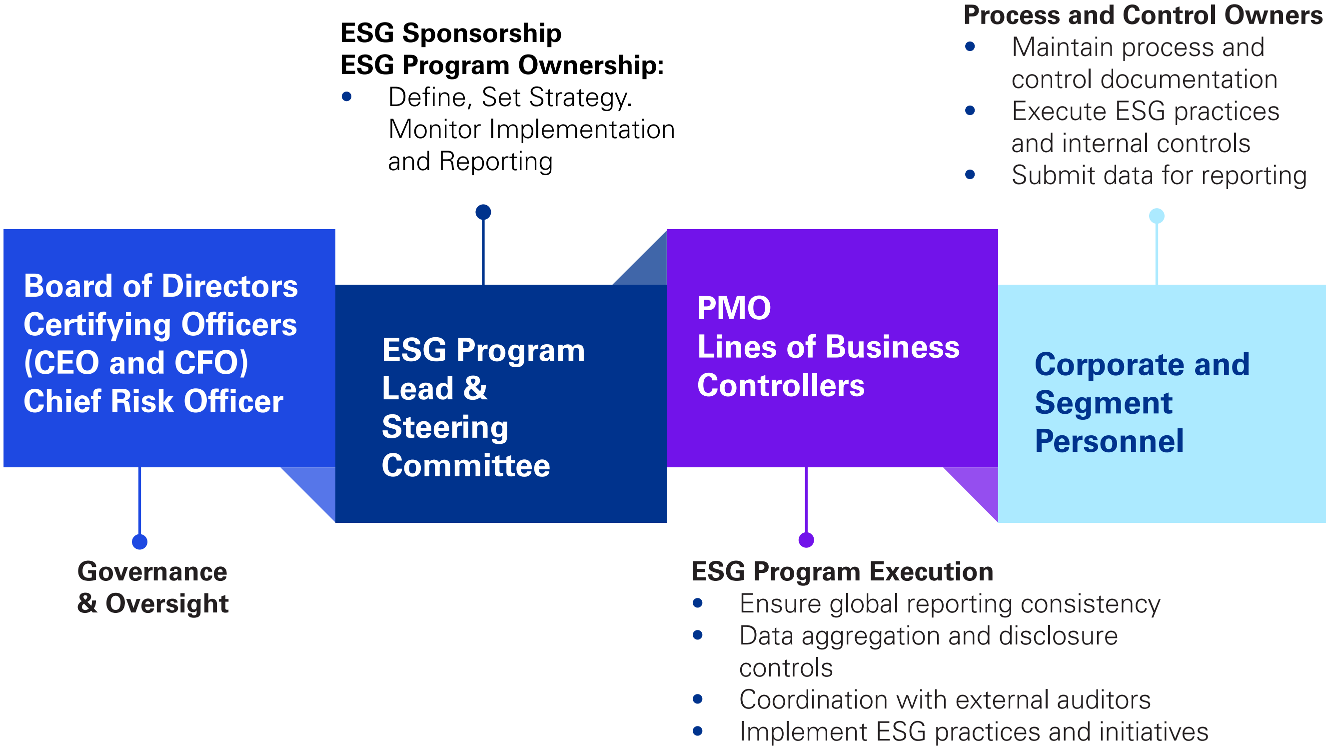
What does the ESG journey look like?

KPMG's view of the full ESG journey for company moves across four phases:

- **Assess:** Identifying the current state of ESG and prioritizing critical areas
- **Design:** Integrating current & future state into goals that feed strategy
- **Operationalize:** Tangible initiatives to make progress against specific areas identified as ESG focal points
- **Measure and Report:** Continuously review performance and future ESG-related decisions that need to be made

To ensure this journey is successful and sustainable over time, a strong governance program, including internal assurance will be needed that addresses board governance and oversight, sponsorship at a executive and steering committee level, program execution including new key roles, and a well structure process with understood control ownership

Figure 1



Why is assurance important?

As ESG progresses and reporting evolves, assurance around ESG data will become crucial along with the evaluation of internal controls around the data. During this journey, management is will need to provide a certain level of assurance regarding the corporate sustainability report or climate data that they would be producing as part of the 10k.

We see four areas as current key drivers to the importance of ESG:

- **Accelerating ESG compliance:**
  - Aspects of SEC Climate Rule will be SOX relevant
  - Attestation will be required for parts of the SEC climate rules
  - Validation is required for EU rules on climate disclosures and several other country disclosures
  - There are other areas of ESG not yet covered by the SEC, such as the social aspect of diversity, which could eventually change
- **Reliance by Stakeholders:**
  - Boards and executive leadership need to be prepared to answer about their strategy and goals involving ESG and progress towards those goals
  - Assurance will be needed to give boards and management the confidence to speak to company progress with some degree of evidence supporting what is said
- **Board and Executive leadership confidence:**
  - Analysts and stakeholders including investors, customers, regulators, and vendors will continue to rely on CSR reports as well as the 10-K to compare companies on ESG areas outside of mandatory disclosures
  - As stakeholders rely on that information, companies need to put some diligence into validating what they put out publicly or face consequences
- **Gaps in other compliance areas**
  - ESG disclosures cover much more than just climate and GHG emissions. These additional areas may already be subject to compliance and disclosure rules in the region or locality of the entity
  - Companies should consider using the trigger of SEC disclosure changes to identify and address these gaps in their regulatory operations.

The most important thing here is to review all the ESG components that apply to you and use a materiality assessment to identify which are most important.

Assurance Model

Most companies already have an established SOX compliance program that gives the assurance needed for internal controls around financial reporting. Companies are advised to leverage that existing assurance process for non-financial ESG processes or metrics (e.g. climate, safety, human capital, etc.) This is a model that organizations could consider but it should really be tailored to their specific ESG needs:

1. **Scope:** Scoping ESG by material items, entities, and value chain will ensure that a complete picture of ESG impact on the company is identified. It needs to be simple to understand and execute.
2. **Level of Assurance:** Not all ESG risks are equal. The level of assurance needed will differ based on the area, the regulatory focus, and the importance of the area from a board, competitive marketplace, and branding perspective. The assurance level needs to be agile enough for different material ESG areas.
3. **Risks:** Risks need to be considered in several areas including strategic, financial, operational, compliance, technology, data, human capital, reputation and external. Focusing on the process alone will be insufficient.

4. **Process and controls:** Once risks are considered, processes will need to be mapped and controls identified commensurate with the risk and level of assurance needed. These need to be agile enough for different levels of assurance.
5. **Technology and data:** The data foundation for identification of ESG performance will be critical to assurance. The technology foundation for the processes and controls will need to be considered.
6. **Communications:** Communication of performance, gaps, and progress will be critically important on the ESG journey. CSR reports will be scrutinized extensively and the information in them must be accurate.
7. **Monitoring and progress:** Critical to ESG reporting is to identify baseline position and identify progress towards goals. The framework needs to be easily repeatable to be able to continuously monitor and identify progress.

Role of an ESG controller

The ESG Controller is a new and evolving role in a company's ESG governance structure, and as a result, there is inconsistency in the market for the role title and responsibilities. In some cases, the responsibilities of the ESG Controller fall under the Chief Compliance Officer while in others in could be in operations, sustainability or parts of the organization that make the most sense. Organizations are increasingly appointing individuals who may or may not be from finance background but who have an acumen for sustainability and is interested to build expertise in the area.

ESG controllers are responsible for ensuring that the organization meets its commitments, provides accurate and transparent reporting, and develops and implements the necessary systems, processes, and controls to achieve success. The key activities include:

- Assuring the company's reporting is in compliance with regulations and consistent with the firm's operational data
- Examining the system of internal controls and validating the integrity of ESG Governance program
- Leading implementation of new disclosures
- Tracking progress on ESG commitments and investments.

We expect this role to evolve further in the future as the scope of ESG solidifies, reporting regulations are finalized, and organizations better define the target operating model they need for this new reporting.

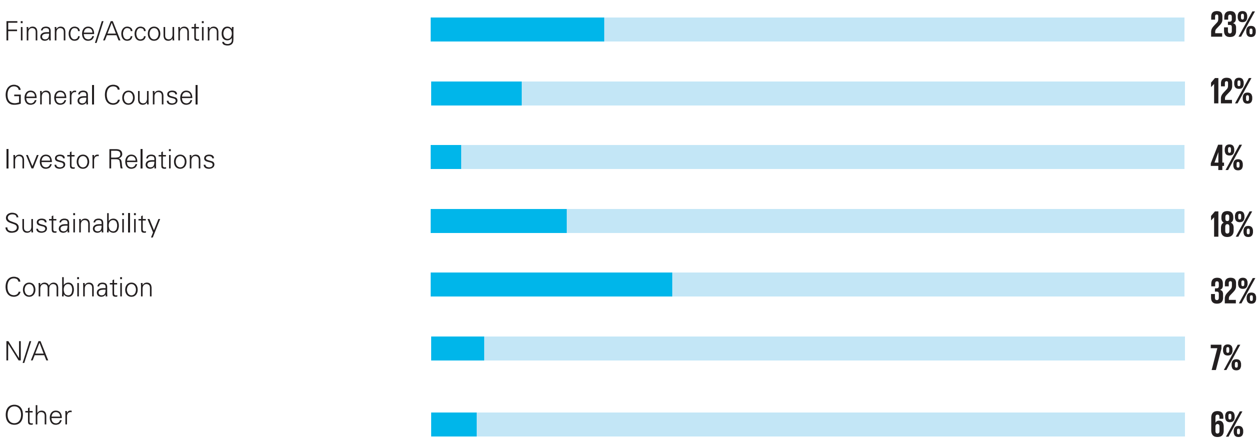
Closing comments

- As we move to a where companies are required to report climate-related information under the new SEC rules, the need to address governance and technology requirements is necessary. Companies asking where they should get started could include:
- Consider implementing a program governance structure if you haven't already
- Understand on the level of remediation required and related cost/benefit. Climate is an important area to focus on. Conduct a gap analysis based on the proposed SEC rules while acknowledging they are subject to change until the final rules come into effect.
- Consider reliability, consistency, speed, and repeatability of data reporting processes. Don't underestimate the importance of data and understand where that's coming from. The role of technology is going to be critical here.
- Think about rationalizing/modifying information disclosed. Examine what really needs to be disclosed.
- Determine the adequacy of internal controls. Effective internal controls can serve a greater purpose than compliance alone. It can become a vital tool to analyze a company's performance, operational efficiency, and risk management.

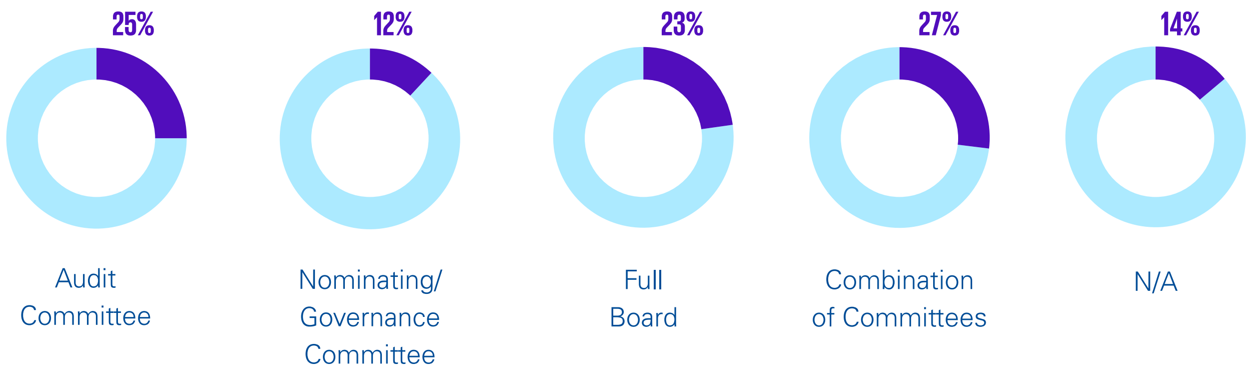
What's on the mind of Risk and Compliance professionals when it comes to ESG?

We polled nearly 1,500 individuals who hold various risk roles at their organizations, and here is what we discovered.

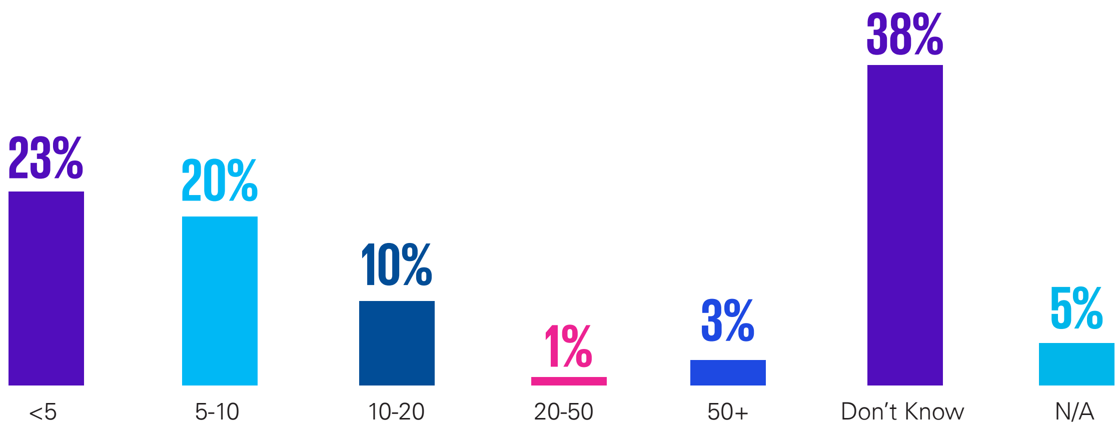
Who has responsibility for ESG reporting in your company?



Which committee of the board of directors has ownership of ESG?



How many systems do you estimate support your ESG program?



How confident are you in the data that supports your ESG disclosures?

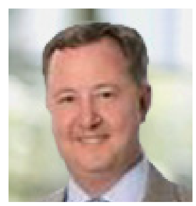
Somewhat | Moderate | Very | N/A

Data was gathered from responses to polling questions posed during our Future of SOX: The SOXification of ESG webcast, which took place on July 13, 2022.

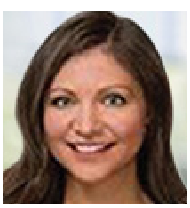
For more insights, visit our Future of SOX webcast series page at visit.kpmg.us/FutureofSox

Contact us

Sue King
Partner and U.S. SOX Solutions Leader
KPMG LLP
E: susanking@kpmg.com



Steve Estes
Partner and IA&ER, ESG Leader
E: sestes@kpmg.com



Lisa Rawls
Americas GRC Technology Service Network Leader,
KPMG LLP
E: lisarawls@kpmg.com

Kirby Kleeberg
Director, GRC
KPMG LLP
E: kkleeberg@kpmg.com

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