2023

CLIMATE RISK AND AUDIT OF FINANCIAL STATEMENTS

Audit guide to climate risk and its impacts on financial statements audit

CPA AUSTRALIA

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ACKNOWLEDGEMENTS & DISCLAIMER

This Guide has been prepared by CPA Australia with the assistance of EY's Climate Change and Sustainability Services team. CPA Australia would like to thank them for their contributions to this Guide.

ISBN 978-1-922690-37-1

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Executive Summary

Climate-related risks are becoming a major area of focus for organisations today. Increasing awareness of the reality and magnitude of climate-related risks has brought about a call to action for the global business community to take steps to mitigate against these risks. With the renewed interest in meeting the binding commitments of The Paris Agreement, which has the goal to limit global warming to well below 2°C, preferably to 1.5°C, compared the pre-industrial levels, organisations need to act now. Organisations must implement plans, including identifying the necessary resources and developing the means to meet these commitments.

Climate change brings about physical and transitional risks that will impact investors, companies, communities and entire economies. All stakeholders including businesses, governments and investors, are required to work together to mitigate the systemic and in some cases material risks arising from climate change, with aspirational sustainability-related goals that support energy transition and decarbonisation.

Disclosing the impact of these climate-related risks continue to gain community and stakeholder interest, with investors now demanding businesses provide more climate-related information to assist with their economic decision-making.

This is important as climate change has the potential to impact an increasing number of entities of all nature and sizes, directly or indirectly. Corporate regulators are looking for this information to assist with their oversight functions.

In addition to playing a crucial role in the preparation of corporate disclosures relating to climate-change management, the accountancy profession is well placed to provide assurance services designed to enhance the credibility of the reporting and disclosures.

A robust qualifications framework, extensive skills and experience, a strong ethical foundation, and the ability to work within a set of regulatory requirements and principles all hold the accountancy profession in good stead to lead the way as the "go to" assurance professionals for climate-related corporate disclosures.

Given the key role auditors play in enhancing the credibility of financial statements through application of the independent audit process, auditors can carefully consider the implications of climate change-related risks and any potential impact on financial reporting, in their audit procedures.

Although management and those charged with governance are ultimately responsible for preparing the financial statements which includes the considerations of climate-related risks, auditors will also need to understand how a business is impacted, including the risks and opportunities climate-related risks pose.

The impact of both physical and global transition-risks is not just related to companies operating in the energy or manufacturing sectors. There can be far-reaching impacts on supply chains, customers, assets and plans for future strategic acquisitions. Assessing and disclosing the impacts are equally important to investors wanting to understand how climate-related risks affect an organisation's economic growth, cash flows, asset values, and future prospects as a whole.

Example key questions auditors can use in relation to the impact of climate-related risks on financial statements include:

- How are you ensuring you have a proficient understanding of the business to perform appropriate risk assessments including climate-related risks?
- Does this risk(s) have a potential financial implication?
- Has the risk(s) been adequately addressed in management's preparation of the annual reporting disclosures?

Introduction and objective

This *CPA Australia Guide on Climate Change Impact* on the Audit of Financial Statements (Guide) has been developed to complement the

CPA Australia Guide on Climate Change and Financial Reporting

published in 2021. This Guide aims to provide a general overview of climate-related issues and risks to be considered by accountancy professionals, specifically the impact such risks might have on financial reporting and how the auditor responds to those risks.

Auditors should also have professional scepticism over the pervasive nature of climate change and associated risks that may impact any organisation, not just those entities in sectors deemed obviously exposed to climate risk.

The aim of this Guide is to demonstrate how climate should be considered in various phases of the financial statements audit currently in practice by accountancy professionals.

This is a crucial first step for auditors of financial statements to assess the adequacy of climate-related reporting impacts in the financial statements.

As part of this Guide we will take you through the audit lifecycle from identifying and assessing risk through to materiality assessments, financial statements, and disclosure impacts, and communicating to those charged with governance.

Context on Standards Development

At the time of the development of this Guide, there are no international accounting or auditing standards which specifically address the reporting and assurance thereon for climate change impacts on financial reporting. However, the International Financial Reporting Standards (IFRS) Foundation Trustees created a new standard setting board, International Sustainability Standards Board (ISSB) which has been established to consider formalised sustainability standards.

The International Auditing and Assurance Standards Board (IAASB) is also working on developing an overarching standard for assurance on sustainability reporting.

Notwithstanding, the principles-based International Standards on Auditing (ISAs) would require auditors to identify and assess all risks including, climate change risks, that may affect the reporter's fair presentation of its financial statements in accordance with IFRS.

For example, auditors should carefully consider and plan their audit work to address climate-related assumptions and estimates that will expose the organisations to measurement uncertainty and related disclosures in the context of the audit of financial statements.

One of the prominent climate-related disclosure frameworks is the Task Force on Climate-Related Financial Disclosures (TCFD) which sets out recommendations for disclosing clear, comparable, and consistent information about the risks and opportunities presented by climate change.

The TCFD recommendations have been widely adopted by private and public sector entities as the basis for more comprehensive disclosures of climate-related information.

Auditors can also consider the TCFD framework to guide their thinking on how the climate-related risks and opportunities can impact on financial statements as illustrated in the following diagram.

Climate-related risks, opportunities and financial impacts

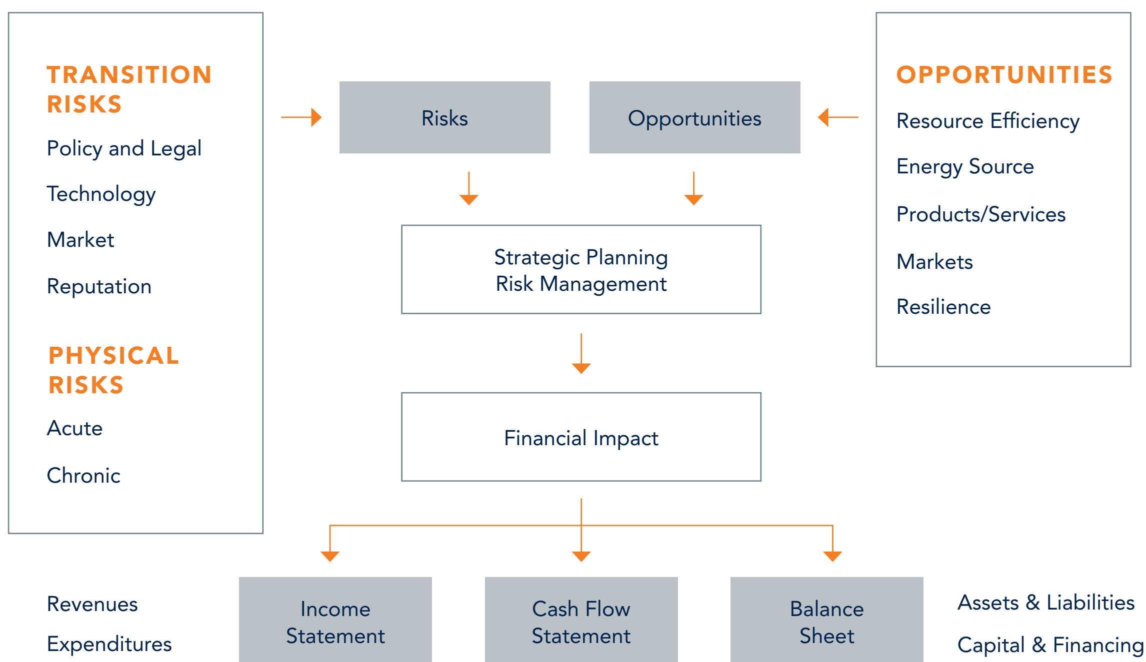


Figure 1 – Climate-related risks, opportunities and financial impacts

Source: Taskforce on Climate-related Financial Disclosures, Implementing the Recommendations of the TCFD, June 2017, p.5.

The TCFD recommendations recognise that the impact of climate change can differ by sector, industry, geography and organisation. However, the core principles of climate-related risks, opportunities and how these impact on an organisation's income statement, cash flow statement and balance sheet remain as factors for consideration.

Identifying and assessing the risks of material misstatement

When conducting an audit of the financial statements, to appropriately assess the impact of climate-related risks, an in depth understanding of the business, its supply chain and its operating environment is necessary.

Auditors looking to identify risks of material misstatement should start by performing inquiries with those within the organisation. Factors to consider when performing these inquiries will be in line with the requirements of ISA 315 *Identifying and Assessing the Risks of Material Misstatement* (ISA 315) and ISA 300 Planning an Audit of a Financial Report (ISA 300).

Factors to consider may include:

Entities Business model

- Understand the organisation's climate-related commitments
- Management's assessment of the impact of climate-related risks
- Length of time during which the organisation has had experience with the subject matter.

Industry factors

- Changes in the industry or business environment in which the organisation operates, including disclosures reflecting the impact of climate risk produced by similar companies and industries
- Relevant industry, regulatory and other external factors.

Regulatory factors

- The complexity of the subject matter, or measurements that involve complex processes
- Any expected changes to the nature of the assets held, including risks of obsolescence and revision of the Upper Earnings Limit (UEL)
- Consideration of the asset base, including the location, value, and the UEL of the assets held
- Obligations in respect of restoration, decommissioning and the basis for the valuation of liabilities.

Other external factors

- Climate-related events and conditions relevant to the organisation and whether there are risk factors
- Use of Private Finance Initiative (PFI): consider the significant geographical areas and sectors covered by prospective financial information, or similar data, relating to customers, operations, and supply chain locations.
- Information around investor and other stakeholders' expectations.

Auditors looking to identify risks of climate-related matters may perform inquiries based on the TCFD framework, these inquiries may include:

Transition risks

- Policy and legal – understand if the organisation is affected by any current or future policies. For example, increased carbon pricing, enhanced emissions and climate-related reporting obligations or new regulations to existing products or services
- Technology – understand if the organisation has been required to make any technological changes in the financial year. For example, substitution of products or services to lower emission alternatives
- Market – understand if the organisation has been affected by changes in the market. For example, consumer behaviour and increased production costs
- Reputation – understand if the organisation has experienced increased stakeholder concern or negative stakeholder feedback based on the goods/services the organisation provides.

Physical risks

- Acute – understand if the organisation has been affected by event-driven changes to the physical environment such as cyclones, hurricanes and flooding
- Chronic – understand if the organisation has been affected by long term shifts in climate patterns, such as increased temperatures or increased rainfall.

Once the auditor has obtained an understanding of the climate-related risks that are relevant to the audit, they may consider whether management's internal controls, as they relate to climate-related matters, are designed, implemented and operating effectively, and the impact they may have on the assessment.

The internal control considerations and specific inquires may include:

- Reviewing the entities risk assessment documentation for items related to climate risk or reviewing specific climate-related risk assessment, relevant to financial reporting.
- Inquire with management on specific climate-related responsibilities and the process for identifying climate-related risks, the types of risks identified, and any action taken to mitigate risk.
- Inquire on the integration of climate risk management processes in the overall risk management system.
- Review key information or management reports related to climate-related risks.

If the client has a less mature approach to climate-related matters, auditors may find reading the financial statements and disclosures of peers within the same industry insightful. This will assist the auditors on what further questions to ask based on the climate-related disclosure(s) seen throughout peer disclosures.

Once an assessment of the risks identified in accordance with ISA 315 has been performed, auditors respond to the risk of material misstatement in accordance with ISA 330 *The Auditor's Responses to Assessed Risks* (ISA330).

Responding to assessed risks

Auditors consider whether those responsible for the preparation of the financial statements applied appropriate consideration of climate risks in its application of existing accounting standards in preparing its financial statements.

Therefore, if climate-related risks materially affect the organisation being audited, auditors consider the adequacy of management's assessment of the impact on the financial statements and whether these effects are accounted for and/or disclosed in the financial statements in accordance with the applicable financial reporting framework.

Auditors should take a 'step back' and review the financial statements holistically including other information to ensure they are complete, accurate, and present a true view of the organisation's financial performance and position.

Examples of potential financial implications arising from climate-related matters may include:

Overstatement of assets

- Asset impairment, including goodwill
- Changes in the useful life of assets
- Changes in the fair value of assets
- Effects on impairment calculations due to increased costs or reduced demand.

Understatement of liabilities

- Changes in provisions for onerous contracts due to increased costs or reduced demand
- Changes in provisions and contingent liabilities, including those arising from fines and penalties
- Changes in expected credit losses for loans and other financial assets.

Materiality

Materiality is organisation-specific and it takes into account the nature and magnitude of information in the context of the audited financial statements. When carrying out materiality assessments, including an assessment of materiality relating to the effect of climate-related risks on the financial statements, management can consider what could reasonably be expected to influence decisions of primary users of the financial statements such as investors.

Auditors are required to make their own independent materiality assessment, exercise professional judgement and scepticism, and be prepared to challenge management's assessment of climate-related risks as relevant to the preparation of the financial statements in accordance with IFRS.

Recognising the pervasiveness of materiality judgement in the preparation of financial statements, the IASB has issued Practice Statement 2 *Making Materiality Judgements* to provide reporting entities with guidance on making materiality judgements when preparing general purpose financial statements, noting that materiality in the context of the Australian Accounting Standards Board (AASB) only relates to financial statements and is not to be applied to Environmental, Social and Governance (ESG) or Integrated Reporting (IR).

Consideration needs to be given to qualitative external factors such as the industry in which the organisation operates, and investor expectations which may make such risks 'material' and warrant disclosures when preparing financial statements, regardless of their numerical impact.

It needs to be emphasised that climate risks can no longer only be considered as Corporate Social Responsibility but in the context of an organisation's financial statements and risks. See the below diagram for considerations when assessing materiality.

Figure 2 – Considerations in Assessing Materiality

AASB Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2

Involving climate change professionals

ISA 620 *Using the Work of an Auditor's Expert* sets out the requirements for using specialised skills or involvement of specialists. In response to the evolving climate-related risk landscape, there may be a need for specialised skills or involvement of specialists in respect of climate-related matters during the planning phases of an audit.

In particular the need to involve climate change professionals as part of the risk assessment procedures of the audit for entities that are impacted more significantly by climate-related risks.

In determining whether to use the work of a specialist and which specialist to use when verifying climate–related data, auditors can assess:

- Knowledge and previous experience of the matter being considered
- The experience of the engagement team members who will be performing the assurance procedures
- The quantity and quality of alternative sources of assurance evidence available
- The significance of the key performance indicator (KPI) or disclosure in relation to the sustainability report as a whole
- The complexity of, and judgement associated with, the estimate or other assurance matter
- The nature, timing and extent of other procedures related to the KPIs and disclosures affected.

When auditors determine that a discussion with an appropriate climate change professional will help facilitate understanding of the potential impact of climate-related risks on the organisation and therefore on the audit, this discussion should take place early in the audit as the team starts to understand the business and respond to risks appropriately.

Performing testing procedures

GOING CONCERN AND ACCOUNTING ESTIMATES:

Going Concern

Climate-related risks will become increasingly important and may have an adverse impact on the viability of entities, albeit the exposure and its severity may vary by industry or geography. Certain industries maybe be more exposed to climate-related risks, for example:

- changes in weather patterns and limitation to water supplies will impact the agriculture industry more than others;
- changing consumer sentiments (i.e. reduced meat/animal product consumption, switching to renewable energy sources) may be wider reaching that will impact on various industries; and
- industries that emit high levels of greenhouse gases and industries that are dependent on fossil fuels, for example: entities operating in the energy, transportation, manufacturing, and construction sectors.

When assessing whether management's going concern assumption is appropriate, auditors evaluate whether management has included all available information about the future. This could include the potential impact of current climate-related risks on their ongoing operations. Auditors consider the possibility of instances of events or conditions, either individually or collectively which may cast significant doubt on the organisation's ability to continue as a going concern.

Auditors also assess the overall reasonableness of management's going concern assessment by ensuring different scenarios have been included in the going concern assessment. Auditors can perform stress tests on the model by including at least one severe but plausible downside scenario to assess the sufficient liquidity for the organisation to continue as a going concern.

Auditors may also consider some of the common examples by industry below when assessing the impact of climate-related risks on the going concern assumption:

Energy:

- Increased operating expenses due to higher compliance costs
- Risk of increased expenses due to the imposition of fines on various operating activities
- Increased insurance premiums if organisation has sites located in a "high risk location"
- Risk of damage to assets in high-risk locations.

Transportation:

- Increased expenses due to abrupt changes in fuel prices
- Reduced revenue and higher costs from negative impacts on the workforce (health, safety, absenteeism)
- Write offs and early retirement of existing assets due to policy changes.

Material and buildings:

- Increased insurance premiums if organisation has sites located in "high-risk location"
- Risk of damage to assets in high-risk locations
- Increased expenses due to supplier shortages of raw materials such as concrete
- Reduced revenue and higher costs from negative impacts on the workforce (health, safety, absenteeism).

Agriculture:

- Increased insurance premiums if organisation has sites located in "high-risk location"
- Risk of damage to assets in high-risk locations.

Food and forestry:

- Increase in costs due to natural disasters affecting crop
- Risk of damage to assets in high-risk locations
- Increase in expenses due to inadequate water supply for plants/trees.

In practice: Audit procedures to respond to the risk of the impact of climate change and the energy transition on the financial statements.

Increasingly, the impact of climate change and the energy transition on financial statements is being recognised as a key audit matter by organisation auditors. In response to this, auditors have included climate change in their assessment of going concern and considered the viability of associated disclosures. The procedures underpinning this assessment have been articulated in some assurance statements in the market.

These procedures can include checking alignment of statements made in the Strategic Report with information in the financial statements, consideration of whether emissions reduction targets are incorporated within the organisation's operational planning and associated frameworks, checking that material climate change risks are incorporated within critical accounting estimates, and procedures over climate change-related legal claims.

ACCOUNTING ESTIMATES:

When auditing accounting estimates (estimation uncertainty, subjectivity and complexity), the extent to which accounting estimates may be impacted by climate-related risks may be considered. Entities may evaluate alternative assumptions or outcomes of accounting estimates, which may be accomplished through a sensitivity analysis.

A sensitivity analysis could lead to the development of a number of outcome scenarios and auditors need to consider the extent to which these outcomes are impacted by climate-related risks.

Accounting estimates that may be more commonly impacted by climate-related risks include, but are not limited to:

Impairment reviews

- Auditors consider climate-related matters that may indicate that an asset is impaired. For example, a decline in demand for products that emit greenhouse gases could indicate a manufacturing plant may be impaired.
- Changes in the external environment, such as climate-change related regulation relevant to an organisation's operations that could have an adverse effect on the organisation may be an indication for impairment.

Tangible asset valuations

- Auditors consider the useful life assessment, such as machinery used to manufacture car engines may have a shorter useful life due to the increase in Electric Vehicles.
- Climate-related matters (flooding, fires) may impact fair value of tangible asset such as land and property.

Intangible assets

- Auditors consider the carrying value of intangible assets, in particular goodwill and indefinite life assets. As climate-related risks may change the nature of the entities operation, resulting in impairment.
- Inventory valuation
- Climate-related matters (flooding, fires) may cause inventory obsolescence.

Provisions, liabilities, and contingent assets

- Auditors consider the climate-related matters affecting the recognition of liabilities in the financial statements such as levies imposed by the governments for failure to meet climate targets, contracts that may become onerous due to potential loss of revenue from a result of climate change.

Expected credit loss provisions for financial instruments

- Banks may have to adjust the value of loan assets where it assesses the financial asset due to climate change, for example loss of revenue on a farming asset due to a warming climate.

Where the auditor identifies that climate-related risks may be relevant for accounting estimates including assumptions used to arrive at a fair value estimate and potential impairments, the auditor applies ISA 540 *Auditing Accounting Estimates and Related Disclosures* (ISA 540). The auditor is expected to respond to the assessed risks of material misstatement in accordance with ISA 540 by selecting an appropriate audit testing strategy.

SA 540 sets out the key requirements relating to the three testing approaches in designing and performing further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

In some cases, however, auditors may decide to make enquiries of others who participate in preparing and presenting the financial report and assertions therein, including individuals who have specialised knowledge relating to the matters about which written representations are requested. Such individuals may include:

- An actuary responsible for actuarially determined accounting measurements
- Staff engineers who may have responsibility for and specialised knowledge about environmental liability measurements
- Internal counsel who may provide information essential to provisions for legal claims.

Enquiries may include whether climate-related risks have been incorporated in the assumptions and data used such as the appropriateness of estimated useful lives and the assumption on the discount rate used. It is also common for auditors to perform an independent sensitivity analysis by developing a range of outcomes based only on amounts that are supported by sufficient, appropriate audit evidence.

When considering the impact of climate-related risks in the financial statements, the auditor applies their professional judgement to evaluate whether:

- the assessments of the risks of material misstatement at the assertion level remain appropriate;
- indicators of possible management bias exist when incorporating climate-related risks in accounting estimates; and
- management's decisions relating to the recognition, measurement, presentation, and disclosure are in accordance with and are reasonable in the context of the applicable financial reporting framework.

Depending on the outcome of the evaluations, the auditor is required to consider the implications for the audit and adjust their audit work accordingly.

In practice: Climate considerations in auditor's impairment review

Climate considerations have been considered in auditors' impairment reviews of Property, Plant and Equipment (PPE), being identified as a key audit matter. In recent assurance reports, auditors have challenged the organisation's assumptions of commodity prices, carbon prices, demand forecasts, asset lives, and provisions in the face of climate change risks.

As part of the procedures informing this, auditors compared the prices that the organisation used to third party Paris-scenarios and through a sensitivity analysis identified assets that could be at risk from changes in prices/discount rates (significant audit risks).

Financial Statement Impacts Considerations

This table sets out some of the key considerations to consider when focusing audit effort on the impact of climate change on the financial statements:

	ASSETS					LIABILITIES	CAPITAL & FINANCING	DISCLOSURES	
	ASSET LIVES	IMPAIRMENT	INVENTORY	FAIR VALUE MEASUREMENT	FINANCIAL INSTRUMENTS	PROVISIONS & CONTINGENT LIABILITIES	CAPITAL AND FINANCING (INCL. GOING CONCERN)	FINANCIAL INSTRUMENT DISCLOSURES	ACCOUNTING JUDGEMENTS & ESTIMATES
Have you made a net-zero commitment	■	■	■			■	■	■	■
Do you have polluting assets?	■	■				■			■
Are you exposed to carbon-related regulation?	■	■				■			■
Do you have a carbon-related customer or product base?	■	■	■			■		■	■
Are you required to purchase emissions credits?						■			■
Are your financial instruments exposed to climate-related risks?				■	■		■	■	■

Disclosures

Auditors should also consider disclosures relating to quantified values as these can inform the adequacy of climate-related risk disclosures in entities' financial statements, such as disclosure on credit risk and risk management.

It is important that even if findings are not material, the auditor must be able to justify why this is the case.

This means that the relevance and reliability of the information to be used as evidence is important and auditors can consider if:

- Evidence obtained from one source is inconsistent with that obtained from another
- There are doubts about the reliability of information to be used as evidence

Or

- Responses to inquiries of the responsible party or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible).

Environmental, Social and Governance (ESG) risks

Organisations in the financial services sector can be exposed to ESG and other emerging risks. The following items are examples of how these risks may impact the organisation:

- Increases in the severity and frequency of climatic events could impact the ability of customers to service their loans or the value of collateral held.
- Actions by governments or regulators to progress the climate change transition may impact the ability of investments, with some assets generating lower returns or certain assets being stranded.
- Current and emerging social, climate change, and environmental related legislation may impact the ability of customers to service their loans or abilities to generate sustainable returns.
- Access to insurance can be impacted if pricing models are changed to reflect increasing risk based off increased climatic events. Alternatively, the value of insurance premiums held by customers may not be sufficient to cover the costs of certain physical risks of climate change. This may impact the value organisations are able to recover in the instance of severe climatic events.
- Insuring assets with high exposure to physical risk may become prohibitive in cost which would lead to a diminished market and potential negative reputational impact.

Many organisations within the financial services sector already consider the above risks in business processes such as when performing credit risk assessments and due diligence process before a customer is granted credit and for new product development. Where these assessments have not proven reflective of conditions, accounting implications such as an impairment provision can be raised.

Consideration of laws and regulations in an audit of financial statements

ISA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report* (ISA 250) deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements, which includes, in the context of climate change risks, consideration of:

- The laws and regulations that may be fundamental to the operating aspects of the business resulting in material penalties, litigation or other consequences.
- Evaluate whether there are unusual or unexpected relationships within the subject matter, or between the subject matter and other related information, that indicate risks of material misstatement due to fraud or noncompliance with laws or regulations. For example, an increase in expenses due to an oil spill may also require a corresponding disclosure for any environmental regulation penalties.
- Evaluate whether other information obtained indicates risk of material misstatement due to fraud or noncompliance with laws or regulation.

Climate-related laws and regulations

The following are examples of relevant laws and regulations that may be considered during the audit. Auditors should monitor for changes and developments not only in the climate and environmental law and regulations, but also in social and governance related laws and regulations as this space is expected to change as the world transitions to net-zero:

- Australia's *Corporations Act 2001* (Cth) requires companies that are subject to environmental regulations give details of their performance for the financial year, including any penalties issued.
- *Australia's National Greenhouse Gas and Energy Reporting Act 2007* (NGER Act) requires companies above a certain threshold to report on their greenhouse gas emissions, greenhouse gas projects and energy consumption and production.
- Australia's *National Environment Protection Measures (National Pollutant Inventory)* (NPI) requires certain companies to report on emissions.
- The United Kingdom *Companies Act 2006* requires companies to obtain the annual quantity of greenhouse gas emissions, reported in tonnes of carbon dioxide equivalent, and energy consumption.
- *European Union Taxonomy Regulation*, adopted by the European Union in 2020, requires assets managers to use the framework to provide businesses and investors with a common language to identify to what degree economic activities can be considered environmentally sustainable.
- Legal action against greenwashing is increasing. Auditors need to be aware of the "green" claims that clients may be making and monitor for any potential lawsuits that might result in material financial impact.

Auditor's report

It is the auditor's responsibility to form an opinion on the financial statements with the aim to provide reasonable level of assurance to primary users that the financial statements as a whole are free from material misstatements, whether due to fraud or error, in accordance with the applicable financial reporting framework.

If the auditor identifies that climate-related risks may impact the client, the auditor is required to consider whether the financial statements appropriately reflect the impact of climate change in both the amounts and disclosures. ISA 700 *Forming an Opinion and Reporting on a Financial Report* (ISA 700) provides the framework for the information to be included in the auditor's report.

CLIMATE-RELATED RISKS AND KEY AUDIT MATTERS (KAM)

ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* (ISA 701) defines key audit matters (KAMs) as those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial report of the current period. KAMs are selected from matters communicated with those charged with governance.

KAMs typically relates to an account or disclosure that is material to the financial statements and that requires significant auditor attention especially audit matters that are challenging, subjective, or involve complex auditor judgement. Estimates that incorporate climate-related risks, especially long-range forecast, would require significant management judgement, and therefore auditing such estimates can be especially challenging and requires complex auditor judgement.

In the absence of corporate reporting requirements specific to climate-related risks, it is expected that where climate-related risks may contribute to a material risk, auditors include this in their KAM. Especially, when there are links between climate-related risk to estimation uncertainty.

Examples include:

- effects of climate on inputs used in cash flow estimates for impairment testing
- assessing the underlying commodity price assumptions used against external climate scenarios e.g. the carbon price used in forecast operating plan
- effects of climate on productive assets' useful lives
- effects of climate on asset retirement/ decommissioning obligations
- effects of climate on recovery of deferred tax assets and acquisition accounting that assigns fair values to the net assets of an acquire organisation
- consistency of the 'other information' with the financial statements, particularly the assumptions used in climate scenarios factored into financial statement estimates and judgements.

When climate change related matters are being included as a KAM in the auditor's report, it should describe why the matter was considered to be one of most significance in the audit and how the matter was addressed in the audit.

The description is in the context of the audit of the financial statements and can include discussion around the work and testing performed, and the role in which an expert or specialist was used.

What the KAM should describe

The KAM should clearly identify the climate-related issues considered in the audit, and provide detailed information on how the issue was addressed. This can include discussion around the work and testing performed, and the role in which an expert or specialist was used.

IN PRACTICE: KEY AUDIT MATTERS (KAM)

Climate considerations have been included in auditors' assurance reports as key audit matters. In recent reports, it was discussed in detail how the key audit matters were affected by considerations related to climate, how the organisation had addressed each matter, the procedures to understand the work performed, and explained the role of the Group's internal climate specialists.

Some examples of KAMs specifically related to climate risks found in recent reports include: the potential impact of climate change and the energy transition on the financial statements, the provisions for environmental obligations and impairment of assets related to the energy transition.

OTHER INFORMATION

The auditor is not required to obtain assurance on the Other Information. ISA 720 *The Auditor's Responsibilities Relating to Other Information* (ISA 720) only requires the auditor to read and consider the other information in the context of achieving the overall objectives of the auditor in expressing an opinion on whether financial statements as a whole are free from material misstatements, in accordance with the applicable financial reporting framework.

Consider including an example of types of Other Information that may fall within the scope of the financial statement auditor's ISA 720 procedures. For example, disclosures in a separately published Integrated Report or in a separately published TCFD report.

Material inconsistency between the Other Information and the financial statements may undermine the credibility of the financial statements and may even indicate potential material misstatements. For example, the organisation may disclose in their strategic report included in the annual report that the board has approved a new climate strategy that requires adjustments to the future operation of the organisation, however the impacts of the new climate strategy were not reflected in the financial statements.

GOING CONCERN

Depending on the severity of the outcomes of the going concerns assessment, the outcomes may also have implications on the auditor's report. For example, auditor's report may need to be modified accordingly if:

- The use of going concern basis of accounting is found to be inappropriate.
- The use of use of going concern basis of accounting is appropriate but a material uncertainty exists, and adequate disclosures made in the financial statements.
- Adequate disclosures of material uncertainty are not made in the financial statements.
- Management is unwilling to make or extend its going concern assessment.

Communication with those charged with governance

It is a requirement of ISA 260 C*ommunication with Those Charged With Governance* (ISA 260) for auditors to be in communication with those charged with governance.

When considering communications with the audit client, the auditor includes any significant climate-related qualitative aspects of the entities accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

Management representations

Auditors would be familiar with obtaining written representations from management and, where appropriate, those charged with governance to confirm that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor including climate-related disclosures. Auditors should consider the requirements of ISA 580 *Written Representations* (ISA 580) when obtaining written representations from management.

Where forward-looking climate-related risks that could potentially impact an organisation's financial statements may exist, such as key assumptions and data used in making the accounting estimates and related disclosures, auditors should also consider obtaining written representation as part of audit evidence that management has established the method and information provided to the auditor are appropriate in achieving the recognition, measurement and disclosures in accordance with the applicable reporting framework.

Some of the specific examples of climate-related written representations auditors can consider are listed below:

- State that all relevant matters are reflected in the measurement or evaluation of the subject matter or statement/assertion.
- State that all known matters contradicting the subject matter or statement/assertion and any communication from regulatory agencies or others affecting the subject matter or statement/assertion have been disclosed, including communications received between the end of the period addressed in the written statement/assertion and the date in the financial report.
- Acknowledge responsibility for:
  - The subject matter and the statement/assertion
  - Selecting the criteria, when applicable
  - Determining that such criteria are appropriate for the responsible party's purposes
- State that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter or statement/assertion have been disclosed.
- State that the organisation has provided all relevant information and access.
- If applicable, state that the responsible party believes the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the subject matter.

- If applicable, state that significant assumptions used when making any material estimates are reasonable.
- State that the responsible party has disclosed:
  - All deficiencies in the design or effective operation of controls or the system of internal control relevant to the engagement of which the responsible party is aware
  - Its knowledge of any actual, suspected, or alleged fraud or noncompliance with laws or regulations affecting the subject matter
  - Other matters as deemed appropriate.
- Include any other written representations deemed appropriate to support other evidence relevant to the subject matter, including a specific representation if a restatement is made to correct a material misstatement in the prior period financial statements that affects the comparative information.

When written representations are directly related to matters that are material to the subject matter:

- Evaluate their reasonableness and consistency with other evidence obtained, including other written representations
- Consider whether those making the representations can be expected to be well informed on the particular matters.

Other developments in climate-related reporting

TASKFORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES:

The Taskforce on Climate-related Financial Disclosures (TCFD) was set up by the Financial Stability Board (FSB) in 2015 to assist companies in developing voluntary climate-related financial risk disclosures in order to truly and fairly represent (and enable the assessment of) the impact of climate-related risks on financial positions and prospects.

In June 2017, TCFD released 11 disclosure recommendations across four pillars (Governance, Strategy, Risk Management and Metrics and Targets). These disclosures belong in the narrative management commentary or related documents outside the financial statements.

The TCFD provides entities guidance on including disclosures throughout the financial statements as a whole (instead of solely in a sustainability report) as there are several areas where climate may impact various areas of the Annual Report.

PRINCIPLES FOR EFFECTIVE DISCLOSURES

1 Disclosures should represent relevant information

2 Disclosures should be specific and complete

3 Disclosures should be clear, balanced, and understandable

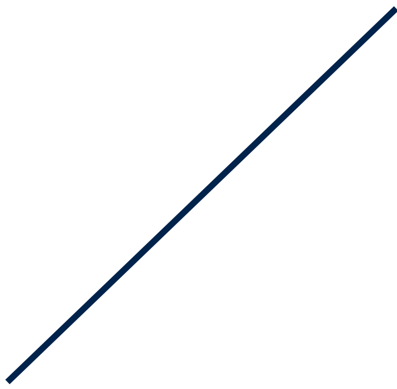
4 Disclosures should be consistent over time

5 Disclosures should be comparable among companies within a sector, industry, or portfolio

6 Disclosures should be reliable verifiable and objective

7 Disclosures should be provided on a timely basis

https://assets.bbhub.io/organisation/sites/60/2021/07/2021-Metrics_Targets_Guidance-1.pdf



INTERNATIONAL SUSTAINABILITY STANDARDS BOARD (ISSB):

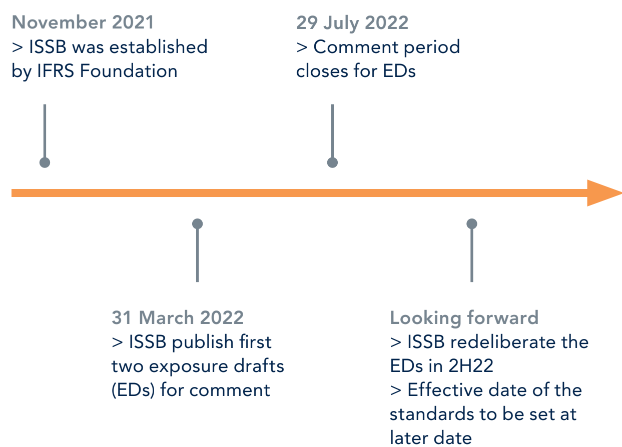
Under the strategic direction of the IFRS Foundation, the ISSB will operate parallel to the International Accounting Standards Board (IASB); the body that sets accounting standards which are required for most listed entities across various jurisdictions. The ISSB will be responsible for developing IFRS Sustainability Disclosure Standards.

The Standards are to be structured in such a way that entities provide all material sustainability-related information that affect investors' assessment of enterprise value. They will require entities to disclose sustainability-related risks and opportunities related to significant sustainability matters.

The Standards will follow a clear structure which is based on the four TCFD content pillars. Required disclosures are categorised by governance, strategy, risk management and metrics & targets.

The Standards will be industry-agnostic and topic-based but will be supplemented with industry specific requirements. The industry-specific requirements are based on existing SASB standards, along with a technical protocol that provides guidance on definitions, scope, implementation, compilation and presentation.

On 31 March 2022, the International Sustainability Standards Board (ISSB or the Board) published its first two exposure drafts (EDs) on IFRS Sustainability Disclosure Standards, namely, General Requirements for Disclosure of Sustainability-related Financial Information and Climate-related Disclosures for public comment.



The ISSB is expected to deliberate the feedback received on the exposure drafts over the course of 2022 and develop and issue the final standards in early 2023.

Questions to consider:

- Has the organisation considered the impact of the proposed new standards?
- What are the climate and sustainability disclosures that the organisation currently reports on?
- Are there sustainability governance and risk management processes in place specific to sustainability? How are they involved in the controls process?
- Are there controls and processes in place to identify, assess and monitor climate and sustainability related issues?

Developments in sustainability assurance

INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB):

In September 2022, the IAASB approved a project proposal to develop an overarching standard for assurance on sustainability (sustainability standard) for use by all assurance practitioners (i.e., professional accountants and other professionals performing assurance engagements). The proposed standard will be framework neutral, standalone in its entirety and will address both limited assurance and reasonable assurance.

The IAASB expects to approve an Exposure Draft in September 2023, with a final standard expected to be approved late 2024 or early 2025.

CONCLUSION

Whilst climate considerations are in their infancy within financial reporting and auditors' consideration, our world is changing. Stakeholders are becoming more conscious of the climate and sustainability information reported by companies and regulatory bodies have been set up to provide further guidance to gain consistency within the market and across jurisdictions.

Resources and Further Information

Taskforce on Climate-Related Financial Disclosures:
https://www.fsb-tcfd.org/

International Sustainability Standards Board:
https://www.ifrs.org/groups/international- sustainability-standards-board/

The Consideration of Climate-Related Risks in an Audit of Financial Statement (IAASB):
https://www.ifac.org/system/files/publications/files/IAASB-Climate-Audit-Practice-Alert.pdf

Climate-related and Other Emerging Risks Disclosures (AASB/IASB):
https://www.aasb.gov.au/admin/file/content102/c3/AASB_AUASB_Joint_Bulletin_Finished.pdf

AUASB Sustainability Assurance Update – October 2022:
https://auasb.gov.au/media/lhwp_1rep/sustainabilityassuranceupdate_10-22.pdf

CPA
AUSTRALIA