ClientEarth

8 December 2021

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Dear PricewaterhouseCoopers LLP

Accounting for climate change – the role of audit

ClientEarth is a non-profit environmental law organisation headquartered in London. ClientEarth's Climate Finance initiative analyses the legal implications of climate change-related financial risks for a wide spectrum of market participants, including companies, investors, company directors, professional advisers and regulators, and has long advocated for auditors to take better account of climate risk in order to comply with their legal duties.[1]

As leading experts on climate change as a legal, financial, and business risk, we are concerned that PricewaterhouseCoopers LLP ("**PwC**") is failing to demonstrate whether and how it takes account of material climate risks when conducting audits on behalf of listed companies using International Financial Reporting Standards (**IFRS**) or US Generally Accepted Accounting Principles (**US GAAP**) in the preparation of their annual accounts, and risks breaching both applicable audit standards and its core legal duties.

As explained below, both the International Accounting Standards Board (**IASB**) and the International Audit and Assurance Standards Board (**IAASB**) have published clear statements that material climate-related matters <u>must</u> be incorporated into financial statements and audits under <u>existing</u> accounting and audit standards. Similarly, the US Financial Accounting Standards Board (**FASB**) has stated that ESG matters (including climate change) should be considered like any other business risk.[2] Moreover, in its capacity as a member of the Global Public Policy Committee (**GPPC**)[3], PwC has openly committed "*to encourage greater transparency on the impact of climate-related matters on companies' financial statements*".[4] PwC has also joined the Net Zero Financial Service Providers Alliance (**NZFSPA**) and the Glasgow Finance Alliance to Net Zero (**GFANZ**), committing to "*align all [its] relevant services and products to achieve net zero*

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[1] See <u>'Risky Business: climate change and professional liability risks for auditors'</u> (ClientEarth, December 2017).

[2] <u>'FASB Staff Educational Paper: intersection of environmental, social, and governance matters with financial accounting standards'</u> (FASB, 19 March 2021).

[3] The GPPC is the global forum of representatives from the six largest accounting networks: PwC, Deloitte, EY, Grant Thornton, KPMG, and BDO, which has as its public interest objective the enhancement of quality in auditing and financial reporting.

[4] See the GPPC's December 2020 letter to the IASB (<u>https://www.ifac.org/system/files/uploads/gateway/GPPC%20Letter%20to%20IASB.pdf</u>).

greenhouse gas emissions by 2050 or sooner, scaling and mainstreaming Paris Agreement-alignment into the core of [its] business."[5]

Nevertheless, a recent report by the Carbon Tracker Initiative (**Carbon Tracker**) and the Carbon Accounting Project, '*Flying Blind: The glaring absence of climate risks in financial reporting*' (the **CT Report**)[6], identifies significant concerns over the failure by PwC to demonstrate that it has adequately considered climate change as a material financial risk in the conduct of its audits of various climate-exposed companies analysed in the CT Report. This is despite widespread recognition that climate change represents a material financial risk for many companies[7] and all of the companies reviewed, and increasing investor concern about the pervasive lack of transparency on climate-related financial risk in corporate financial reporting. PwC is failing to demonstrate to the companies it audits, their investors, and the wider market that it is conducting its audits in line with applicable audit standards and legal rules, and its own public commitments on climate change.

In this letter, we:

(i) set out the clear guidance from international accounting and audit standard setters that material climate-related issues must be considered when drawing up and auditing company accounts;

(ii) demonstrate the materiality of climate change as a financial risk, particularly to climate-exposed companies like those identified in the CT Report, and their investors;

(iii) highlight, by reference to the CT Report's key findings, where PwC and other auditors are failing to demonstrate that they fulfil existing audit standards, or to meet the expectations of the world's largest investors, on climate change;

(iv) identify (using the UK and US as primary examples) the core legal duties PwC may already be in breach of (absent the demonstration of adequate scrutiny of climate-related issues in its audits); and

(v) call on PwC to urgently address the concerns identified in this letter, to ensure that it is prepared to address material climate risk when conducting audits for financial years ending 2021 and onwards, and to alert the companies it audits to its intention to apply existing audit standards more rigorously on climate change.

We consider the issues identified in this letter to be systemic within corporate reporting and parts of the audit profession (including PwC), and intend to engage with regulators to heighten scrutiny of PwC's and other auditors' performance on climate issues in future reporting cycles.

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[5] See the Net Zero Financial Service Providers Alliance commitment (https://www.netzeroserviceproviders.com/our-commitment/).

[6] See 'Flying Blind: The glaring absence of climate risks in financial reporting' (Carbon Tracker, 16 September 2021)

[7] See, for example, the UK Financial Conduct Authority's statement that *"climate-related risks and opportunities are widely understood to be financially material to many issuers' assets and therefore may need to be disclosed*" in its Final Technical Note at Appendix 2, page 52, of its Policy Statement PS20/17: Proposals to enhance climate-related disclosures by listed issuers (December 2020).

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1 Audit and accounting standards are clear on climate

1. Auditors have a critical role to play in providing investors with assurance that information disclosed by a company about its financial position and the trends and risks facing its business is: (i) prepared in accordance with the relevant legal requirements, (ii) is free from material misstatements, and (iii) otherwise gives a true and fair view of the financial position of the company and its results for the relevant period. It is critical that material climate-related factors are incorporated into this assessment. This is reflected in recent guidance from international accounting and audit standard setters on their respective standards.

2. Most of the carbon-intensive companies reviewed in the CT Report account under IFRS.[8] The IFRS Foundation has issued a clear statement that in applying existing IFRS standards, "*companies must consider climate-related matters in applying IFRS Standards when the effect of those matters is material in the context of the financial statements taken as a whole*."[9]

3. According to the IFRS Foundation, *"information is material if omitting, mis-stating or obscuring it could reasonably be expected to influence decisions that primary users of financial statements…make on the basis of those financial statements…For example, 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."*[10] As explained below, climate related issues are so clearly material to the financial position of the companies covered in the CT Report, and their investors, that they must be reflected in financial statements prepared under IFRS.

4. An earlier IFRS Foundation publication[11] welcomed by institutional investors[12] emphasised that companies facing climate impacts "*are likely to judge that it is necessary to explain how they have considered climate related risk in their impairment assessments, and…other judgements made in relation to the recognition or measurement of items in the financial statements*" and that under the current IFRS standards, an assessment of climate-related risks should be incorporated into financial statements.

5. Various IFRS standards may require companies to consider climate change issues, including:

    5.1. disclosure, in a manner helpful to investors, of the assumptions and judgements made about climate-related matters where those matters create material uncertainties that affect accounting estimates and / or the company's ability to continue as a going concern, under IAS 1;

    5.2. climate-related changes to estimates of the residual values and expected useful lives of company assets under IAS 16 and IAS 38;

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[8] Page 12 of the CT Report.
[9] 'Effects of climate-related matters on financial statements' (IFRS Foundation, November 2020), page 1.
[10] 'Effects of climate-related matters on financial statements' (IFRS Foundation, November 2020), page 1.
[11] 'IFRS® Standards and climate-related disclosures' (IFRS Foundation, November 2019).
[12] 'Investor groups call on companies to reflect climate-related risks in financial reporting' (PRI Accounting for Climate Change, 16 September 2020).

5.3. asset impairment, and asset cash flow expectations affected by climate issues under IAS 36;

5.4. climate-related changes in provisions and contingent liabilities or newly onerous contracts under IAS 37; and

5.5. fair value measurements of assets and liabilities that are affected by climate matters under IFRS 13.[13]

6. Companies may also need to provide additional climate-related disclosures under IAS 1 when compliance with individual IFRS standards is otherwise insufficient to enable investors to understand the impact of climate matters on the company's financial statements.[14]

7. The FASB has stated a similar position on the requirements of US GAAP in relation to environmental, social and governance (**ESG**) matters, including climate change. In its recent staff educational paper, the FASB states that "*when applying financial accounting standards, an entity may consider the effects of certain material ESG matters, similar to how an entity considers other changes in its business and operating environment that have a material direct or indirect effect on the financial statements and notes thereto*" and goes on to give examples of topical accounting standards which may require the consideration of ESG factors under US GAAP.[15]

8. In addition to this clear guidance on the need to consider climate change under these financial statement frameworks, the IAASB is equally clear that climate-related risks must be considered in the application of the International Standards on Auditing (**ISAs**) during audit. In its October 2020 staff audit practice alert, the IAASB clarified that while the phrase 'climate change' does not feature in the ISAs, climate-related events or conditions may contribute to the susceptibility to misstatement of amounts and disclosures in an entity's financial statements, and therefore fall within the auditor's remit to assess the risk of material misstatement and obtain sufficient audit evidence on which to base their opinion.[16]

9. To illustrate the broader point, the IAASB went on to provide examples of several ISAs under which climate-related risks may need to be considered including:

9.1. identifying and assessing the risks of material misstatement – ISA 315;

9.2. the auditor's determination of materiality – ISA 320;

9.3. the auditor's responses to assessed risks – ISA 330;

9.4. auditing accounting estimates and related disclosures (including impairment of PPE and intangible assets, fair value of assets and liabilities and provisions for contingent liabilities) – ISA 540; and

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[13] See pages 2-6 of 'Effects of climate-related matters on financial statements' (IFRS Foundation, November 2020) for the IFRS Foundation guidance on these points.
[14] See para. 17(c) of IAS 1 and page 1 of 'Effects of climate-related matters on financial statements' (IFRS Foundation, November 2020).
[15] 'FASB Staff Educational Paper: intersection of environmental, social, and governance matters with financial accounting standards' (FASB, 19 March 2021).
[16] 'The consideration of climate-related risks in an audit of financial statement' (IAASB, October 2020).

9.5. the auditor's responsibilities relating to other information – ISA 720.

10. Although the US Public Company Accounting Oversight Board (**PCAOB**) has not published equivalent additional guidance on climate-related risks, given the FASB's guidance on accounting for ESG matters and the similarities between the guidance on identifying and addressing risks in financial statement audits under the ISAs and the PCAOB Auditing Standards[17], there is in our view a strong argument that PCAOB auditing standards require material climate-related matters to be taken into account in a similar way to IAASB standards and, where relevant, described as critical audit matters in the audit report. In a speech at the International Corporate Governance Network's 2020 conference, while serving as PCAOB board member, J. Robert Brown Jr. stressed that the effects of ESG matters, including climate change, on the financial statements are "*uncertain, complex and highly dependent upon the particular assumptions used by management*", making them "*obvious candidates*" for full consideration as critical audit matters in the auditors' report, being "*the sorts of things that can keep an auditor up at night*."[18]

11. The International Federation of Accountants (**IFAC**) has also emphasised[19] the critical role of professional accountants in quantifying the financial impacts of climate issues, ensuring adequate climate-related reporting without material omission or misstatement, and aligning climate-related information and disclosures with company climate commitments and strategic decisions.

12. Clearly, international accounting and audit standard setters believe that the existing legal duties and standards applicable to accounting and audit require the consideration of material climate-related matters when drawing up and auditing company accounts, along with corresponding disclosure (where necessary) for investors to understand the company's financial position. Unless the approach taken to such issues is clearly disclosed in financial statements and audit reports, these requirements are not fulfilled and it is not clear that the directors and auditors of a climate-exposed company have fulfilled their legal duties to draw up and provide audited accounts that fairly reflect the financial position of the company, in line with applicable accounting and audit standards. The CT Report shows that PwC and other auditors are habitually failing to demonstrate compliance with their legal and professional duties and public commitments on climate change. These failures create a material information gap[20] for investors, and fundamentally erode trust in audit and corporate reporting.

[17] See footnote 29 on page 13 of the CT Report and compare, for example, ISA 315 and PCAOB AS2110.
[18] See J. Robert Brown Jr.'s speech to the ICGN Global Virtual Summit in November 2020, 'It's Not What You Look at that Matters: It's What You See, Revealing ESG in Critical Audit Matters'.
[19] 'Corporate Reporting: Climate Change Information and the 2021 Reporting Cycle' (IFAC, 7 September 2021).
[20] For example, see related investor concerns set out in recent letters sent to KPMG, Deloitte, EY and PwC, from a group of investors representing over $4.5 trillion as part of a campaign led by Sarasin & Partners.

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2 Climate change is material to companies and investors

13. Climate change presents material financial risks across the global economy and to companies operating in practically all sectors – especially to carbon-intensive businesses like those identified in the CT Report.

14. To achieve the net zero pathway of the International Energy Agency (**IEA**)[21], there can be "*no new oil and gas fields approved for development*" and "*no new coal mines or mine extensions*"[22].

15. In policy terms, the direction of travel is equally clear. Recent commitments made at COP26, such as the multinational pledge to end all investment in new coal power generation[23], the UK's ambition to create the world's first' net-zero-aligned financial centre'[24],and the Glasgow Climate Pact commitment to urgent step downs in fossil fuel financing and the phasing down of unabated coal power[25], add momentum to the existing tide of regulation and policy aimed at accelerating a net zero transition.

16. Governments have already made ambitious national and international commitments to address climate change. The UK, for example has committed to achieve 'net-zero' greenhouse gas emissions by 2050[26], and to reduce its emissions by 78% (compared to 1990 levels) by 2035 its sixth carbon budget[27]. The United States, led by the Biden administration, has committed to achieve a 50-52% reduction from 2005 levels in economy-wide net greenhouse gas pollution by 2030[28]. Since 2015, 44 governments have committed to no new coal, and a further 40 are without any projects in the pre-construction pipeline and could readily commit to 'no new coal'[29].

17. This policy environment creates a transitional risk many of the companies assessed in the CT Report are directly exposed to, with clear implications for the estimates and assumptions that should reasonably be used in preparing accounts. BP, for example, wrote $17.5bn off the value of its oil and gas assets in 2020 due to its forecasts of an accelerating transition away from fossil fuels, illustrating the materiality of the transition to fossil-exposed company financial projections.[30]

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[21] The IEA pathway is used in the CT Report as a benchmark for the Paris-alignment of oil, gas and carbon pricing and demand projections used by the companies surveyed – see page 4 of the CT Report.
[22] See page 21, 'Net Zero by 2050: a Roadmap for the Global Energy Sector' (IEA, May 2021)
[23] 'COP26: More than 40 countries pledge to quit coal' (BBC, 5 November 2021)
[24] 'Chancellor: UK will be the world's first net zero financial centre' (HM Treasury, 3 November 2021)
[25] 'COP26 keeps 1.5C alive and finalises Paris Agreement' (UKCOP26, 13 November 2021)
[26] Section 1 Climate Change Act 2008
[27] The draft Carbon Budget Order 2021 (which is to be enacted pursuant to Part 1 of the Climate Change Act 2008) sets emission targets that imply a 78% reduction in emissions (compared to 1990 levels) by 2035.
[28] FACT SHEET: President Biden Sets 2030 Greenhouse Gas Pollution Reduction Target Aimed at Creating Good-Paying Union Jobs and Securing U.S. Leadership on Clean Energy Technologies (22 April 2021)
[29] See E3G's report, 'No New Coal by 2021: the collapse of the global coal pipeline' (E3G, 13 September 2021)
[30] 'BP to take up to $17.5bn hit on assets after cutting energy price outlook' (Anjli Raval, FT, 15 June 2020)

18. All businesses will ultimately need to align their operations and product lines with national emissions reduction trajectories. Companies that fail to transition their businesses in time will face regulatory obstacles, loss of consumer demand, may face significant future write-downs of previously overvalued assets. In some cases, they may ultimately fail to continue as a going concern. This throws into sharp relief the materiality of climate-related assumptions to company financials for many businesses, and especially the carbon-intensive companies considered in the CT Report. Whether and how climate-exposed companies have reflected these risks in their financial statements is information that is material to investor decision making.

19. Many businesses now refer to climate-related risks and opportunities, and make climate-related commitments in their narrative reporting or through other public channels. If so, the assumptions, accounting estimates and risk assessments adopted in the company's accounts should be consistent with its stated commitments and strategies on climate change. Inconsistencies raise questions over which description of the company's position is accurate and which is misleading, and may compound financial greenwashing[31]. In other words, it may mislead investors by creating a false picture of the financial impacts of climate change on the company, and misdirect capital away from genuine net zero or other climate commitments.[32] Auditors are charged with ensuring that financial and narrative reporting is consistent and that financial statements give a fair view of the company's affairs to prevent exactly these kinds of misstatements. As explained below, however, the CT Report shows that significant parts of the audit profession (including PwC) are failing in this regard for even the most climate-challenged companies in the world.

20. The world's largest investors recognise the materiality of climate change to financial accounting. In September 2020, a broad coalition of institutional investors representing over $103 trillion in global assets under management called on companies to reflect material climate-related risks appropriately in financial accounts, and to apply IFRS accounting standards requirements in letter and spirit. The group noted auditors' key role in ensuring standards are consistently applied, including "*appropriate reflection of climate-related risks in financial statements, and the transparency of assumptions.*" In addition, the group demanded that the assumptions made by companies in preparing IFRS accounts should be compatible with the Paris Agreement, or a corresponding sensitivity analysis provided.[33]

21. The Institutional Investors Group on Climate Change (**IIGCC**), representing over 250 asset owners and asset managers with over €33 trillion in assets under management, has gone further still, demanding that directors and auditors "*deliver Paris-aligned accounts – accounts that properly reflect the impact of getting to net zero emissions by 2050 for assets, liabilities, profits and losses.*"[34] The IIGCC sets out the climate-related disclosures it expects to see in the annual report and accounts, including a clear statement that the Paris Agreement goals have been considered in drawing up the accounts, an explanation of how critical accounting assumptions are consistent with net zero by 2050, and confirmation that the financial accounts

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[31] This can take various forms; see, for example, ClientEarth's 'Greenwashing Files' (2021).
[32] See page 4 of 'Investor Expectations for Paris-aligned Accounts' (November 2020, IIGCC).
[33] 'Investor groups call on companies to reflect climate-related risks in financial reporting' (PRI Accounting for Climate Change, 16 September 2020).
[34] Page 4 of 'Investor Expectations for Paris-aligned Accounts' (November 2020, IIGCC).

are consistent with the company's narrative reporting on climate risk. The IIGCC is equally clear that its members should increasingly take action against company directors, audit committees and auditors that fail to meet these expectations.[35]

22. Although the use of Paris-aligned accounting assumptions is not yet explicitly required under accounting and audit standards, companies and their auditors risk failing the expectations of a broad spectrum of investors, by not using, nor rigorously explaining divergence from, Paris-aligned accounting assumptions. Moreover, the demands of the IIGCC and the wider investor coalition mentioned above are such that the materiality of climate-related financial risks, and associated disclosures, to investors' stewardship and decision making is clearly beyond doubt.

23. The IAASB has acknowledged that, given investors have identified climate-related risks as being used in their economic decision making, auditors of entities affected by climate risk may need to take it into account when determining materiality.[36] Coupled with increasing investor calls for climate information and disclosure, this makes arguments that climate issues are not material in the corporate accounting context untenable. However, the CT Report shows that, despite the demonstrable materiality of climate-risk to investor decision-making, PwC and other auditors are failing to demonstrate that they meet the clear requirements of existing audit standards in relation to climate change.

3 Auditors are not clear on climate: findings from the CT Report

24. The CT Report examined the 2020 financial reporting of 107 publicly-listed carbon-intensive firms to determine whether and how those firms, and their auditors, have considered material climate-related risks in their financial reporting and audit reports. The CT Report also assessed whether investor demand for Paris-alignment of assumptions and estimates had been met.

25. 'Carbon intensive' in this context means that significant institutional investors have identified the 107 companies as highly carbon exposed: 94 are included among the Climate Action 100+ ("**CA100+**") investor focus list[37]; the remaining 13 companies were companies with obvious relevant financial risks[38]. Given that CA100+ companies account for "*over 80% of corporate industrial greenhouse gas emissions*", these companies are key to driving the global net-zero emissions transition and their business models will be deeply impacted by it.

26. There is, in our view, no doubt that climate transition risk is material for the companies included in the CT Report and their investors. Accordingly, there was an underlying expectation that these companies would explicitly consider material climate issues in their

[35] Pages 13 to 18 of 'Investor Expectations for Paris-aligned Accounts' (November 2020, IIGCC).
[36] Page 6 of 'The consideration of climate-related risks in an audit of financial statement' (IAASB, October 2020)
[37] See page 43, of the CT Report, and the Climate Action 100+ investor focus list of companies here.
[38] Page 16 of the CT Report.

2020 financial reporting, that any material assumptions would be clearly shown, and that their auditors would consider climate risk explicitly in their audits of the financial statements.

27. However, the CT Report found little evidence that these companies or their auditors adequately considered climate-related matters in the 2020 financial statements and audit reports (if they did so at all).[39] For 80% of companies whose annual reports were assessed, auditors' consideration of (or failure to consider) climate caused "*significant concerns*"[40]. Of the total 107 firms, PwC was responsible in whole or in part for the audits of 33 companies. Significant concerns were identified in relation to all of them.

28. In relation to audit, the CT Report found that[41]:

28.1. **Most climate-related assumptions and estimates were not visible in the financial statements:** 75% of companies failed to provide disclosure of the climate- sensitive quantitative assumptions and estimates used in preparing the financial statements. This made it difficult to assess whether companies had accounted for climate risks (or related commitments, such as emissions reduction pledges). Both company accounting amounts and related disclosure is subject to audit as part of the financial statements as a whole.

28.2. **80% of auditors provided no indication of whether or how they had considered material climate-related matters**, such as the impact of emissions reduction targets, changes to regulations, or declining demand for company products when auditing financial statements. There was therefore little evidence that auditors are considering the financial effects of material climate-related risks or companies' announced climate strategies when considering topics including asset impairment assessments and useful life assumptions.

28.3. **Even with considerable observable inconsistencies across company reporting ('other information' and financial statements), auditors rarely commented on any differences:** the CT Report highlighted "*significant concerns*" for 59% of the consistency checks auditors were required to perform. For around half of the remaining 41%, companies' discussions of climate matters were consistently limited across financial and other reporting; and

28.4. Finally, **companies and their auditors do not appear to use 'Paris-aligned'[42] assumptions and estimates, and are generally failing to use inputs aligned with published climate scenarios**: only 25% of companies disclosed at least some of the quantitative climate-related inputs that they used. Of those 26 companies, only seven used inputs that they claimed were aligned with published climate scenarios[43]. None of

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[39] See Appendix 3 of the CT Report for a full list of companies reviewed and their performance.
[40] See page 6 of the CT Report at Figure 1.
[41] See pages 43-44 of the CT Report.
[42] Article 2.1a of the Paris Agreement under the United Nations Framework Convention on Climate Change (**UNFCCC**) sets the goal of "*Holding the increase in the global average temperature to well below 2°C above preindustrial levels and pursuing efforts to limit the temperature increase to 1.5°C above preindustrial levels*" and Article 2.1.c sets the goal of "*Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*".
[43] *Such as the International Energy Agency's Stated Policies Scenario (STEPS) or Sustainable Development Scenario (SDS)*

these appeared to use assumptions and estimates aligned with the goals of the Paris Agreement[44] or to provide corresponding sensitivity analysis.

29. The CT Report also found that all of the audits which identified, and considered, climate issues were prepared under ISA standards (or country equivalents). None of the audits prepared under PCAOB standards appeared to consider climate. There were also troubling instances where, for companies listed both in Europe / the UK and in the US, auditors included references to climate change in their ISA audit reports, but omitted corresponding references in PCAOB audit reports filed in the US for the same company.[45]

30. These conclusions reinforce the findings of our review of the annual corporate reporting of the largest 150 companies of the UK FTSE 250 for 2019-20, where we found that only 4% of audit reports provided a clear explanation of whether auditors had considered climate-related factors.[46] Though the companies assessed in the CT Report are global, its findings also echo the conclusion of the UK Financial Reporting Council (**FRC**), as UK audit regulator, that in most audit reports for UK company 2019 financials auditors failed to consider climate change when identifying and assessing the risks of material misstatement to the financial statements[47]. For the same period, the FRC identified potential breaches of IFRS standards in relation to the consideration and disclosure of climate change in company financial statements.[48]

31. **These findings show how PwC and other auditors are habitually failing to demonstrate that they properly take account of climate-related risk in the conduct of their audits, as required by existing audit standards and as demanded by the world's largest investors.** This creates a material information gap for investors looking to make informed investment decisions which factor in the impact of climate change on the financial position of the companies they invest in. Rather than facilitating the massive reallocation of capital required to bring global finance flows in line with the goals of the Paris Agreement[49] by ensuring the accuracy of financial disclosures, assumptions and estimates for the companies most exposed to climate risk, auditors instead appear to be presenting a direct and potentially catastrophic obstacle by failing to explicitly address climate risks in their audits.

4 PwC risks breaching its core legal duties

32. By failing to evidence that it meets the requirements of existing audit standards on climate change, PwC risks breaching its core professional and legal duties and consequently faces potentially serious investigative and enforcement action from both regulators and investors.

[44] For the purposes of the CT Report, oil, gas and carbon prices and demand projections provided in the International Energy Agency's Net Zero Emissions by 2050 Scenario (IEA NZE2050) were used as a benchmark for 'Paris-alignment' – see page 19 of the CT Report
[45] See page 30 of the CT Report.
[46] See page 5 of ClientEarth's report, 'Accountability Emergency: A review of UK-listed companies' climate change-related reporting (2019-20)' (4 February 2021)
[47] Page 20 of the FRC's 'Climate Thematic 2020: Audit'.
[48] Page 5 of the FRC's 'Climate Thematic Review 2020'.
[49] See Mark Carney's 'Open letter on climate-related financial risks' (17 April 2019)

33. In the UK, for example, statutory auditors have a core legal duty to report to the company's members on whether the company's accounts: (a) give a true and fair view of the company's financial position and profit and loss; (b) have been properly prepared in accordance with the relevant financial reporting framework; and (c) have been prepared in accordance with the requirements of the Companies Act 2006.[50] In doing so, they must have regard to the primary duty on the directors of the company not to approve accounts unless satisfied they give a true and fair view of the company's assets, liabilities, financial position and profit or loss.[51] UK auditors must also review the company's directors' report, strategic report and (if applicable) corporate governance statement to report on whether: (i) they are consistent with the company's financial statements; or (ii) contain any material misstatements.[52]

34. In carrying out the audit, the auditor must comply with applicable audit standards[53] with the overall objective of obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether due to fraud or error, and prepared in all material respects in accordance with the relevant financial reporting framework. Reasonable assurance is a high, but not absolute, level of assurance obtained when the auditor has obtained sufficient appropriate audit evidence to reduce the risk of making an inappropriate opinion when the accounts are materially misstated. The auditor must exercise professional scepticism and judgement in planning and carrying out the audit.[54] In our view, this exercise necessitates careful consideration by the auditor of whether appropriate pricing and other assumptions have been used - particularly where, as for the companies considered in the CT Report, climate change poses material risks to a company's future viability and asset valuations.

35. In the US, to take another example, auditors of public company financial statements must register with the PCAOB[55] and must apply the auditing standards set by the PCAOB[56] when conducting audits. US auditors must express an opinion on the fairness with which the financial statements present, in all material respects, the company's financial position, operations and cash flows in accordance with US GAAP.[57] They must plan and perform audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error.[58] In doing so, auditors must exercise reasonable care and diligence, and professional scepticism.[59]

36. In performing such duties in the UK, the US, and internationally, auditors have a critical role to play in providing investors with assurance that information disclosed by a company about its financial position and the trends and risks facing its business is prepared in accordance with the relevant legal requirements, and otherwise gives a true and fair view of the financial position of the company and its results for the relevant period. Crucially, auditors have an

[50] Section 495(3)(a) to (c) of the UK Companies Act 2006.
[51] Section 393(2) of the UK Companies Act 2006.
[52] Sections 496 and 497A of the UK Companies Act 2006.
[53] Regulation 4(1) Statutory Auditors and Third Country Auditors Regulations 2016.
[54] See International Standard on Auditing (UK) 200.
[55] Section 102 of the Sarbanes-Oxley Act of 2002.
[56] Under section 103 of the Sarbanes-Oxley Act of 2002.
[57] See PCAOB AS 1001, para. 1.
[58] See PCAOB AS 1001, para. 2.
[59] See PCAOB AS 1015.

independent duty to obtain reasonable assurance that the financial statements are free from material misstatement. It is critical that auditors incorporate material climate-related factors into this assessment, but they are failing to demonstrate to companies and investors if or how they have done so. As a result, it is often unclear if or how auditors have exercised professional scepticism and judgement to obtain reasonable assurance that the financial accounts of climate-exposed companies are free of misstatement. From the investor's perspective, absent clearer disclosure, substantial write-downs or impairments of the kind seen at BP[60], may be temporarily hidden by untested climate assumptions made by management.

37. PWC openly acknowledges that "*climate change isn't a challenge for tomorrow, it needs to be tackled now*"[61] and claims to have extensive awareness of climate-related risks and their implications for financial reporting[62]. PWC even emphasises the important role of accountants in "*accurately quantifying the financial impact of…physical and transitional climate risks*" to support transparency over the impact of climate change on business, which is "*a crucial component in tackling this most important of all issues: the future of the planet*."[63] Nevertheless, PwC does not appear to be carrying this over when performing audits. **There is little evidence that PwC has considered these issues consistently, or at all, when performing audits for companies assessed in the CT Report.**

38. In these circumstances, PwC risks breaching its legal and professional duties and is exposed to significant legal (and broader commercial) liability risk as a result, potentially including but not limited to:

    38.1. regulatory investigation and / or sanction for failure to adhere to the legal and professional standards applicable to auditors in the jurisdictions in which PwC operates;

    38.2. claims by a company and / or its shareholders (through derivative action) for breach of contract and / or legal duty in circumstances where climate risks materialise that were overlooked in historic audit opinions, giving rise to loss;

    38.3. in extreme cases, criminal liability for knowingly or recklessly causing an audit report to contain false, misleading or deceptive material[64]; and

    38.4. investor action against the company's auditors, directors and audit committee at the annual general meeting, in line with IIGCC recommendations in relation to failures in relation to Paris-aligned accounting and / or expected disclosures (e.g. voting against auditor and audit committee chair reappointment).

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[60] See footnote 30.
[61] See PWC's 'Making the transition to net zero' landing page.
[62] See, for example, PWC's 'Sustainability assurance and reporting services' landing page: PWC acknowledges that "*stakeholders want to know about an organisation's sustainability performance and how it is accurately reporting on its corporate activities to support climate change, resource scarcity and socially responsible investing*".
[63] 'Climate change disclosures: Can accountants save the world?' (Naomi Rigby, PWC, 20 May 2021).
[64] See, for example, section 507 of the UK Companies Act 2006.

39. We consider the issues identified in the CT Report to be systemic within corporate reporting and parts of the audit profession, and intend to engage with regulators to heighten scrutiny of audit performance on climate issues in future reporting cycles.

5 Calling on PwC to act now on climate change

40. At least one-fifth of the world's 2,000 biggest listed companies have set net-zero emissions targets in order to meet the Paris Agreement[65]. These companies "*will now be establishing targeted strategies and short- and medium-term targets to decarbonize their business models and reduce emissions. If these actions result in material financial implications, they will need to be reflected in a company's financial reporting*".[66] Such actions are essential to mitigate climate risk, but may have significant financial and accounting implications, including on expected cash flows, revenue and costs. Moreover, if a company's public climate commitments are not reflected in its financial statements, there is a high risk of misleading investors as to the relevant financial implications. Empty commitments may also lead to greenwashing.

41. In support of these efforts, auditors must:

    41.1. provide evidence, through disclosure and the discussion of key / critical audit matters, of the work they have done during audits to address material climate-related issues, and demonstrate clearly how they have scrutinised and used professional scepticism in evaluating management's inputs on these issues, to obtain the reasonable assurance required by audit standards;

    41.2. ensure that companies have considered climate-impacted assumptions and estimates and that these are transparently disclosed in the financial statements and accompanying notes;

    41.3. ensure that company financial statements are consistent with other company disclosures and commitments on climate change, particularly in narrative annual filings;

    41.4. develop firm-wide policies to consistently address these issues; and

    41.5. encourage management to consider using appropriate Paris-aligned assumptions, or rigorously explain the reason(s) for using non-aligned assumptions.

42. We further call on PwC to:

    42.1. carry out a comprehensive review and assessment of: (i) its audit of annual reports for the companies assessed in the CT Report and any others included in the CA100+ list; and (ii) its wider statutory audit practices, to identify and address audit failings in relation to climate change-related risk;

[65] Taking stock: A global assessment of net zero targets | Energy & Climate Intelligence Unit (eciu.net).
[66] 'Corporate Reporting: Climate Change Information and the 2021 Reporting Cycle' (IFAC, 7 September 2021).

42.2. make corrective statements where failings are identified and / or where PwC considers it is otherwise necessary to do so to ensure compliance with its legal duties, and that investors have the information they need to fully understand the financial position of companies PwC audits;

42.3. ensure, in relation to future audits, that it clearly demonstrates how it has complied with its legal duties and professional standards in relation to climate change-related risk, and properly takes account of investor expectations, including when making any determinations (particularly in relation to materiality) in the course of the audit; and

42.4. include a clear explanation of its approach to climate-related issues in its audit report for all audits of climate-exposed companies including, but not limited to, those identified in the CT Report (including in cases where climate issues were not considered material, it which case it should provide an explanation of why this was the case).

43. We understand that investors and other stakeholders will be monitoring the quality of audits published in 2022 for companies' 2021 financial reporting periods, with a particular focus on the issues set out in this letter. **We therefore call on PwC to urgently address its failings on climate change and to meet the minimum requirements of existing standards.**

44. Finally, we ask that you share this letter with the PwC partners responsible for the audit of climate exposed companies featuring in the CT Report. They as professionals, as much as the networks to which they belong, are accountable for ensuring good quality audits. We also urge you to engage on the matters raised in this letter with all other climate-exposed companies for whom PwC provides audit and accounting services.

45. We would welcome the opportunity for further discussion of these issues with you and your audit partners. If you would like to discuss the contents of this letter, please contact Maria Petzsch (mpetzsch@clientearth.org), Robert Clarke (rclarke@clientearth.org) or Joanne Etherton (jetherton@clientearth.org).

Yours faithfully,

James Thornton

Chief Executive Officer, ClientEarth