Climate Change & the Statutory Auditor

by Fiona Gaskin & Melissa Reddy

It's clear that climate change risk has risen up the corporate agenda and is now a standard item for consideration at Board level. But what does it mean for the annual report and the audit of the financial statements?

When I started my training as an accountant over 20 years ago, I don't think I could have imagined a world where climate change needed to be considered in the context of financial statements. However, that's exactly the world that exists now. With the increased focus on climate change and supported by the development of frameworks such as the Task Force for Climate related Disclosures (TCFD), consideration of climate change risks and opportunities has become more formal and detailed, as has the impact of those risks and opportunities on the financial statements. Reporting of climate related matters is becoming far more mainstream with 50% of FTSE350 companies voluntarily reporting on TCFD.[1] In addition, the Financial Conduct Authority (FCA) has mandated that all UK premium listed companies must report on TCFD for their 2021 Annual Financial Report on a comply or explain basis.

Through a risk identification and assessment process, an organisation may deem climate change to be a principal risk. Even where this is not the case, an organisation may include detail about their assessment of climate risk in the front half of the annual report given the focus on the topic by stakeholders such as investors.

When climate change is identified as a principal risk, similar to any other principal risk, the impact on the front and the back half of the annual report needs to be assessed. The TCFD framework requires, for example, significant disclosures on climate risks and future scenarios. This includes considering what physical risks the organisation might be exposed to, such as an increased risk of flooding, as well as transitional risks as the world looks to transition to a lower carbon model, for example, the impact that an increase in carbon tax may have on an organisation.

Examples of some climate change related risks and opportunities include:

- increased consumer demand for products which are seen to be helping with reducing climate change impacts, e.g. plant-based food,
- increased costs from raw material price increases, for example if the climate is affecting crop yields,
- cost of actions required to reach Net Zero commitments, or
- reduced revenue from the outright ban of a key ingredient used in production and/or a finished good in its end market.

The risks and opportunities posed by climate change are not theoretical; many are happening now, and others are coming very quickly. One example of this is the proposed EU phasing out of new internal combustion cars by 2035. This will have an impact on not only car manufacturers, but the related upstream and downstream businesses. As the impact of these risks and opportunities are considered, due consideration as to their potential impact on the financial statements is also required.

Climate Change - what accounting standard is that?

The short answer to the above question is that there are no specific accounting standards right now, but climate change is a factor to be considered when applying existing accounting standards. The International Accounting Standards Board (IASB) have noted that the principle-based approach of IFRS standards means that climate change risk is addressed by the existing IFRS standards, even though it is not explicitly referenced in those standards. At its core, reflecting climate risk in financial statements is little different to any other risk. If assets are affected, then it's IAS 16 Property, Plant and Equipment or IAS 36 Impairment of Assets. If provisions are affected, then it's IAS 37 Provisions, Contingent Liabilities and Contingent Assets and so on.

The IASB issued educational material which contains a non-exhaustive list of examples regarding how climate risk might affect the measurement and disclosure requirements of different IFRS standards and the various paragraphs of those standards that might be referenced in determining how companies consider the effects of climate-related matters in applying the principles in IFRS.

When applying this guidance, it's important to consider that many parts of the financial statements involve consideration of time periods which are greater than 12 months and therefore the possible effect of climate change over that longer time horizon is important. For example, property, plant and equipment typically have useful economic lives spanning decades, and other valuations are underpinned by discounted cash flow models with significant assumptions about the future taken all the way into perpetuity. How might these calculations be impacted by the risks and opportunities the specific organisation faces in relation to climate change?

What does that mean for a statutory auditor?

The statutory auditor considers any potential implications, including disclosures, for the financial statements from risks and other matters and this would include the potential impact of

1 *Source: https://www.pwc.co.uk/audit/assets/pdf/reporting-on-a-changing-world.pdf issued July 2021

environmental or other matters, for example the potential impact on assets lives or impairment reviews. An example of this might be an expected fine due to non-compliance with an environmental regulation and consideration as to whether or not a provision is required.

The statutory auditor also has responsibilities in respect of the front half of the Annual Report which include:

- To read the other information and consider whether it is materially inconsistent with the financial statements or the auditor's knowledge obtained in the audit, or otherwise appears to be materially misstated in the context of the auditor's understanding of the legal and regulatory requirements applicable to the statutory other information. An example of this might be a disclosure in the front half of the annual report which speaks to replacing equipment with new less carbon intensive models within the next 12 months, but there is no consideration of any possible amendments to the useful economic lives used for depreciation or no consideration of whether an impairment is required for the existing equipment in the financial statements.
- State whether, based on their knowledge and understanding of the company and its environment obtained in the course of the audit, they have identified material misstatements in the directors' report and, where they have so identified such misstatements, give an indication of the nature of each of such misstatement.
- For companies that apply the UK Corporate Governance Code, to report based on knowledge obtained in the audit where the auditor has anything material to add or to draw attention to regarding:
  - The directors' confirmation in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity.
  - The disclosures that describe those risks and explain how they are managed or mitigated.

To assist statutory auditors in considering their responsibilities, in late 2020 the Financial Reporting Council (FRC), the independent regulator in the UK, released a thematic review of climate-related considerations by boards, companies, auditors, professional associations and investors. The core finding of the review highlighted that greater consideration should be given to the climate-related risks by auditors when completing their work. The thematic review[2] suggests that this understanding needs to be tailored to the individual circumstances of each entity and the materiality of the audit and proposes six key stages shown on the next page.

What's on the horizon?

The topic of climate change and Environmental, Social and Governance (ESG) topics more generally are rapidly evolving areas, but some key points to highlight include:

1. The EU's proposed Corporate Sustainability Reporting Directive (CSRD), which is due to be effective from 1 January 2023, includes a requirement for certain companies to increase their disclosures about sustainability and requires them to obtain limited assurance over the related disclosures. The assurance element is still being reviewed by the EU including who will be permitted providers of this assurance and what standards will apply.
2. In support of CSRD and to facilitate the required assurance, European sustainability reporting standards are being developed by EFRAG (draft standards expected to be available mid-2022) and will be tailored to reflect EU policies.
3. The IFRS Foundation Trustees are working to establish a new board focused on sustainability-related disclosure standards (the proposed International Sustainability Standards Board—ISSB) under the IFRS Foundation's governance structure.

Conclusion

Regardless of the industry, climate change and its impact on current and future operations should be considered by all organisations. This includes a specific and thorough consideration of the physical and transitional risks the organisation is directly exposed to, as well as those up and down its value chain. Transparency over the impact of climate change on business, and businesses' impact on the climate, is a crucial component in tackling this most important of all issues: the future of the planet.

As statutory auditors, the focus is still on consistency of the "other information" in the front half of the report along with the disclosure of principal risks and consideration of potential risks and their impact on the financial statements. However, with focus on this area by regulators and other stakeholders, it's clear that this cannot be a tick the box exercise and formal consideration of climate change should be completed by the auditor.

This is a fast-evolving area with more detailed standards from both the EU and the IFRS Foundation expected.

Fiona Gaskin,

Fiona is a partner with PwC in Dublin, leading the Trust and Transparency team. She has focused on helping clients with non-financial reporting for over 10 years.

Melissa Reddy,

Melissa is an Environmental Scientist and sustainability specialist with PwC Ireland. She supports clients on their sustainability ambitions and reporting requirements.

2 https://www.frc.org.uk/getattachment/0ef2c94a-9028-4efa-ac80-3b8c2e0d9a11/Audit-FINAL.pdf

FRC 2020 Thematic Review
1. Risk assessment
Obtaining an understanding of the potential effects of climate-related risks on the entity's audit and annual report is an important part of the initial risk assessment phase. Audit teams may consider utilising existing industry-specific guidelines, upcoming environmental legislation and firm guidance to assist them when performing their risk assessment procedures.
2. Controls
Audit teams should invest time to appropriately understand management's procedures for addressing the impact of climate change on their organisation. This will allow auditors to assess whether an appropriate risk response is in place.
3. Audit procedures
As part of their risk assessment, auditors should consider identifying financial statement balances which may be impacted by climate change. These risks could then be assessed throughout the audit testing of the affected balances. Auditors could also consider leveraging the sensitivity analysis used to assess going concern to determine whether climate related risks may impact the key assumptions.
4. Audit Specialists
Audit teams may use specialists to assist in reviewing climate specific disclosures and contributing to the climate-related risk assessment or support on specific areas of audit testing.
5. Disclosures
If entities have chosen to adopt, either fully or partially, TCFD disclosures, audit teams should consider assessing these against the published TCFD recommendations. Similarly, if companies have chosen to include climate-related commitments in the front half of their reports, audit teams should determine whether these are consistent with the activities they have observed throughout the audit. Any actions which may seem incongruous to these plans, such as particular capital expenditure or business development activity, could be identified for discussion by the auditors and considered for further examination, if appropriate.
6. Reporting
The review concluded that the majority of audits used only basic wording when reporting the relevance of climate-change to those charged with governance. Entities which showed good practice in this area included measures such as making specific reference to environmental disclosures in the representation letter and presenting to those charged with governance on how climate-related issues could be disclosed in the front and back halves of the annual report.