TONE at the TOP®

Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

Issue 122 | April 2024

# What New SEC Climate-Related Disclosure Rules Mean for Boards

The U.S. Securities and Exchange Commission (SEC) has taken a major step in sustainability reporting by publishing final requirements for climate-related disclosures in public company registration statements and annual reports[1]. In its final rule, the SEC noted that lack of consistency and comparability in reporting have made it more costly for investors to obtain and analyze decision-useful information.

Indeed, until recently there have been few mandates that required disclosures and a wide range of reporting frameworks to choose from. Yet, many companies voluntarily publish a variety of climate-related data for use by investors and other stakeholders. A 2023 PwC and Workiva poll found that 95% of executives of US-based public companies said they were prioritizing sustainability reporting and taking proactive, compliance-related measures, even though disclosure was not yet required in the United States when the survey was taken.[2]

The initial SEC proposal on climate-related disclosures received considerable attention and generated significant concern when it was first issued in 2021. The SEC received more than 24,000 public comments, including meaningful concerns from respondents across the business and political landscape. This resulted in some controversial initial proposals being dropped. While the new rules are already facing numerous court challenges, boards should be aware of them and understand the potential eventual impact on their organizations. This is also a good time to recognize the many ways that internal audit can help organizations manage compliance with the new SEC mandates, including providing assurance and advisory services related to new compliance-related strategies, policies, and controls. This issue of Tone at the Top will discuss some of these key considerations for boards.

## Changing Expectations

The SEC's final rule significantly expands existing disclosure requirements by adding robust new reporting guidelines. Information that registrants must disclose includes:

- Material climate-related risks that could affect company strategy, results of operations, and financial condition, and how the organization is mitigating or adapting to them.

- For some organizations, data on material Scope 1 greenhouse gas (GHG) emissions— those directly controlled by the company—and Scope 2 emissions—indirect emissions related to electricity, steam, heat, or cooling that the company purchases. Also provide attestation reports on the required disclosures.

- Available data on climate-related targets or goals that are (or are likely to be) material to the registrant's business, results of operations, or financial condition.

- The financial statement effects of severe weather events and other natural conditions, such as costs and losses.

Compliance is phased in and dependent on the registrant's filer status and the content of the disclosure. An SEC factsheet on the new rules can be found here.

## Scope 3 Disclosure Is Dropped

One of the most controversial aspects of the SEC's initial proposal was the requirement that organizations report Scope 3 GHG emissions, or those that the company does not directly control but that occur because of its activities. This category includes a significant number of upstream and downstream emissions produced by an organization's suppliers and vendors, its business travel and employee commutes, as well as factors such as investments and leased assets. The SEC said it dropped this requirement from the final rule, based on comments received on the proposal and the cost, complexity, inconsistency, and potential unreliability associated with this reporting. The rule could have affected many smaller companies that are exempt from Scope 1 and 2 reporting themselves but are suppliers for larger companies that would have relied on them for Scope 3 information. These companies may still come under pressure from stakeholders to report on their own emissions, however.

## A Focus on Boards

Boards of SEC registrants are given special responsibilities in the new SEC rule, which mandates disclosure about directors' oversight of climate-related risks and any role by management in assessing and managing material climate-related risks. Companies subject to the rules must also disclose:

- Which board committees or subcommittees, if any, are responsible for overseeing climate-related risks.

- How these committees and subcommittees are informed of climate-related risks.

- Whether and how these groups monitor progress on any disclosed climate-related target, goal, or transition plan.

The rules don't apply to registrants that don't undertake board oversight of climate-related risks. The SEC also eliminated some proposed requirements for boards, including the need to:

- Identify board members responsible for the oversight of climate-related risks.

- Describe board members' climate expertise.

- Provide details on the frequency of board or board committee discussions of climate-related risks.

## About The IIA

The Institute of Internal Auditors (IIA) is a nonprofit international professional association that serves more than 245,000 global members and has awarded more than 195,000 Certified Internal Auditor (CIA) certifications worldwide. Established in 1941, The IIA is recognized throughout the world as the internal audit profession's leader in standards, certifications, education, research, and technical guidance. For more information, visit theiia.org.

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# Other Key Standards

The SEC requirements are not the only ones that boards should be aware of. The European Union climate reporting rules under its Corporate Sustainability Reporting Directive must be applied in FY 2024 for reports published in 2025. They are meant to strengthen reporting requirements on social and environmental data. They generally apply to large companies, even some non-EU companies that operate there. Small and medium-sized companies aren't affected if they don't have listed securities, and those that do can use simplified rules.

The new SEC and EU requirements reflect the rapid evolution of sustainability reporting and the related compliance risks. The marketplace is responding with new frameworks to help organizations make sense of what it can and should report. The International Sustainability Standards Board (ISSB) was created by the IFRS Foundation in late 2021 to meet the need for a single source of decision-useful, comparable sustainability information that would meet the needs of investors, companies and international policy makers. In mid-2023, the ISSB published two standards, IFRS S1, General Requirements for Disclosure of Sustainability-related Financial Information, and IFRS S2 Climate-related Disclosures. The ISSB guidance is not mandatory, but it is expected to have a wide influence on global reporting. The board reports that nearly 400 organizations from 64 jurisdictions have committed to promoting the adoption of ISSB climate-related reporting at a global level.[3]

# The Value Added by Internal Audit

"Organizations need to recognize that ESG reporting must be built on a strategically crafted system of internal controls and accurately reflect how an organization's ESG efforts relate to each other, the organization's finances, and value creation," according to The Institute of Internal Auditors.

As boards work to understand the rules' impact for their organizations, they should be aware of the advice and assurance that internal audit can offer. Internal audit can, for example, help to ensure regulatory compliance and promote related best practices, as well as provide boards with insights on new types of review and assurance on compliance with the new rules.[4]

Internal audit can also:

- Provide assurance on the effectiveness of sustainability risk management, including climate-related reporting. Internal auditors can review reporting metrics for accuracy and relevance, ensure reporting is consistent with formal financial disclosure filings, and perform materiality or risk assessments on climate disclosure filings.
- Incorporate sustainability into audit plans so that related risks can be recognized and managed.
- Offer objective, independent advice on sustainability concerns. For example, internal audit can a vise on the development of an effective sustainability control environment and recommend reporting metrics that provide the most appropriate quantitative and qualitative data.
- Use its holistic knowledge of the organization to advise on sustainability governance effectiveness, identifying proper roles and responsibilities as well as training needs.

# Beyond Compliance

"Ensuring ESG reporting is driven by strategy rather than viewed as simply a compliance exercise is an overarching responsibility of corporate boards," according to KPMG. As compliance takes center stage with new reporting rules, boards can rely on internal audit not only to provide assurance on whether the company is meeting its regulatory mandates but also to offer advice on the best management approaches to climate issues and other sustainability concerns.

## QUESTIONS FOR BOARD MEMBERS

What climate-related impacts is our company facing? What are the related risks?

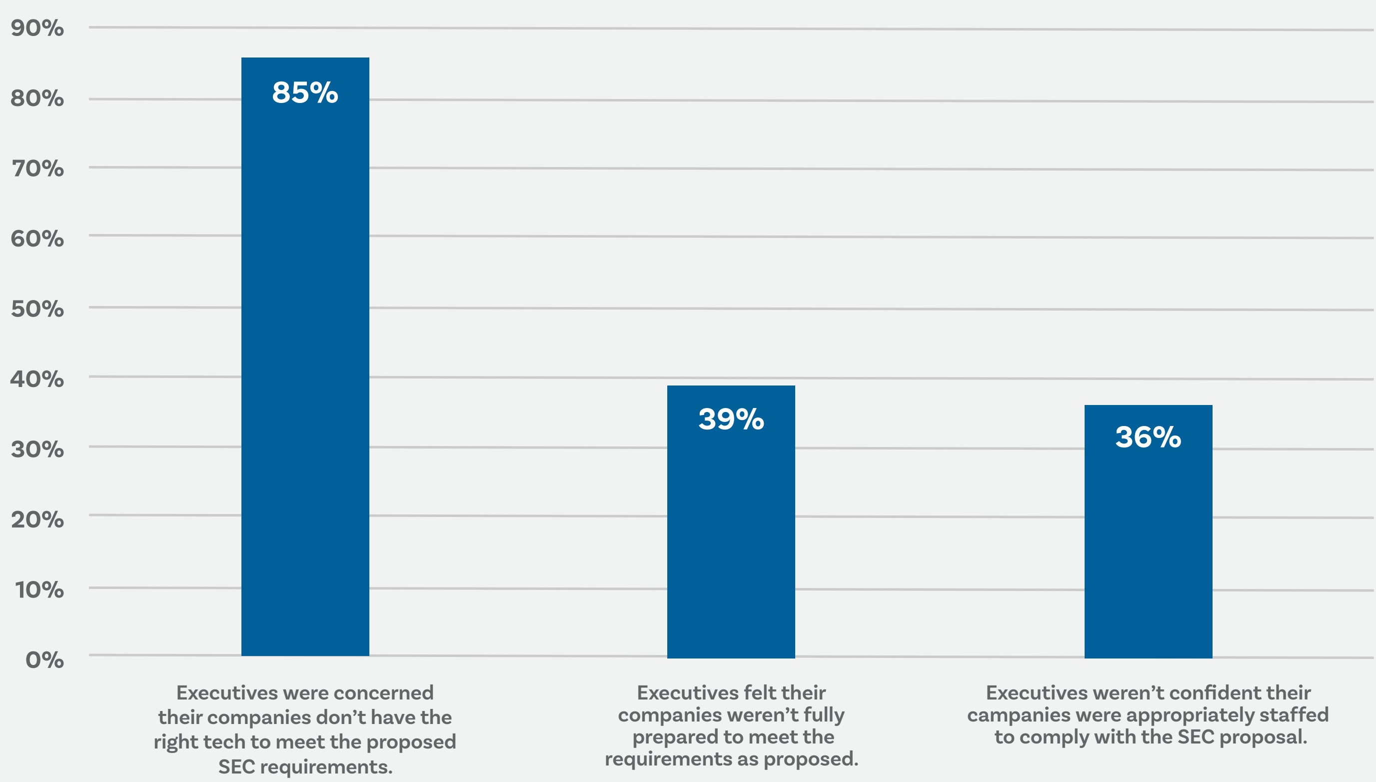
How can we ensure our data collection and reporting mechanisms enable us to comply?

What changes to our reporting systems will be necessary for nonfinancial reporting measures?

How is climate considered in the organization's risk appetite?

What kind of reporting does the board currently receive on climate-related concerns? How will or should that change going forward?

## Are Companies Ready to Comply with the SEC Rules?




***Source:*** : "Change in the Climate: How US Business Leaders Are Preparing for the SEC's Climate Disclosure Rule," PwC and Workiva Survey, 2023. A survey of 300 executives at US-based public companies with at least $500 million in annual revenue fielded after the SEC proposal was released but before final rules were published.

"The Enhancement and Standardization of Climate-Related Disclosures for Investors ," U.S. Securities and Exchange Commission, March 6, 2024.

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