ClientEarth

04 May 2023

The Joinery,
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The Global Public Policy Committee

By email:

[redacted]

Dear Global Public Policy Committee

Background

ClientEarth remains very concerned by evidence which suggests that most companies in the Climate Action 100+ (**CA100+**) focus list[1] and their auditors do not fully consider climate-related matters when preparing their financial statements or the audits thereof, or at the very least do not explain if and how they have done so.[2] In particular, we are concerned that, in some cases, this may indicate that accounting standards, audit standards, or associated legal requirements have not been met, and it remains our view that an urgent improvement in practice is required.

This evidence must be considered against the context in which it arises, one of: (i) escalating climate risk[3]; (ii) a vast proliferation of corporate climate and 'net zero' commitments appearing in the 'front end' of corporate reports[4]; and (iii) consistent, repeated demands from large groups of investors for more transparency regarding how climate-related matters and related assumptions and estimates have affected accounting and audit for particular companies, precisely because

[1] The CA100+ focus list is made up of high-emitting companies that have been identified by CA100+ as "*key to driving the global net zero emissions transition*". The 166 companies on the list account for up to 80% of global corporate industrial greenhouse gas emissions, according to CA100+. See: Companies | Climate Action 100+.

[2] See, for example, the key findings of the interim assessments against the CA100+ Net Zero Company Benchmark published by the CA100+ in October 2022, which are available here. Only a small minority of focus companies scored better than 'No' on any of the metrics that make up this assessment (on a strict 'yes/no' binary assessment against each metric. See pages 55-60 of the October 2022 interim assessments. The *Still Flying Blind* report published by Carbon Tracker in October 2022 (available here) found that, for the 134 highly carbon-exposed companies assessed in the report: 98% did not provide sufficient information to demonstrate how their financial statements include consideration of the financial impacts of material climate matters; and 96% of auditors did not sufficiently address how they considered the impact of climate (see p.6 of the report).

[3] In a Climate Risk Bulletin updated in May 2022 (available here), SASB concluded that climate risk is "*ubiquitous*" in the sense that it significantly affects 68 out of the 77 industries in SASB's Sustainable Industry Classification System equating to 89% of the market capitalisation of the S&P Global 1200, or US$45.2 trillion. See pp.5 and 8 of the Bulleting.

[4] In the October 2022 interim assessments against the Net Zero Company Benchmark, CA100+ found that 73% of focus companies had committed to achieve net zero emission by 2050 or sooner across some or all of their emissions footprint (up from 69% in March 2022). See: Climate Action 100+ Net Zero Company Benchmark shows continued progress on net zero commitments is not matched by development and implementation of credible decarbonisation strategies | Climate Action 100+. More generally, in June 2022, Net Zero tracker concluded that "*large companies committing to net zero [had hit] critical mass in Europe*", with more than one third of the world's largest publicly traded companies having net zero targets, up from one fifth in December 2020. See Net Zero Stocktake 2022 | Net Zero Tracker.

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such information influences their decisions on stewardship and investment.[5] The clear implication of these developments is that information on climate-related matters is becoming more and more material, in the sense that "*omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements*".[6] Over two years ago, in its November 2020 educational material on the effects of climate-related matters on financial statements prepared applying IFRS Standards, the IFRS Foundation confirmed that "*information about how management has considered climate-related matters in preparing a company's financial statements may be material with respect to the most significant judgements and estimates that management has made*."[7] This is more true than ever in today's climate context.

In December 2020, the GPPC wrote[8] to the Chair and Vice-Chair of the International Accounting Standards Board of the IFRS Foundation (**IASB**), committing to "play its part" in supporting the application of the IFRS Foundation's guidance on the consideration of climate matters in IFRS accounting and to encourage greater transparency on the impact of climate-related matters on companies' financial statements. Since then, however, the evidence suggests that only limited shifts in financial disclosure practices by companies and their auditors have taken place, and the GPPC has not provided any further public statement as to why this is considered acceptable.

ClientEarth sent a series of letters setting out its concerns in this area to the "Big Four" audit firms – Deloitte, KPMG, EY and PWC – and the Financial Reporting Council (**FRC**) in December 2021.[9] This prompted over a year of engagement with the Global Public Policy Committee (the **GPPC**) in relation to climate change, accounting and audit. On 23 January 2023, at the GPPC's request, ClientEarth met with representatives of the GPPC to discuss several questions identified by ClientEarth in the course of this engagement. A document setting out these questions, which was provided to the GPPC in advance of our meeting, is enclosed with this letter.

The purpose of this letter is to summarise our understanding of certain points articulated by the GPPC in our January meeting. While ClientEarth hopes that the GPPC may be prepared to develop its stance on these issues, we are sending (and intend to publish) this letter because we consider it essential to have available a clear public statement of the GPPC's position to aid understanding of the role of the GPPC and its member networks in driving: (a) improvements in accounting and audit practice (including disclosure) under existing rules; and (b) reform (where required) to audit and accounting standards that will deliver the transparency regarding climate-related considerations in accounting and audit needed by investors and other users of financial and non-financial reporting.

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[5] In September 2020, investor groups representing over US$103 trillion in assets under management (**AUM**) called on companies to provide transparency regarding climate-related risks in their financial statements (Investor groups call on companies to reflect climate-related risks in financial reporting | PRI Web Page | PRI (unpri.org)). In November 2020, 38 investor members of the IIGCC representing $9.3 trillion in AUM wrote to 36 of Europe's largest companies calling for those companies to provide 'Paris-Aligned Accounts' (Leading investors call on Europe's largest companies to address missing climate change costs in financial accounts – IIGCC). In April 2022, 34 investor members of the IIGCC representing US$7.3 trillion in AUM wrote to 17 of Europe's largest companies asking why expectations over climate related accounting disclosures have not been met, copied to the lead audit partners for each company concerned (Investors put Audit Committee Chairs on notice over continued omission of climate risks in financial reporting ahead of 2022 AGM season – IIGCC).
[6] See the definition of "*Material*" provided in IAS 1 and, by cross-reference, IAS 8.
[7] See p. 1 of 'Effects of climate-related matters on financial statements' (IFRS Foundation, November 2020).
[8] The GPPC's 17 December 2020 letter to IASB is available here: GPPC Letter to IASB.pdf (ifac.org).
[9] ClientEarth's letters to each the "Big Four" audit firms are available here: Deloitte, KPMG, EY, PwC. ClientEarth's letter to the FRC is available here.

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The Global Public Policy Committee's approach to climate change

The comments below represent ClientEarth's understanding of the GPPC's position on certain topics raised at our January meeting and should not be taken as indicative of ClientEarth's views[10] on these matters. Rather, we are surprised and disappointed by the GPPC's stance and do not consider the positions outlined below to represent a compelling response to the materiality of the issues presented by climate change for accounting and audit practice, as laid out in principles, standards and guidance.

Following our January meeting, we understand that:

1. It is the GPPC's position that the audits conducted by its member networks (Deloitte, KPMG, EY, PWC, BDO and Grant Thornton) are conducted to a high quality and comply with: (a) applicable audit standards; and (b) the guidance in relation to climate change provided by the International Auditing and Assurance Standards Board (**IAASB**)[11]. Furthermore, the GPPC considers that the audited financial statements audited by its member networks comply with the relevant accounting standards and, as applicable, the guidance in relation to climate matters provided by the International Accounting Standards Board of the IFRS Foundation (**IASB**)[12] and the staff of the Financial Accounting Standards Board (**FASB**) (with respect to US GAAP)[13]. The GPPC has not identified specific elements of this guidance with which it disagrees, or that its member networks decline to apply in practice.

2. The GPPC disagrees with the interpretation of audit and accounting standards, and findings in relation to audit and accounting performance set out in the "*Flying Blind*"[14] and "*Still Flying Blind*"[15] reports published by Carbon Tracker in 2021 and 2022. However, to our knowledge, the GPPC has not provided a public explanation of its objections in relation to the analysis of reporting by any individual company or auditor covered in these reports. In the GPPC's view, the transparency and rigour with which climate related risks are reflected in the accounting and audit of CA100+ focus companies has improved significantly since year-end 2020 reporting, is already sufficient, and is expected to improve further in year-end 2022 reporting.

3. PWC have conducted analysis showing that the audit reports of c.94% of FTSE 350 companies for financial years ending in 2021 include substantive comments in relation to climate change by the auditor. However, no report or summary of these findings is currently available publicly. The GPPC has not indicated that corresponding analysis is available for audits conducted in other jurisdictions.

4. The GPPC cannot currently anticipate a situation in which climate change would be included as a standalone critical audit matter (**CAM**) in US audit reports, or mentioned in relation to other CAMs, even if climate change has been included as a key audit matter

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[10] The points noted in this letter represent ClientEarth's understanding of the GPPC's position, as articulated in the 23 January meeting, rather than the GPPC's own statement of its views.
[11] See '<u>The consideration of climate-related risks in an audit of financial statement</u>' (IAASB, October 2020).
[12] See '<u>IFRS® Standards and climate-related disclosures</u>' (IFRS Foundation, November 2019) and <u>'Effects of climate-related matters on financial statements'</u> (IFRS Foundation, November 2020).
[13] See the FASB Staff Educational Paper on '<u>Intersection of Environmental, Social and Governance Matters with Financial Accounting Standards</u>' (19 March 2021).
[14] Available <u>here</u>.
[15] Available <u>here</u>.

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(**KAM**), or otherwise mentioned in the ISA-based audit report relating to the financial statements of the same company. According to the GPPC, this is because the applicable criteria are different and only specific line items in the financial statements can be addressed in a CAM. The GPPC did not explain why climate-related risks would not be addressed within other CAMs relating to specific line items. The specific reference for disallowing reporting on climate was not provided.

5. The GPPC would expect climate change to have been considered and discussed with the audit committees of all of the companies covered by the Flying Blind reports (i.e. broadly, companies in the CA100+ focus list). As such, the GPPC suggests that the subsequent omission of climate change from the accounts and audit reports of such companies would be because the rules (including IAS 1 – see below) do not require disclosure in relation to climate change. For instance, this may be because climate change is not considered by the company or auditor to be material in the context of the financial statements as a whole (notwithstanding the prevailing context, described above, of escalating climate risk, the increasing proliferation of corporate climate and 'net zero' commitments, and consistent, repeated demands from large groups of investors for more transparency regarding material climate-related information). In particular, as far as the GPPC is aware, IAS 1 has never been applied in practice so as to require additional disclosure which was not already required under other (topical) accounting standards. The GPPC has not indicated whether and in what circumstances it considers that the contextual factors noted above might lead to climate-related matters being considered material to the financial statements of a company being audited by one of the GPPC member networks.

6. Although the GPPC:

    a. considers that reform to accounting and audit standards may be necessary to provide investors with the accounting and audit information they expect to see in relation to climate change;

    b. is committed to supporting the development of enhanced financial and non-financial reporting and assurance standards to bridge the information gap by fully incorporating climate risk; and

    c. is engaged in outreach and collaboration with a range of bodies including reporting and auditing standard setters in relation to these issues,

    the GPPC has not made or developed any particular request for *accounting* requirements to be revised. Further, the GPPC has no intention to issue a public statement regarding the nature of the reforms to auditing and accounting standards that may help provide investors with the information they wish to see in relation to climate risk.

7. The GPPC considers that the ISSB's sustainability reporting standards will deliver a step change in how climate risk is reflected in narrative or non-financial reporting (which will be interconnected with the financial statement reporting by companies).

8. The GPPC member networks have made eight commitments[16] as signatories to the Net Zero Financial Service Providers Alliance (**NZFSPA**)[17], including commitment No.1 to:

> "*Align all relevant services and products to achieve net zero greenhouse gas emissions by 2050 or sooner, scaling and mainstreaming Paris Agreement-alignment into the core of our business*."

This commitment is, however subject to the caveats that: (i) "*The way in which a member aligns is up to the member at firm-level*"; and (ii) the NZSPA explains commitment No.1 in interpretative guidance as requiring that auditors "*plan and perform audits in accordance with professional standards and related guidance issued by standard setters, including as they relate to climate-related matters, and commit to discharging obligations under professional standards as external auditors with quality, integrity, and independence*." The GPPC recognises that pursuant to this commitment, its member networks should conduct audits in compliance with the guidance mentioned in point 1 above. According to the GPPC, they do so.

9. The GPPC member networks have been considering carefully what the NZFSPA commitments mean for their audit practices. We understand that public reporting by the audit firms of progress made against the NZFSPA commitments (pursuant to commitment No. 8) is expected to be released soon, however we were not provided with a date by which to expect such reporting, or a list of the KPIs or metrics expected to be included in such reporting. We understand these KPIs / metrics are still being developed and that they may relate only to 'inputs' into the audit process such as staff training, methodologies and discussions with the audit committee, rather than providing a measure of the resulting reporting by the company in its financial statements and the auditor in their report.

10. Although the NZFSPA is not currently a recognised "partner" of the Race to Zero campaign[18], the GPPC member networks would support the NZFSPA joining the Race to Zero campaign and subscribing to its minimum criteria.[19]

ClientEarth's position on these issues

ClientEarth does not agree with or endorse the positions set out above. Rather, as noted above, we remain concerned by evidence suggesting that climate related matters may not currently be fully considered in the course of accounting and audit, or fully explained in financial statements and audit reports, including for some of the most climate-exposed companies in the world.[20] In

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[16] The eight commitments made by members of the NZFSPA are set out here.

[17] BDO, Deloitte, EY, Grant Thornton, KPMG and PWC are all listed as "Alliance Signatories" on the NFSPA website: Committed to Net Zero - Net Zero Financial Service Providers Alliance (netzeroserviceproviders.com).

[18] See '*Race to Zero – Meet our Partners*', here.

[19] The Race to Zero's minimum criteria are available here. The Race to Zero Expert Peer Review Group's '*Interpretation Guide*' (Version 2.0 June 2022) is available here. We note that, in relation to the concept of "serviced emissions" of professional services firms, the guide states that "*Corporates in the professional services industry (i.e. consulting firms) should follow a similar approach to the Advertised emissions in so far as they should recognise the influence they wield over their clients, who themselves may be heavy emitters. Leveraging the power of advocacy is critical to achieving a faster transition. Members in Race to Zero are therefore all urged to consider the potential wider impact they have through their industry regarding emitting GHGs, and to take responsibility for reducing those emissions as fast as possible*" (p.5).

[20] i.e. those on the CA100+ focus list.

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this context, we do not consider the GPPC's position (or rather, its lack of a public position) to represent adequate leadership on these issues.

As indicated above, we consider a public statement of our understanding of the GPPC's position to be a helpful stepping-stone to progress in this area. We would welcome a timely public statement from the GPPC explaining how the GPPC is contributing, or intends to contribute, positively to improved practice in this area, including by way of clarification of our current understanding of the GPPC's position, if required. Should the GPPC wish to respond to the contents of this letter, or to provide a statement of its position, we would be grateful for a response by 18 May 2023, after which time we plan to publish.

Yours sincerely,

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Encl.

ClientEarth's questions for the GPPC (dated January 2023)

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