Published by
NACD

Governance Challenges 2022

CLIMATE GOVERNANCE

Board Oversight of Climate Change

Guiding toward long-term value in a climate-change impacted world

By Susan Angele, KPMG Board Leadership Center

Tool Objective

This tool helps boards to establish and continuously improve their oversight of risk and opportunity as the impacts of climate change continue to evolve.

Many may recall the classic experiment: we are asked to watch a short film and count the number of times a ball is passed among a group of students, and at the end of the film we discover that very few have noticed the large person in a gorilla suit who walked among the students throughout the film's duration. Given the important issues that have continued to pile on one after another over the past few years—COVID-19, racial reckoning, political polarization, supply chain woes, inflation, the Russian government's invasion of Ukraine—it may indeed be difficult to turn our attention to the gorilla of climate change.

Yet the business implications of climate change continue to accelerate, and the proposed rule on climate-change related disclosure promulgated by the US Securities and Exchange Commission (SEC) adds a measure of urgency for public companies. The following are areas for boards to focus on, along with questions to consider, as they work to enhance their governance to integrate climate change issues into risk, strategy, company culture, core values, and the company's relationship with its stakeholders. This tool is adapted from *Boardroom Climate Competence, Getting Ahead of the Curve*, and *Boardroom Climate Competence, Organizing for Oversight*, by Susan Angele, KPMG Board Leadership Center, and Amanda North, Plan C Advisors.

DEVELOP A PLAN FOR BOARD CLIMATE COMPETENCE AND OVERSIGHT STRUCTURE

- **Assess the board's current level of climate awareness.** Given the increasing importance of climate considerations to strategy, risk, reputation, and social license to operate, it is increasingly important for boards in every industry to have knowledge sufficient to enable critical questions and the ability to assess management's responses.
- **Develop a plan for knowledge building.** Should the board add climate knowledge to the board matrix and recruit a director with expertise in climate-specific issues relevant to the company's strategy and risk? Is the board setting expectations for all directors to become climate literate by taking advantage of the numerous director education programs on the topic? Should the board engage outside experts—either independently or in conjunction with management—for the purpose of formal or informal learning sessions?
- **Evolve the board's structure and agendas to integrate climate-related oversight.** Consider how climate awareness will be incorporated into the overall work of the board, and how the board will be structured for oversight of climate-related risk, opportunity, targets, and disclosure.

As the board discusses external factors influencing strategy and risk, such as technology disruption, geopolitical issues, and changing talent demands, is climate change included in this mix? Does each board committee include climate considerations in its work—oversight of disclosure and controls for audit; incentive compensation considerations for comp and human capital; and considerations of board composition and effectiveness for nom/gov? Is time allocated to a deep dive into the company's decarbonization goals, strategies, and oversight of implementation? Will this work be done by an existing committee, such as nom/gov, or will the board establish a separate committee? Who will oversee the company's disclosures—both from a compliance perspective and from a broader climate-related communication strategy perspective?

- **Prevent political polarization.** Like many topics that have both a political aspect and an impact on the business environment, climate discussions can easily be derailed by debates about what governments should (or should not) be doing. Board leadership should keep the focus on the business implications and the role of the board as a steward of the company's long-term value.

ENGAGE WITH MANAGEMENT IN A DISCUSSION OF CLIMATE-RELATED RISK

- **Assess physical risk using a long-term lens.** Extreme weather patterns are affecting companies across all industries. Is management prepared if, for example, multiple points across the value chain were to be affected by drought, storm damage, fire and/or flood, simultaneously? Has management included the board in its crisis planning exercises? Does the company's enterprise risk management process consider climate-based risks over a 10- to 20-year horizon? Is the company engaging in scenario planning to understand and build resilience to long-term climate-related supply chain stressors on agriculture, migration patterns, and geopolitical and/or financial stability?

- **Engage management in continuing discussions about transition risk.** As defined by the Task Force on Climate-related Financial Disclosures, transition risks are risks "associated with the transition to a lower-carbon global economy, the most common of which relate to policy and legal actions, technology changes, market responses, and reputational considerations."[1] How are climate-related government regulations, taxes, and incentives changing the landscape in countries where the company does a significant amount of business? What are the implications of changing stakeholder expectations for the company's reputation and ongoing ability to maintain customer and talent loyalty? What new competitive risks are on the horizon?

Board leadership should keep the focus on the business implications and the role of the board as a steward of the company's long-term value.

[1] See TCFD, *Recommendations of the Task Force on Climate-related Financial Disclosure* (June 2017), Appendix 5, Glossary and Abbreviations, Climate-Related Risk (definition), p. 62.

ENCOURAGE A FOCUS ON CLIMATE-BASED OPPORTUNITY AS WELL AS RISK

- **Brainstorm with management on new business ventures enabled by climate-related change.** Consider a "climate foresight" exercise, in collaboration with management, focused on opportunities that the company may be able to leverage. How might current physical risks be turned into a competitive advantage? If climate change increases the importance of adaptation over time, might the company lean into goods and/or services that would become more compelling? As the company works to reduce its carbon footprint, what new value creation opportunities open up: Products or logistics for a circular economy? Innovative ideas to capture carbon along with a business model to monetize the approach?
- **Encourage engagement across the entire enterprise.** If the company's goals are developed by a siloed sustainability team, implementation will be challenging at best. Ask management how climate awareness is filtered throughout the organization, how carbon goals are linked to business goals at all levels of the organization, and how the entire organization is engaged in climate-related strategies.

ASSESS THE COMPANY'S STRATEGY FOR GREENHOUSE GAS EMISSION GOALS

- **Educate the board on the differences among Scopes 1, 2, and 3.** Understanding the difference is fundamental to any discussion of the company's current carbon footprint and future goals. "Scope 1" refers to direct company-owned or controlled emissions, such as those generated by manufacturing facilities. "Scope 2" refers to emissions associated with the production of energy consumed by a company—for example, how much of a company's facility runs on oil heat and how much runs on power generated by renewable energy such as solar, wind, or water? "Scope 3" is harder to track but potentially more impactful. It refers to indirect emissions associated with company activities from sources not owned or controlled by a company, including the supply chain. Using automobiles as an example, Scope 1 emissions are those generated directly from the use of fossil fuels—for example in connection with machinery used to manufacture the cars. Scope 2 emissions are those generated by the production of electricity consumed—for example, to keep the lights on in offices and facilities used for manufacturing, distribution, and storage. Scope 3 emissions include the harder-to-measure but dramatic impact of transitioning from the manufacture and sale of gas-powered vehicles to those powered by electricity.

The board can help by setting expectations, supporting the development and implementation of a plan for tracking data as a priority, and offering introductions to management counterparts at comparable companies that track successfully.

- **Assess management's current ability and future plans for tracking the data.** Particularly for companies below the Fortune 500, management may be challenged by the talent, processes, and capital investment in technology needed to ensure accurate tracking. The board can help by setting expectations, supporting the development and implementation of a plan for tracking data as a priority, and offering introductions to management counterparts at comparable companies that track successfully. The audit committee should assess controls and assurance of the veracity of the data.

- **Collaborate on net-zero goals.** Simply, "net zero" refers to a balance in the amount of greenhouse gas emissions emitted with the amount removed from the atmosphere. Variables include what is measured (Scopes 1, 2, and/or 3), the baseline established for measurement (e.g., xx% reduction compared to the company's emissions in the year 20xx), the time frame (net zero by 20xx), and the methods (mix of actual reduction and carbon offsets/credits), among others. As stakeholder expectations evolve, it is important for the board to understand the company's goals in the context of expectations.
- **Oversee implementation.** As a matter of best practice, boards are taking a deep dive into understanding the company's implementation path before approving the public announcement of a long-term goal. If the path is not clear, realistic, and measurable in short-term increments as well as over the long term, the company may find itself accused of "greenwashing"—making public statements that are not consistent with the company's actual conduct. A board committee should be tasked with oversight of the long-term goal and the interim steps along the way.

THE AUDIT COMMITTEE SHOULD TAKE A 360 DEGREE VIEW OF THE COMPANY'S CLIMATE-RELATED COMMUNICATIONS

Ask management to catalog the places in which climate communications occur. Unlike financial reporting, climate-focused communications are frequently generated in different parts of the company and used for different purposes: risk disclosures and descriptions of board oversight in SEC filings, sustainability reports, responses to customer ESG information requests, marketing materials, and more. Proposed SEC regulations, once final, will serve as a baseline. In addition, customers, investors, employees, and other stakeholders may call for information beyond the bare requirements. Given the spotlight on "greenwashing" and the potential for siloed communications, encouraging management to understand where these communications appear and why is the first step in developing an accurate and consistent approach.

> The board, in collaboration with management, sets the tone in connection with climate-related communications.

- **Assess the framework for management oversight of key communications.** Who in management is accountable for the accuracy of climate-related communications? What approvals are required before communications are released? Are different lenses applied to climate-related communications, including legal compliance, consistency with corporate values, and alignment with the company's previously stated goals, as well as calibration against stakeholder expectations and against competitors? Is there a cross-functional team to make these assessments? Do the management committees for review of financial disclosures and climate-related disclosures intersect to avoid silos? What role does internal audit play? How will the company prepare to implement assurance requirements set forth in SEC rules once the proposed rule is final? Even if not required by regulation, what level of assurance will the company implement voluntarily?
- **Set the tone.** The board, in collaboration with management, sets the tone in connection with climate-related communications. What is the company's philosophy with respect to transparency and climate leadership, and how will it be adjusted as pressures and trends evolve?

SET EXPECTATIONS FOR CONTINUOUS LEARNING AND OVERSIGHT AS PHYSICAL IMPACTS, PREDICTIVE SCIENCE, AND STAKEHOLDER INTERESTS EVOLVE

As boards guide their companies forward, the multifaceted implications of climate change will continue to impact business—and the planet—for decades to come. A steady hand, knowledge about the past, and a focus on the future, setting the tone, and guiding the company to long-term growth consistent with societal expectations and the company's values—all are the hallmarks of an effective board member in general. These are even more important in the face of the potentially existential threat posed by a changing climate. It is therefore incumbent on directors to stay informed on the issues and provide oversight as the issues evolve.

A Framework for Board Oversight

Consider assessing oversight in the context of six areas described in detail in the framework set forth in *Boardroom Climate Competence: Getting Ahead of the Curve*:

- LEVEL SETTING
  Focus the discussion.
- RISK ASSESSMENT
  Take a comprehensive look at climate risks for your business.
- OPPORTUNITY ASSESSMENT
  Reevaluate your strategies in light of climate change to identify opportunities for growth and transformation.
- INTEGRATION
  Encourage engagement across the entire enterprise.
- BOARD GOVERNANCE
  Ensure that climate-related oversight is built into board composition, structure, and processes.
- COMMUNICATION
  Set the tone for disclosure and stakeholder engagement.