

IIGCC response to FCA consultation CP21/18: Enhancing climate-related disclosures by standard listed companies

About us

IIGCC's mission is to support and enable the investment community in driving significant and real progress by 2030 towards a net zero and resilient future. IIGCC's 330+ members, representing €39 trillion assets under management, includes many of the largest global and UK-based institutional investors and asset managers.

As the leading investor group on climate change in Europe, IIGCC is also responsible for the implementation of the Climate Action 100+ initiative in Europe across all key sectors. The Climate Action 100+ initiative was initiated in December 2017 to support investor engagement with the 167 most systemically important companies in the transition to net zero emissions. More than 600 investors, responsible for over \$55 trillion in assets, are now part of the initiative.

For more information visit www.iigcc.org and [@iigccnews](https://twitter.com/iigccnews).

Executive summary

In October 2020, IIGCC responded to the FCA's [consultation](#) to introduce reporting aligned with the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations for premium listed issuers.¹ More recently, we have issued responses to a number of consultations under HM Treasury's roadmap to mandate TCFD-aligned disclosures across the economy by 2025. This includes the Department for Work and Pension's [proposed TCFD rules](#) for trustees of occupational pension schemes, as well as the Department for Business, Energy and Industrial Strategy's [proposals](#) to mandate climate-related financial disclosures by publicly quoted companies, large private companies and LLPs.² In light of the input we received from our members during these processes, we wanted to take the opportunity to reflect and summarise some of the key issues raised regarding climate-related disclosure.

In addition to the below answers, we would also like to draw attention to our expectation that companies and auditors ensure climate risks are fully incorporated in company financial statements. This is not addressed directly by the consultation, but is critical to achieving the UK Government's commitment to reach net zero by 2050. Further details can be found in our Investor Expectations report on Paris-aligned accounts.³ We would strongly encourage the FCA to review this and would welcome a follow up conversation.

In summary, IIGCC recommends that all companies should manage and disclose against climate-related risks and opportunities. In addition, we expect companies to:

- fully incorporate climate-related risks into their financial statements, alongside narrative reporting.

¹ IIGCC response to CP 20/3, available [here](#).

² IIGCC initial response to DWP TCFD consultation (Oct 20), available [here](#). IIGCC response to final DWP proposals, available [here](#). IIGCC response to BEIS TCFD consultation, available [here](#).

³ Investor Expectations for Paris-aligned Accounts, available [here](#).

- make climate-related disclosures irrespective of the type of instrument they issue (e.g. global depository receipts (GDRs), shares other than equity shares).
- be subject to mandatory TCFD disclosure requirements within a clearly defined timeframe, and disclose against the Climate Action 100+ (CA100+) Net Zero Company Benchmark (the Benchmark) indicators as an additional reporting requirement.
- be subject to external audit/assurance with regards to TCFD disclosures and the financial impacts of material climate-related risks within company accounts.

IIGCC response to selected consultation questions

Q1: Do you agree with our proposal to extend the application of our existing TCFD-aligned disclosure requirement (set out in LR 9.8.6R(8)) to issuers of standard listed equity shares, excluding standard listed investment entities and shell companies? If not, what alternative scope would you consider to be appropriate, and why?

IIGCC strongly supports proposals to extend the existing TCFD Listing Rule to all companies, including standard listed issuers. Company reporting in line with the TCFD recommendations is vital for investors to understand their exposures to climate risk and capture opportunities. The extension of the TCFD requirements to a wider spectrum of listed issuers will increase the availability, quality and comparability of climate-related data across the market, which will in turn support better investment and capital allocation decisions. The proposals also represent a critical step towards achieving the UK Government's ambition for all listed companies to disclose in line with the TCFD recommendations by 2022.

In addition to the disclosure of material climate risks in the narrative report, companies should also seek to fully incorporate these risks into their financial statements.⁴ While this is not an issue that is addressed directly by the TCFD recommendations, integrating material climate risks into financial statements complements, and is consistent with, improved narrative reporting in line with TCFD. Aligning company accounts with the Paris Agreement will support the necessary shifts in capital deployment away from fossil fuels and towards sustainable activities.

Q2: Do you consider that issuers of standard listed GDRs and standard listed issuers of shares other than equity shares should also be subject to our TCFD-aligned disclosure requirements? If not, what alternative approach would you consider to be appropriate, and why?

In line with the TCFD recommendations, IIGCC believes it is critical for all companies with public and private debt or equity to identify and manage climate-related risks and opportunities, irrespective of the type of instruments they issue. The extension of the TCFD proposals to issuers of GDRs and shares other than equity shares will therefore help to maintain a consistent approach to climate-related disclosures across the Standard Segment.

Q5: Do you agree that, subject to the TCFD's final guidance materials being broadly consistent with those proposed, we should incorporate them into our existing and proposed handbook guidance provisions as described (including both the existing guidance relating to LR 9.8.6R(8) and our proposed new guidance relating to LR 14.3.27R):

⁴ See IIGCC's Investor Expectations for Paris-aligned Accounts, [here](#).

- a. *the TCFD's proposed updates to the TCFD Final Report and TCFD Annex*
- b. *the TCFD's proposed standalone guidance document on metrics, targets and transition planning*
- c. *the TCFD's technical supplement on measuring portfolio alignment.*

If not, what alternative approach would you prefer?

IIGCC agrees that it would be appropriate for the FCA to reference the updated TCFD Final Report, Annex, and proposed guidance, to the extent that the proposals align with those put forward in this consultation.

In IIGCC's response to the June 2021 TCFD consultation on metrics, targets and transition plans,⁵ we raised a number of concerns with regard to the proposed metrics and targets, as well as the supplementary guidance for financial services firms. These concerns are summarised below for the FCA's consideration.

With regards to the proposed cross-industry climate metrics, IIGCC's key concern related to their high-level nature, which provides excessive flexibility for companies to interpret and calculate the metrics in a variety of ways. IIGCC's view is that in order to effectively operationalise the proposed metrics, it will be essential for standard setters to build on the proposals by introducing consistent, standardised methodologies for calculating them.

IIGCC also emphasised the need for a differentiated approach between the metrics and targets to be developed and disclosed by investors in relation to portfolio alignment, and those to be made by companies in order to support investors' assessments of current and forward-looking alignment of their holdings. The proposed metrics in the TCFD consultation have been developed on a cross-industry basis, and do not sufficiently distinguish between the relevance of the metrics and targets for investors versus companies.

In relation to the proposed technical supplement on measuring portfolio alignment, IIGCC agreed with the 7 criteria proposed by the supplement. However, IIGCC is cautious about the continued expectation that implied temperature rise metrics are the most optimal portfolio alignment metrics, given the current challenges associated with such a methodology. Our preference is to focus on alignment against net zero emissions rather than a temperature metric, because net zero emissions by 2050 is a clearer and more specific goal, and greater transparency against this goal is possible compared to temperature metrics. While in theory, a temperature metric is an attractive option to express portfolio alignment, there are concerns as to whether portfolio performance can be summarised into a single temperature metric (e.g. 1.5°C, 2°C) in a technically robust way that avoids producing misleading results. However, IIGCC acknowledges that forward-looking assessments of alignment for assets and measuring portfolio performance are critical for achieving the transition to net zero, and we support continuing efforts to develop recommendations in this area.

Q7: Do you agree with our encouraging listed companies to consider the SASB metrics for their sector when making their disclosures against the TCFD's recommended disclosures, as appropriate? If not, please explain.

⁵ IIGCC response to TCFD public consultation on metrics, targets and transition plans/technical supplement on measuring portfolio alignment, available [here](#).

IIGCC supports efforts to ‘flesh out’ the TCFD’s principles-based approach with sector-specific, standardised metrics, such as the SASB metrics. As the consultation notes, the TCFD recommendations alone do not constitute a corporate reporting standard. In order to enhance investment decision-making, investors need access to more granular data from investee companies, which necessitates the development of a more detailed reporting standard that builds on and underpins the TCFD’s recommendations, including in relation to the disclosure of consistent and comparable metrics.

In particular, IIGCC recommends that the FCA references the Climate Action 100+ (CA100+) Net Zero Company Benchmark (the Benchmark) as a disclosure requirement. The Benchmark was developed to provide investors with robust and comparable information on how companies are realigning their business strategies and operations with the goals of the Paris Agreement and a net zero emissions future. It builds on the TCFD recommendations with more guidance on company actions and disclosures of most relevance to investors’ decision-making. This is achieved through a series of core Benchmark indicators and sub-indicators (set out in Annex 1). These indicators map on to and build upon, the four pillars of the TCFD, with climate risk reporting consistent with the recommendations of the TCFD as an indicator in its own right.

Q8: Do you agree with our approach to maintain a ‘comply or explain’ compliance basis until such time as a common international reporting standard has been published and adopted in the UK? If not, what alternative approach would you prefer, and why?

Given the importance of TCFD disclosures to investors, and their reliance on the information published by investee companies, IIGCC recommends that the FCA establishes a reasonable timeframe for moving away from a ‘comply or explain’ basis for corporate disclosures towards mandatory TCFD reporting, with a clear deadline set.

IIGCC acknowledges the FCA’s intention to take stock of the development of the IFRS Foundation’s proposed International Sustainability Standards Board (ISSB) before proposing a mandatory compliance basis for the rules. However, as the consultation notes, it will take time for any such initiative to be finalised, with only a draft standard tabled for H1 2022. The introduction of mandatory TCFD-aligned disclosure requirements for pension scheme trustees, asset managers and FCA-regulated asset owners has shifted the dial with regards to the need for investee companies to report in line with TCFD on a mandatory basis. These investors will depend on the quality, consistency and comparability of disclosures made by their investee companies to inform their understanding of exposures to climate-related risks and opportunities. As long as the regime for listed companies continues to operate on a ‘comply or explain’ basis, there is a risk that reporting coverage gaps will materialise that could undermine the capacity of investors to meet their own TCFD-related obligations.

Q9: Do you agree with our approach not to require third-party audit and assurance for issuers’ climate-related disclosures at this time? If not, what additional requirements would you consider to be appropriate?

IIGCC strongly believes that climate-related disclosures – both narrative and financial – should be independently audited.

Independent, third-party assurance and audit will be critically important in order to improve the reliability of climate disclosures made by companies. This should be results focused rather than only process

focused. The narrow focus on process has been one of the weak points of financial audit today – and one criticised for allowing auditors to ‘tick boxes’ but failing to deliver on the ultimate purpose – alerting shareholders to inaccuracies. Assurers should provide an opinion as to whether the actual data provided is reliable, not just whether it was gathered in the right way (e.g. whether critical accounting assumptions/estimates are consistent with the Paris Agreement). With a few noteworthy exceptions however, auditors are silent on climate risks.

The FCA could consider introducing a proportionate regime for the assurance and audit of climate-related disclosures. For example, while premium and standard-listed issuers (as well as large private companies) could be subject to a full audit, small and medium-sized enterprises could at least initially be subject to limited assurance or otherwise appropriately scaled requirements.

We would also highlight the European Commission’s proposed approach to assurance requirements under the revised NFRD, now known as the Corporate Sustainability Reporting Directive (CSRD).⁶ Under the proposed CSRD, sustainability disclosures will be subject to limited assurance engagements by the statutory auditor. The European Commission will review the requirements once the rules have been in force for three years, which could be accompanied by proposals to introduce reasonable assurance requirements as the market evolves. IIGCC recommends that the FCA should consider the introduction of similar requirements in the context of TCFD assurance as a minimum for all companies, with a view to moving towards reasonable assurance as the market develops. This would support greater quality and reliability of TCFD disclosures over time.

Q10: Do you agree that our new rule should take effect for accounting periods beginning on or after 1 January 2022? If you consider that we should set a different timeframe, please explain why.

IIGCC supports rapid implementation of the new requirements, and we therefore agree with the FCA’s proposed timetable. However, it will be important for the FCA to engage with other regulators and government departments to mitigate any risks stemming from mismatched timings across the wider HMT roadmap for mandatory TCFD disclosures. Asset owners and managers will depend on the disclosures made by investee companies in order to meet their own TCFD-related reporting obligations. However, while the first reports for standard issuers will be published in 2023, TCFD disclosure rules for the largest occupational pension schemes and authorised master trusts will enter into force from October 2021 (with reports to be published within 7 months of the end of the scheme year underway on that date).

IIGCC appreciates that there are limits in terms of what the FCA can do to address this challenge. Nevertheless, we stress the importance of ongoing collaboration and communication between the FCA, DWP, BEIS and others to prevent the risk of reporting gaps and to support the timely flow of climate-related information across the investment chain.

⁶ EU proposals for a Corporate Sustainability Reporting Directive, available [here](#).

Discussion topics on ESG integration in UK capital markets

In addition to the above responses, we have provided feedback on the FCA's discussion topics for integrating wider ESG matters into the UK capital markets. Please find our specific feedback on the discussion questions below.

UK green bonds

IIGCC supports the development of a UK bond standard, starting with green bonds, given the urgency of the risks stemming from climate change. In order to avoid market fragmentation and promote international consistency, the framework should build on existing standards (e.g. the ICMA Principles and UN Sustainable Development Goals) and, where possible, align with EU standards.

To prevent greenwashing, and to ensure that capital is directed towards assets and projects which support the transition to net zero, green bonds should meet the criteria established by the EU and forthcoming UK green taxonomies. Taxonomy-aligned investments for fixed income holdings are an essential component of the Paris Aligned Investment Initiative's Net Zero Investment Framework,⁷ which provides a basis for investors to align their portfolios with net zero by increasing investment in climate solutions, leveraging the EU Taxonomy's climate mitigation criteria.

Requiring issue proceeds to be aligned with established taxonomies will help to reduce prevailing market uncertainty about whether bonds are being used to finance activities and projects which are verifiably sustainable. However, the credibility of this approach will depend on the extent to which EU Taxonomy upholds, as a minimum, the level of climate ambition and associated criteria recommended by the Technical expert group on sustainable finance (TEG). In addition, for companies to raise capital to support their transition to net zero, it will also be necessary to expand the range of 'transitional' activities in scope of the Taxonomy. Without this more transition-oriented approach, green bond issuances will inevitably be lower than they could be, and transition activity will be curtailed. IIGCC acknowledges that a UK green bond framework will need to align with the criteria established by the UK taxonomy, and we reiterate the above points in the context of the development of UK-specific technical screening criteria.

Finally, we expect that any green bonds issued in line with a proposed framework should be subject to external verification, in line with the requirements of the proposed EU Green Bond Standard. Verifiers of UK green bonds should be registered/authorised or supervised by the FCA.

Sustainability-linked bonds and loans

IIGCC's position is that the FCA should establish guidelines for sustainability linked bonds and loans. We strongly recommend these guidelines build on existing initiatives such as the Sustainability-Linked Bond Principles and Sustainability-Linked Loan Principles.

At present, there is potential for companies to self-determine their outcomes or targets, without a clear reference point for assessing an ambitious vs 'business as usual' outcome. As the market for these instruments grows, transparency and clarity regarding the setting, monitoring and reporting of outcomes will be essential to ensure the integrity of the market. There are challenges for investors

⁷ Net Zero Investment Framework, available [here](#).

looking to undertake in-depth assessments of the outcomes, both from a transparency perspective (given companies have much greater knowledge of their business models) as well as capacity perspective (for example, to assess dozens of issues as the market grows). By comparison, the approach for traditional green bonds (with ringfencing of proceeds against a green taxonomy) is easier in terms of assessment, as well as management and monitoring of budgeting and proceeds.

In addition, UK guidelines could support the growth of this market by providing an additional incentive for investors to ensure issuers are upholding sustainability principles, and to help ensure the credibility of sustainability-linked bonds or loans.

ESG ratings

IIGCC's position is to call for improved transparency and, ideally, improved consistency between ESG ratings; however, from an investor perspective, we do not consider that heavy regulation of this industry is presently required. ESG ratings are only one of many (not the only) data sources utilised by investors when assessing investments.

The rapid growth in the ESG ratings space has resulted in differences in methodology and metrics. Different rating agencies have different philosophies and users need to appreciate these in order to fully understand the rationale behind the ratings. As investors increase their experience of working with different agencies, their understanding of each agencies' methodology can often improve. The greater the transparency of the agencies' methodology and the rationale underpinning the ratings, the easier it is for investors to understand and utilise the agencies' ratings.

Annex 1: Climate Action 100+ Net Zero Company Benchmark

Disclosure Indicator	Description
1	Net-zero GHG Emissions by 2050 (or sooner) ambition
1.1 (sub-indicator)	<p>Metric a): The company has made a qualitative net-zero GHG emissions ambition statement that explicitly includes at least 95% of scope 1 and 2 emissions.</p> <p>Metric b): The company's net zero GHG emissions ambition covers the most relevant scope 3 GHG emissions categories for the company's sector, where applicable.</p>
2	Long-term (2036-2050) GHG reduction target(s)
2.1 (sub-indicator)	The company has set a target for reducing its GHG emissions by between 2036 and 2050 on a clearly defined scope of emissions.
2.2 (sub-indicator)	<p>The long-term (2036 to 2050) GHG reduction target covers at least 95% of scope 1 & 2 emissions and the most relevant scope 3 emissions (where applicable).</p> <p>Metric a): The company has specified that this target covers at least 95% of total scope 1 and 2 emissions.</p> <p>Metric b): If the company has set a scope 3 GHG emissions target, it covers the most relevant scope 3 emissions categories for the company's sector (for applicable sectors), and the company has published the methodology used to establish any scope 3 target.</p>
2.3 (sub-indicator)	The target (or, in the absence of a target, the company's latest disclosed GHG emissions intensity) is aligned with the goal of limiting global warming to 1.5°C.
3	Medium-term (2026 to 2035) GHG reduction target(s)
3.1 (sub-indicator)	The company has set a target for reducing its GHG emissions by between 2026 and 2035 on a clearly defined scope of emissions.
3.2 (sub-indicator)	<p>The medium-term (2026 to 2035) GHG reduction target covers at least 95% of scope 1 & 2 emissions and the most relevant scope 3 emissions (where applicable).</p> <p>Metric a): The company has specified that this target covers at least 95% of total scope 1 and 2 emissions.</p> <p>Metric b): If the company has set a scope 3 GHG emissions target, it covers the most relevant scope 3 emissions categories for the company's sector (for applicable sectors), and the company has published the methodology used to establish any scope 3 target.</p>
3.3 (sub-indicator)	The target (or, in the absence of a target, the company's latest disclosed GHG emissions intensity) is aligned with the goal of limiting global warming to
4	Short-term (up to 2025) GHG reduction target(s)
4.1 (sub-indicator)	The company has set a target for reducing its GHG emissions up to 2025 on a clearly defined scope of emissions.
4.2 (sub-indicator)	<p>The short-term (up to 2025) GHG reduction target covers at least 95% of scope 1 & 2 emissions and the most relevant scope 3 emissions (where applicable).</p> <p>Metric a): The company has specified that this target covers at least 95% of total scope 1 and 2 emissions.</p> <p>Metric b): If the company has set a scope 3 GHG emissions target, it covers the most relevant scope</p>

	3 emissions categories for the company's sector (for applicable sectors), and the company has published the methodology used to establish any scope 3 target.
4.3 (sub-indicator)	The target (or, in the absence of a target, the company's latest disclosed GHG emissions intensity) is aligned with the goal of limiting global warming to 1.5°C.
5	Decarbonisation strategy
5.1 (sub-indicator)	<p>The company has a decarbonisation strategy to meet its long and medium-term GHG reduction targets.</p> <p>Metric a): The company identifies the set of actions it intends to take to achieve its GHG reduction targets over the targeted timeframe. These measures clearly refer to the main sources of its GHG emissions, including Scope 3 emissions where applicable.</p> <p>Metric b): The company quantifies key elements of this strategy with respect to the major sources of its emissions, including Scope 3 emissions where applicable (e.g. changing technology or product mix, supply chain measures, R&D spending).</p>
5.2 (sub-indicator)	<p>The company's decarbonisation strategy includes a commitment to 'green revenues' from low carbon products and services.</p> <p>Metric a): The company already generates 'green revenues' and discloses their share in overall sales.</p> <p>Metric b): The company has set a target to increase the share of 'green revenues' in its overall sales OR discloses the 'green revenue' share that is above sector average.</p>
6	Capital allocation alignment
6.1 (sub-indicator)	<p>The company is working to decarbonise its future capital expenditures.</p> <p>Metric a): The company explicitly commits to align future capital expenditures with its long-term GHG reduction target(s).</p> <p>Metric b): The company explicitly commits to align future capital expenditures with the Paris Agreement's objective of limiting global warming to 1.5° Celsius.</p>
6.2 (sub-indicator)	<p>The company discloses the methodology used to determine the Paris alignment of its future capital expenditures.</p> <p>Metric a): The company discloses the methodology it uses to align its future capital expenditure with its decarbonisation goals, including key assumptions and key performance indicators (KPIs).</p> <p>Metric b): The methodology quantifies key outcomes, including the share of its future capital expenditures that are aligned with a 1.5° Celsius scenario, and the year in which capital expenditures in carbon intensive assets will peak.</p>
7	Climate policy engagement
7.1 (sub-indicator)	<p>The company has a Paris-Agreement-aligned climate lobbying position and all of its direct lobbying activities are aligned with this.</p> <p>Metric a): The company has a specific commitment/position statement to conduct all of its lobbying in line with the goals of the Paris Agreement.</p> <p>Metric b): The company lists its climate-related lobbying activities, e.g. meetings, policy submissions,</p>

	etc.
7.2 (sub-indicator)	<p>The company has Paris-Agreement-aligned lobbying expectations for its trade associations, and it discloses its trade association memberships.</p> <p>Metric a): The company has a specific commitment to ensure that the trade associations the company is a member of lobby in line with the goals of the Paris Agreement.</p> <p>Metric b): The company discloses its trade associations memberships.</p>
7.3 (sub-indicator)	<p>The company has a process to ensure its trade associations lobby in accordance with the Paris Agreement.</p> <p>Metric a): The company conducts and publishes a review of its trade associations' climate positions/alignment with the Paris Agreement.</p> <p>Metric b): The company explains what actions it took as a result of this review.</p>
8	Climate governance
8.1 (sub-indicator)	<p>The company's board has clear oversight of climate change.</p> <p>Metric a): The company discloses evidence of board or board committee oversight of the management of climate change risks via at least one of the following:</p> <ul style="list-style-type: none"> • There is a C-suite executive or member of the executive committee that is explicitly responsible for climate change (not just sustainability performance) and that executive reports to the board or a board level committee, and/or; • The CEO is responsible for climate change AND he/she reports to the board on climate change issues, and/or; • There is a committee (not necessarily a board-level committee) responsible for climate change (not just sustainability performance) and that committee reports to the board or a board-level committee. <p>Metric b): The company has named a position at the board level with responsibility for climate change, via one of the following:</p> <ul style="list-style-type: none"> • A board position with explicit responsibility for climate change, or; • CEO is identified as responsible for climate change if he/she sits on the board.
8.2 (sub-indicator)	<p>The company's executive remuneration scheme incorporates climate change performance elements.</p> <p>Metric a): The company's CEO and/or at least one other senior executive's remuneration arrangements specifically incorporate climate change performance as a KPI determining performance-linked compensation (reference to 'ESG' or 'sustainability performance' are insufficient).</p> <p>Metric b): The company's CEO and/or at least one other senior executive's remuneration arrangements incorporate progress towards achieving the company's GHG reduction targets as a KPI determining performance linked compensation (requires meeting relevant target indicators 2, 3, and/or 4).</p>

8.3 (sub-indicator)	<p>The board has sufficient capabilities/competencies to assess and manage climate related risks and opportunities.</p> <p>Metric a): The company has assessed its board competencies with respect to managing climate risks and discloses the results of the assessment.</p> <p>Metric b): The company provides details on the criteria it uses to assess the board competencies with respect to managing climate risks and/or the measures it is taking to enhance these competencies.</p>
9	Just transition: The company considers the impacts from transitioning to a lower-carbon business model on its workers and communities
10	TCFD disclosure
10.1 (sub-indicator)	<p>The company has committed to implement the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).</p> <p>Metric a): The company explicitly commits to align its disclosures with the TCFD recommendations OR it is listed as a supporter on the TCFD website.</p> <p>Metric b): The company explicitly sign-posts TCFD aligned disclosures in its annual reporting or publishes them in a TCFD report.</p>
10.2 (sub-indicator)	<p>The company employs climate-scenario planning to test its strategic and operational resilience.</p> <p>Metric a): The company has conducted a climate-related scenario analysis including quantitative elements and disclosed its results.</p> <p>Metric b): The quantitative scenario analysis explicitly includes a 1.5° Celsius scenario, covers the entire company, discloses key assumptions and variables used, and reports on the key risks and opportunities identified.</p>

Annex 2: Paris-aligned accounting and audit

IIGCC welcomes efforts by regulators and standard setters to establish expectations for companies to disclose against material climate risks in their financial statements, alongside increasing scrutiny over the reliability of these disclosures. For example, the UK's Financial Reporting Council (FRC) sent out a reminder to Audit Committee Chairs and Financial Directors in October 2019 making it clear that financial statements must incorporate material climate risks (as part of existing financial accounting rules).⁸ In November 2020, the FRC published its findings of a thematic review of climate-related considerations by boards, companies and auditors, noting that more needs to be done to meet investor expectations, including in relation to the development of Paris-aligned accounts.⁹

This is an issue with enforcement rather than the rules themselves, since it is noted that International Financial Reporting Standards already requires information material to a company to be included in financial statements (under International Accounting Standard 1).¹⁰ Materiality of information is determined by whether it could reasonably be expected to influence decisions made by investors. In terms of determining materiality, it should be clear that investors view climate risks as material for a wide range of companies - there are tens of trillions of assets backing the TCFD and its call for more quantitative data on climate risks facing businesses.

With regards to Paris-aligned accounting specifically, investors are calling for companies to provide the following information in their financial statements and/or associated notes:

- How critical accounting judgments have been tested against credible economic scenarios that are consistent with achieving net zero carbon emissions by 2050 to 2070 in line with the Paris Agreement, and any adjustments made to these assumptions.
- 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.
- Implications for dividend paying capacity of Paris-alignment (e.g. adjustments to distributable reserves; threshold assumptions that would trigger cuts to dividends).
- Consistency between narrative reporting on climate risks and the accounting assumptions.
- Steps taken by the Audit Committee to ensure material climate risks – including those associated with Paris-alignment – are properly considered by the external auditor, and the impact that this has had.

As part of this, financial reports should reflect and be consistent with any assumptions made over commodity or energy prices and consumer demand used in developing Paris Agreement-Aligned strategies and targets.

Recent guidance published by International Accounting Standards Board (IASB) Board outlines how climate risks should already be incorporated under existing accounting standards, providing a valuable framework for directors and audit firms. These cover all the categories noted in the question above, for

⁸ FRC Year-end letter 2019/20, available [here](#).

⁹ FRC Climate Thematic Review 2020, available [here](#).

¹⁰ As was reiterated in an IASB paper setting out the importance of incorporating material climate risks under existing IFRS. See [here](#) for more information.

instance:

- asset impairment, including goodwill
- changes in the useful life of assets - changes in the fair valuation of assets
- effects on impairment calculations because of increased costs or reduced demand
- changes in provisions for onerous contracts because of increased costs or reduced demand
- changes in provisions and contingent liabilities arising from fines and penalties
- changes in expected credit losses for loans and other financial assets.

Another key mechanism to ensure accounting standards are properly enforced is via audit; with a few noteworthy exceptions, auditors are silent on climate risks. The FCA needs to enforce auditor duties with respect to existing accounting standards.

In January 2019, investors sent letters to the UK's largest audit firms (PWC, KPMG, Deloitte and EY). In December 2019, KPMG and Deloitte published detailed papers outlining how directors should ensure climate risks are incorporated into the accounting process, which builds on the IASB framework. In summary, the key actions auditors need to take include:

- Establish whether accounting standards have been properly followed, including necessary adjustments for material climate risks. Critical accounting estimates or judgements must reflect these factors. As noted above, for those using IFRS, the decision on materiality rests not just with directors' personal views but must take account of whether investors have indicated that they believe the information to be material.
- Ensure consistency between the narrative disclosures around climate risks, the company's strategy and the financial statements.
- Ensure capital maintenance / solvency rules are adhered to, such as dividend legality.

In the event that management chooses not to presume Paris-alignment in their accounting, for instance due to a belief that the Paris Agreement is unlikely to be implemented, then auditors need to consider two courses of action:

- Opinion qualification: the auditor must first determine whether managements' assumptions/ estimates are consistent with providing a true and fair view / fair representation of the entity's economic health. If not, then they should qualify their accounts to alert shareholders to this fact.
- Supplementary disclosures including sensitivity analysis: If the auditors determine the core assumptions meet local statutory requirements, and are consistent with accounting standards, then they should ensure that sensitivity /scenario analysis is produced in the Notes to the accounts indicating how Paris-aligned assumptions would impact the financial statements (as highlighted under recent IASB guidance for IAS1 above). If management and the board choose not to make these supplementary disclosures, auditors should make appropriate commentary in their report to shareholders. This is particularly important where shareholders have already made clear that they believe climate risks to be material.