ACCIF – the audit committee's role in understanding and addressing the impact of climate change

> **Purpose of this paper**
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> In this paper we are examining the issue of climate change through the lens of the audit committee and the responsibilities within their remit.
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> We aim to provide some context for the current focus on corporate action on climate change, review board responsibilities and reporting requirements and set out the key matters for audit committees to address.
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> The intention is for this to be a tool to help audit committee chairs and members to provide effective oversight and fulfil their responsibilities. We welcome your comments on the content of this paper, whether there are further resources required at this stage and what those might be.

Introduction

In the sections below we describe some recent developments as well as a reminder of existing reporting obligations which should trigger company disclosures around the impact of climate change. However, we acknowledge that this is a rapidly developing area and further development of standards and investor demands may require updates to this paper. At present, our focus is predominantly on the existing requirements and the introduction of a Listing Rule on reporting against the Taskforce Climate-related Financial Disclosures (as described below).

We would also stress that this paper focuses specifically on the role of the audit committee and highlights the key aspects of the audit committee agenda where the impact of climate change should be being considered. We recognise that as board members there are additional, more strategic risk and opportunity considerations which need to be identified and assessed, but that is not the purpose of this paper.

As a final point of context, we would like to emphasise the message that all companies and sectors are impacted differently by the effects of climate change (both those they are causing and those they need to respond to) and so audit committees must take responsibility for developing company and sector appropriate responses based on the guidance below.

Relevant developments (as at November 2020)

Government's Green Finance Strategy – all listed companies to report using the TCFD framework by 2022.

FCA consultation CP20/03 (consultation closed on 1st October 2020) – this proposed a new rule for commercial companies with a UK premium listing requiring them to state whether they comply with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and to explain any non-compliance. On 9th November FCA CEO, Nikhil Rathi, confirmed that the new rules will come in to effect for reporting periods beginning 1 January 2021.

Chancellor's announcement on environmental disclosures - the UK will become the first country in the world to make TCFD aligned disclosures fully mandatory across the economy by 2025. The joint Government Regulator TCFD Taskforce has published a roadmap for implementing mandatory disclosures, many of which will come into force by 2023. The upcoming rules and regulations will capture a significant portion of the economy including listed commercial companies, UK registered large private companies, banks, building societies, insurance companies, UK authorised asset managers, life insurers, FCA regulated pension schemes and occupational pension schemes.

FRC Climate Thematic Review - the FRC has completed a review of climate-related issues as they affect governance, reporting and audit, and the roles of a range of market participants. The review highlights the important roles that boards, companies, audit firms, professional associations and investors have to play in delivering society's climate ambitions. While the FRC's review highlights some examples of better practice, the overall message is that more needs to be done.

The key messages for boards are that they have a responsibility to consider the impact of their company on the environment and the likely consequences of any business decisions in the long term. The implications of climate change will affect a wide range of companies, and in developing a company's strategic direction, boards should be taking into account all the possible effects of climate change. The FRC is encouraging UK public interest entities to report against the TCFD recommended disclosures **and**, with reference to their sector, using the Sustainability Accounting Standards Board metrics. In addition, the review has made clear the FRC's expectation that corporate reporting should address the impact of climate change on its financial statements.

Shareholder pressures – including messaging in Larry Fink's annual letter to CEOs, targeted letters to AC Chairs and Audit Partners from Sarasin representing a long list of investors and the Investment Association's Shareholder Priorities for 2020 (see Appendix). Also Climate Action 100+, a global investor initiative, is actively targeting the world's largest corporate greenhouse gas emitters to ensure that they take necessary action on climate change. Climate Action 100+ involves over 370 investors collectively representing $35 trillion in assets. See the Appendix for further detail on these shareholder announcements.

Company commitments – in December 2019 Repsol announced that it was cutting the value of its assets by billions of dollars because the global transition to a lower carbon economy is weakening the outlook for oil and gas prices. In June 2020, BP cut its estimates for oil and gas prices in the coming decades between 20% and 30% and increased the expected cost of carbon emissions. This was expected to result in non-cash impairment charges and write-offs in the second quarter, estimated to be in a range of $13 billion to $17.5 billion post-tax.

Standard setting - the IFRS Foundation issued a Consultation Paper on Sustainability Reporting on 30 September 2020, in which it seeks stakeholder views on whether it should broaden its oversight responsibilities to include sustainability reporting, and, if so, establish a separate standard-setting board to undertake this role. This follows a paper in November 2019 from Nick Anderson (a member of the IASB) intended to help investors understand what already exists in the current accounting standard requirements and guidance on the application of materiality, and how it relates to climate and other emerging risks. His paper makes it clear that while climate-change risks and other emerging risks are not covered explicitly by IFRS Standards, the Standards do address issues that relate to them.

A reminder of existing responsibilities

- The strategic report requires companies to report on their principal risks and environmental matters when material. The FRC's Guidance on the Strategic Report has been updated to cover requirements on the reporting of non-financial information, including environmental matters.

- The Miscellaneous Reporting Regulations (and the updated UK Corporate Governance Code) require boards to provide a statement explaining how the matters (including risks and opportunities arising from environmental matters) set out in section 172 of the Companies Act 2006 have been considered and addressed.

- The Streamlined Energy and Carbon Reporting Regulations require quoted companies to disclose in their directors' report (alongside existing greenhouse gas emission disclosures) their total energy consumption, identifying what proportion of the figures reported relates to emissions and energy consumed in the UK and offshore area.

In its Annual Review of Corporate Reporting, and in an open letter to all Audit Committee Chairs and Finance Directors, the FRC has further emphasised their expectation that boards address and report on the effects of climate change. The FRC has stated:

"In times of uncertainty, investors and other stakeholders expect greater transparency of the risks to which companies are exposed and the actions they are taking to mitigate the impact of those uncertainties. The FRC expects companies to think beyond the period covered by their viability statement and identify those keys risks that challenge their business models in the medium to longer term and have a particular focus on environmental issues."

The FCA's proposals in more detail

At the time of writing, although the FCA has confirmed that a new Listing Rule will be introduced with effect for periods commencing on or after 1 January 2021, the final policy and detailed rules have not yet been issued. The consultation paper, which follows on from the FCA's related Discussion Paper and Feedback Statement issued last year, proposes to introduce a new continuing obligation in the Listing Rules. LR 9.8.6R(8) (the new climate-related disclosure rule) would require commercial premium-listed companies to include a new statement in the annual report setting out:

- whether they have made disclosures consistent with the four recommendations and eleven recommended disclosures set out in section C of the TCFD Final Report in their annual financial report (also listed below for convenience);
- where these disclosures can be found in the annual report; and
- a "**comply or explain**" obligation to explain :

- why, if they have not made disclosures consistent with some or all of the TCFD's recommendations and/or recommended disclosures; or
- why they have included some or all of the disclosures in a document other than their annual report.

The aim of these proposals is to drive the provision of more consistent, comparable and decision-useful of climate-related financial disclosures which it is hoped will support more appropriate pricing of risks and allocation of capital in the economy.

A reminder of the relevant TCFD recommendations

1. Governance

Disclose the organisation’s governance around climate-related risks and opportunities

1. Describe the board’s oversight of climate-related risks and opportunities
2. Describe management’s role in assessing and managing climate-related risks and opportunities

2. Strategy

Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation’s businesses, strategy and financial planning where such information of material

1. Describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term
2. Describe the impact of climate-related risks and opportunities on the organisations’ businesses, strategy and financial planning
3. Describe the resilience of the organisation’s strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario

3. Risk Management

Disclose how the organisation identifies, assesses and manages climate-related risks

1. Describe the organisation’s processes for identifying and assessing climate-related risks
2. Describe the organisation’s processes for managing climate-related risks
3. Describe how processes for identifying, assessing and managing climate-related risks are integrated into the organisation’s overall risk management

4. Metrics and Targets

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material

1. Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process
2. Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas emissions, and the related risks
3. Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets

An overview of the SASB metrics

The Sustainability Accounting Standards Board (SASB) has developed a complete set of 77 industry standards which identify the minimal set of financially material sustainability topics and their associated metrics for the typical company in an industry. SASB standards use the Sustainable Industry Classification System to group companies based on shared sustainability risks and opportunities. This tool allows companies to determine the primary SICS industry for tens of thousands of companies listed around the world, enabling investors and corporations to determine which SASB sustainability accounting standard is applicable to that company.

A company considering use of SASB standards self-determines which standard(s) is relevant, which disclosure topics are financially material to its business, and which associated metrics to report, taking relevant legal requirements into account.

Key matters for the audit committee to address

As premium listed companies are going to be required to provide these disclosures, the audit committee has clear responsibilities within its remit. These are as follows:

Review of risk management systems	**Do the audit committee's monitoring and review activities demonstrate that the company's risk management systems are effective at identifying and assessing material climate-related risks?** *[TCFD 1.1 Describe the board's oversight of climate-related risks and opportunities and TCFD 3 Disclose how the organisation identifies, assesses and manages climate-related risks]* • Is the risk assessment focusing on the resilience of the business model, i.e. looking at the impact of climate change on the business as well as the impact of the business on climate change? • Are the systems for identifying, assessing, managing and monitoring risks using the best available information to make informed decision? • Are both the physical and transition risks of climate change being considered? • Has any reference been made to the COSO ESG framework to assist in developing a robust framework for risk identification and assessment? • Do the disclosures make clear the sources of emerging risk and other long-term climate-related factors affecting the company's viability?
Resilience	**Based on the assessment of risk is the audit committee satisfied that there has been appropriate consideration of the resilience of the business to any potential threats?** *[TCFD 2.3 Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario]* • Has the company developed capability in implementing a rigorous climate-related scenario analysis process? • Does analysis support the development of an understanding of how the physical and transition risks and opportunities of climate change might plausibly impact the business over time? • In identifying scenarios, has management made use of existing publicly available scenarios[1] and models or developed their own scenarios or a combination of these? • Is it clear that the business impacts[2] related to climate change relevant to the industry and economic sector(s)/sub-sector(s) in which the organisation operates have been considered? • Is the audit committee satisfied that the scenarios are sufficiently challenging, diverse and relevant?
Integrity of corporate reporting	**Have all material climate-related risks, opportunities and strategic decisions been disclosed and adequately reflected in asset and liability valuations?** *[TCFD 4 Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material]* • Are the disclosures decision-useful, comparable and consistent such that they drive capital to where it needs to go? • Is the company reporting the "best truth" based on the information which is available now whilst acknowledging that this area of metrics and information is constantly evolving? • Are the metrics and indicators being reported aligned to the way stakeholders are measuring your performance, based on feedback received? Are you putting that lens on your business? • Is the internal management information right and fit for purpose? • Are the disclosures subject to the same disclosure governance as financial reporting?

[1] These are set out in the TCFD Technical Supplement "The use of scenario analysis in disclosure of climate-related risks and opportunities"

[2] For example: input costs, operating costs, revenues, supply chain, business interruption and timing

	• To what level of oversight or assurance have the metrics been subjected? • What external data, or external expertise, has the company relied upon and is this appropriate and credible? • How does the methodology used for constructing the metrics compare to other companies in the sector?
Significant financial reporting judgements	**Have all material climate-related risks, opportunities and strategic decisions been disclosed and adequately reflected in asset and liability valuations?** • How does the scenario testing impact key judgements and estimates around valuations and impairments? • Do forecasts include continued growth of demand into perpetuity when this is clearly not sustainable under current consumer trends and/or potential government action? • Is management thinking widely enough about impairment risks, in terms of supply chain, in terms of demand? How could these future changes impact cash flow generating capacity? Where could extra costs arise? • Is the audit committee satisfied that the financial statements are complying with para 122 of IAS 1 to disclose the judgements management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements? • In relation to the significant financial reporting judgements, are the disclosures clear on the assumptions which underlie those judgements so that investors are fully in the picture and able to assess the reasonableness of the conclusions presented?
Nature and quality of assurance	**Is the audit committee comfortable that the level of assurance over climate-related data and analysis is appropriate?** • Is the board getting the appropriate data to properly and effectively assess the impact of climate change? • How much due diligence is done on the production of that data? • Has the audit committee considered the level of assurance it is getting on the risk management and internal control systems, and whether this is enough to help the board in satisfying itself that they are operating effectively? • Is the audit committee comfortable with the level of resources allocated to obtaining assurance over this information? • Has the external auditor appropriately factored material climate risks into their audit plan? • Has the audit committee assessed the resources available within the audit firm to support audit teams in evaluating the impact of climate change on the company?

In order to provide effective oversight of these activities, audit committees should also be considering their own composition, knowledge and skillsets. The WEF Climate Governance Principles raise the following considerations:

- What steps is the audit committee taking to ensure it remains sufficiently educated about the relevant climate-related risks and opportunities for its business?
- Has the audit committee considered whether it would benefit from the advice of external experts? If so, has the audit committee considered which experts would be most well suited?
- How can the audit committee plan for succession to ensure that climate awareness does not stop if an important individual or a vocal climate champion leaves the organization or the committee?
- Has an assessment of climate-competence gaps taken place?
- What kind of skills should be incorporated into the desired profile for a new audit committee member?

Relevant resources to support the development of these disclosures

TCFD framework – final report and supporting documents Implementation guidance and Use of scenario analysis
TCFD – latest status report
FRC Thematic Review
FRC Lab report on climate-related reporting
Nick Anderson – IFRS Standards and climate-related disclosures
SASB Standards Overview
WEF International Business Council's 'Towards common metrics and consistent reporting on sustainable value creation'
WEF Climate Governance Principles
Chapter Zero website

- Boardroom Toolkit
- Physical Climate Risk Primer
- Directors' Climate Journey
- Change Management Toolkit

Climate Financial Risk Forum Guide

APPENDIX – Shareholder pressures

Messaging from 2020 Larry Fink letter to CEOs

"Awareness is rapidly changing, and I believe we are on the edge of a **fundamental reshaping of finance**"

"In the near future – and sooner than most anticipate – there will be a **significant reallocation of capital**"

"We will use [TCFD- and SASB-aligned reporting] and our engagements to ascertain whether companies are properly managing and overseeing these risks within their business and adequately planning for the future. **In the absence of robust disclosures, investors, including BlackRock, will increasingly conclude that companies are not adequately managing risk.**"

Targeted letter to particular companies from Sarasin & Partners

Raises the following challenges to both the AC Chair and the Audit Partner:

To provide us with sufficient comfort that the accounts are reflecting material climate risks, we would welcome the following disclosures:

- How critical accounting judgments have been tested against credible economic scenarios that are consistent with achieving net zero carbon emissions by 2050 to 2070 and any adjustments made to these assumptions.
- The results of sensitivity and/or scenario analysis linked to variations in these judgements/estimates, including one that is Paris-aligned if this is not used as the base case.
- Adjustments to distributable reserves to reflect transition risks to ensure dividends are not paid out of capital as per requirements under the Companies Act; and threshold assumptions that would trigger cuts to dividends.
- Steps taken by the Audit Committee to ensure material climate risks are properly considered by the external auditor, and the impact that this has had.

The Investment Association – Shareholder Priorities 2020

To support our members engage with companies on climate change, IVIS will introduce a new section to its ESG report, highlighting to investors whether the company has made climate change-related disclosures. This will be informed by four questions, aligned with TCFD.

1. Does the company describe its governance of climate related risks and opportunities?
2. Does the company describe the actual or potential impacts of climate related risks and how it will assess and manage them?
3. Does the company explain how its strategy takes into account the impact of climate change?
4. Does the company describe climate change related metrics and targets?

Climate Action 100+

Climate Action 100+ is an investor initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. The companies include 100 'systemically important emitters', accounting for two-thirds of annual global industrial emissions, alongside more than 60 others with significant opportunity to drive the clean energy transition.

Investors signed on to Climate Action 100+ are requesting the boards and senior management of companies to:

1. Implement a strong governance framework which clearly articulates the board's accountability and oversight of climate change risks and opportunities;
2. Take action to reduce greenhouse gas emissions across the value chain, consistent with the Paris Agreement's goal of limiting global average temperature increase to well below 2 degrees Celsius above pre-industrial level;
3. Provide enhanced corporate disclosure in line with the final recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and, when applicable, sector-specific Global Investor Coalition on Climate Change Investor Expectations on Climate Change to enable investors to assess the robustness of companies' business plans against a range of climate scenarios, including well below 2 degrees Celsius, and improve investment decision-making.

The list of 161 focus companies is available on the Climate Action 100+ website.