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Dear FRC Supervision Committee

Auditing and climate change – the role of the FRC

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]

We are concerned by the global failure of the audit profession to support and meet (respectively) the clear requirements under existing accounting and audit standards for material climate-related matters to be incorporated into company financial statements and audits. The focus of this letter is the breach by auditors operating in the UK of applicable audit standards and legal duties. As competent authority for the regulation of statutory auditors and the audit market in the UK, the FRC has ultimate responsibility for taking enforcement action to rectify these failings.[2]

We are further concerned that the FRC is failing to effectively intervene in the audit profession's clear and persistent failure to take proper account of climate change when auditing company financial statements. In particular, we see little evidence of the FRC taking meaningful enforcement action against the UK's largest audit firms in circumstances where those firms are

[1] See 'Risky Business: climate change and professional liability risks for auditors' (ClientEarth, December 2017).
[2] See the 'Respective Roles of Government, the FRC and the Accountancy Profession' (FRC); Regulation 3(1) of the Statutory Auditors and Third Country Auditors Regulations 2016 (**SATCAR**); and the Secretary of State's 17 June 2016 direction to the FRC.

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failing to demonstrate that they meet accounting and audit standards in relation to climate-change. This is despite:

(i) the purpose of the FRC, which is to "*serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them*"[3];

(ii) the FRC's recommendation that *"[climate-related] matters should be considered for their impact upon the financial statements in the same manner as any other matters which could have a material impact on the financial statements*"[4];

(iii) the findings of the FRC's 2020 Climate Thematic Review[5] that auditors:

(a) are failing to consider climate change when identifying and assessing the risks of material misstatement in financial statements;[6]

(b) are potentially breaching IFRS standards in relation to the consideration and disclosure of climate change in company financial statements;[7] and

(c) *"need to improve their consideration of climate-related risks when planning and executing their audits*.";[8] and

(iv) the FRC's commitment to "*work with companies and information users to ensure that the developing framework for audit and assurance of ESG information meets their needs*".[9]

On 8 December 2021, we wrote to the "big four" auditors – EY, Deloitte, KPMG and PwC – to put them on notice that, by failing to consider climate change in their audits, as demonstrated in a recent report[10] by the Carbon Tracker Initiative and the Carbon Accounting Project (the **CT Report**), they risk breaching audit standards and their duties under UK law. We enclose copies of our letters to the big four, calling on each firm to ensure that it addresses material climate risk explicitly when conducting audits, as required by existing audit standards, to carry out a comprehensive review of its audits of 2020 company financials to identify and correct climate-related audit and reporting failures, and alert the companies it audits to its intention to apply existing audit standards more rigorously in relation to climate change in future audits.

In this letter, we call on the FRC to prioritise and deliver urgent and effective oversight of, and enforcement against, auditors who fail to comply with their legal duties and / or the requirements of applicable audit standards in relation to climate change. Robust regulatory enforcement is

[3] See 'Our Purpose' (FRC).
[4] See page 3 of the FRC's 'FRS 102 Factsheet 8: climate-related matters' (FRC, November 2021).
[5] See 'Climate Thematic Review 2020' (FRC, November 2020).
[6] Page 20 of 'FRC Climate Thematic 2020: Audit'.
[7] Page 5 of the FRC's 'Climate Thematic Review 2020'.
[8] 'Climate Thematic Headline Findings' (FRC, November 2020).
[9] Page 8 of the 'FRC statement of intent on environmental, social and governance challenges' (FRC, July 2021).
[10] See 'Flying Blind: The glaring absence of climate risks in financial reporting' (Carbon Tracker, 16 September 2021).

essential to protect: (i) the interests of investors, for whose benefit company financial statements are ultimately prepared; and (ii) the integrity of the UK's financial market as a whole.

1. Auditors are failing on climate change

1.1. Over several years, we have repeatedly alerted you to corporate failures to adequately disclose the material climate-related trends and risks facing their businesses in the narrative sections of their annual reports as required by UK company law, and the failure of auditors to demonstrate that they adequately consider such risks when auditing those disclosures.[11] We have also drawn your attention to the findings of our review of UK listed companies' climate change related reporting for 2019-20, which found that:

1.1.1. only 40% of companies clearly referred to climate change in their discussion of principal risks and uncertainties; and

1.1.2. only 4% of audit reports clearly disclosed whether auditors had considered climate change-related factors in their audit.[12]

Building on these findings, we also called on the FRC to take appropriate enforcement action in respect of the climate laggards among corporates and auditors. Since our report, which we also shared with the FCA, was published in February 2021, it has been referenced by the FCA as a source of authoritative insight into the state of UK corporate reporting.[13] However, we are not aware of a substantive oversight or enforcement response to our findings from the FRC.

1.2. In addition to including climate-related narrative disclosures in their annual reports, companies must, under existing accounting standards, take account of material climate-related matters in their financial statements. Similarly, auditors must, under existing audit standards, assess the impact of climate change on a company's financial position when forming an opinion as to whether the financial statements give a true and fair view of the company's financial position and profitability, and are free of material misstatement.

1.3. As explained in our letters to the big four, this position is abundantly clear from recent guidance published by the IFRS Foundation[14] on the requirements of the International Financial Reporting Standards (**IFRS**) in relation to climate change, and from a recent staff audit practice alert published by the International Audit and Assurance Standards Board (**IAASB**)[15] on the requirement to consider climate change during audit under the International Standards on Auditing (**ISAs**).

1.4. In addition, the world's largest investors are unequivocal that they need to understand the impact of climate change on company financial statements. In September 2020, a

[11] See ClientEarth's referrals to the FRC of Cairn Energy plc (2016), SOCO International plc, now Pharos Energy plc (2016), Balfour Beatty plc (2018), Bodycote plc (2018), EnQuest plc (2018), EasyJet plc (2018), Carnival plc and Carnival Corporation (2021) and Just Eat Takeaway.com N.V. (2021)
[12] 'Accountability Emergency: A review of UK-listed companies' climate change-related reporting (2019-20)' (ClientEarth, 4 February 2021).
[13] See paragraph 2.9 of, and paragraph 5 of annex 2 to, the FCA consultation paper CP21/18.
[14] See 'Effects of climate-related matters on financial statements' (IFRS Foundation, November 2020), and earlier educational material published by the IFRS Foundation: 'IFRS® Standards and climate-related disclosures' (IFRS Foundation, November 2019).
[15] 'The consideration of climate-related risks in an audit of financial statement' (IAASB, October 2020).

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 in letter and spirit. The group noted the key role of auditors 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.[16]

1.5. 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.*"[17] In November this year, a group of investors led by Sarasin & Partners, representing over $4.5 trillion in assets under management, wrote to the big four auditors calling on them to deliver net zero aligned audits and to "*sound the alarm when company financial statements ignore the global transition to a 1.5°C temperature pathway*."[18]

1.6. The demands of the IIGCC and the wider investor coalition mentioned above are such that the materiality of climate-related financial risks, and associated financial disclosures, to investors' stewardship and decision making is beyond doubt, reinforcing the need for such risks to be reflected in the financial statements.

1.7. In its 2020 Climate Thematic Review[19], the FRC itself confirmed that the IFRS standards "*provide a clear framework for incorporating the risks of climate change into companies' financial reporting*" and set out its expectation for companies to consider climate matters and related IFRS Foundation guidance when preparing their annual reports and accounts.[20] In relation to audit, the FRC has:

1.7.1. acknowledged that a number of ISAs already "*require a consideration of climate related issues in the process of an audit of financial statements*"[21];

1.7.2. noted that "*investors see the auditor as having a key role and expect them to consider risks facing the company as a result of climate change, and expect appropriate challenge of management, particularly where climate-related risks have an impact on the entity's accounting estimates.*"[22]; and

1.7.3. published detailed guidance on the corresponding integration of climate-change for the preparers of financial statements under FRS 102.[23]

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[16] 'Investor groups call on companies to reflect climate-related risks in financial reporting' (PRI Accounting for Climate Change, 16 September 2020).
[17] Page 4 of 'Investor Expectations for Paris-aligned Accounts' (November 2020, IIGCC).
[18] 'Investor Expectations: Net-Zero Audits' (Sarasin & Partners, November 2021).
[19] See 'Climate Thematic Review 2020' (FRC, November 2020).
[20] See pages 4-5 of 'FRC Climate Thematic: Reporting' (FRC, November 2020).
[21] See page 6 of 'FRC Climate Thematic: Audit' (FRC, November 2020).
[22] See page 6 of 'FRC Climate Thematic: Audit' (FRC, November 2020).
[23] See the FRC's 'FRS 102 Factsheet 8: climate-related matters' (FRC, November 2021).

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1.8. Meanwhile, the big four auditors continue to make public claims as to their extensive awareness of climate-related risks and their implications for financial reporting[24], and purport to offer clients expert assistance in reflecting climate-change impacts in their financial reporting.[25] Deloitte, for example, goes as far as suggesting that finance professionals should drive their businesses to prepare Paris-aligned accounts in order to provide the "*quality information*" investors need "*to shift capital flows towards activities aligned with the Paris Agreement*".[26]

1.9. The CT Report shows, however, that this is not in practice carried over into audits conducted by the big four. These firms are habitually failing to demonstrate that they properly take account of climate-related risk in the conduct of their audits, even when auditing some of the most climate-exposed companies in the world.[27] If there is climate expertise within the consulting practices of the big four, it does not appear to be shared with their audit teams.

1.10. For context, the big four were responsible for conducting 105 out of the 107 company audits assessed in the CT Report. All of the companies assessed in the CT Report are highly carbon exposed.[28] They are therefore key to driving the global net-zero emissions transition, and their business models, accounting assumptions and financial positions will be deeply impacted by it.

1.11. For 80% of companies whose annual reports were assessed, auditors' consideration of (or failure to consider) climate caused "*significant concerns*"[29]. Specifically, the CT Report found that[30]:

1.11.1. **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 for an assessment to be made as to whether companies had accounted for climate risks (or related commitments, such as emissions reduction pledges).

1.11.2. **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

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[24] See, for example, Deloitte's 'Climate resources for finance professionals' landing page: "*The material impact climate change can have on a business' cash flows and financial performance makes it vital to consider and reflect the impact in financial statements.*"
[25] See, for example, KPMG's guidance: 'What's the impact on cash flow projections used for impairment...' (KPMG, 28 June 2021)
[26] 'Climate resources for finance professionals': Step Eight – delivering Paris-aligned accounts.
[27] Of the 107 companies whose corporate reporting (and the audit thereof) was reviewed in the CT Report, 94 are included among the Climate Action 100+ ("**CA100+**") investor focus list, which in total accounts for "*over 80% of corporate industrial greenhouse gas emissions*" – see footnote 2 to page 2 of the CT Report, footnote 10 to page 4 of the CT Report, and the Climate Action 100+ investor focus list of companies, here. The remaining 13 companies were "*companies with obvious energy transition related financial risks*" – see footnote 40 to page 16 of the CT Report.
[28] See page 16 of the CT Report.
[29] See page 6 of the CT Report at Figure 1.
[30] See pages 43-44 of the CT Report.

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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.

1.11.3. **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

1.11.4. **Companies and their auditors do not appear to use 'Paris-aligned'**[31] **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[32]. None of these appeared to use assumptions and estimates aligned with the goals of the Paris Agreement[33] or to provide corresponding sensitivity analysis.

1.12. These findings are consistent with conclusions drawn by the FRC in its 2020 Climate Thematic Review (which are set out in more detail in the opening paragraphs of this letter[34]). The FRC found that auditors failed to consider climate change in many audit reports for UK company 2019 financials[35], are potentially breaching IFRS standards by failing to consider climate change during audit[36], and "*need to improve their consideration of climate-related risks when planning and executing their audits*."[37] However, so far as we can tell from publicly available information, additional and meaningful monitoring and enforcement action by the FRC to date in relation to climate change related-reporting that is consistent with these commitments is still sorely lacking.

1.13. The FRC has subsequently made climate risk a key focus of its routine monitoring of annual reports and accounts for the 2021/22 reporting cycle.[38] One of the FRC's key expectations will be that "*companies [should] provide sufficient information so that users*

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[31] 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*".

[32] Such as the International Energy Agency's Stated Policies Scenario (STEPS) or Sustainable Development Scenario (SDS).

[33] 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.

[34] See the text to footnotes 5 to 8.

[35] Page 20 of 'FRC Climate Thematic 2020: Audit'.

[36] Page 5 of the FRC's 'Climate Thematic Review 2020'.

[37] 'Climate Thematic Headline Findings' (FRC, November 2020).

[38] See 'Annual review of corporate reporting: 2020/21' (FRC, 27 October 2021) and 'FRC to focus on climate-related reporting as new disclosure requirements beckon' (FRC, 27 October 2021).

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can understand the relationship between uncertainties and scenarios discussed in narrative reporting and the assumptions applied and sensitivities considered in the financial statements."[39] On 3 December 2021 the FRC announced that its supervisory focus for 2022/23 will include a further thematic review, undertaken in collaboration with the FCA, on reporting by premium listed companies against the recommendations of the Task Force on Climate Related Financial Disclosures (**TCFD**) and the extent to which the financial statements reflect the impact of climate change.[40]

1.14. In our view, inadequate audit practices in relation to climate change are systemic and entrenched across the profession. This must be urgently addressed by the FRC to ensure investors are provided with the accurate and reliable financial information they need in order to efficiently (re-)allocate capital to support the net zero transition, to drive the UK towards a finance pathway consistent with the goals of the Paris Agreement, and to support flagship financial sector commitments made by the UK Government at COP26.[41]

2. The FRC must act now on climate change

2.1. We welcome the FRC's publicly stated focus on climate-related financial risk. However, continued monitoring of company reporting and audit is unlikely to be effective without robust enforcement action to close the accountability gap. If the FRC does not enforce against auditors that fail on climate change, it risks being ignored by those it regulates.

2.2. As noted in the opening paragraphs of this letter, we are concerned by: (a) the persistent failings of the audit profession in this area; and (b) the apparent reluctance of the FRC either: (i) to engage meaningfully with the specific referrals made by ClientEarth highlighting examples of the most egregious climate reporting failures[42]; or (ii) to take adequate enforcement action over audit failings on climate more broadly.

2.3. We note that the FRC is due to relaunch as the Audit, Reporting and Governance Authority (**ARGA**) during 2023 with enhanced regulatory powers and transparency expected to follow, and increased budget and staff capacity forecast in preparation for the transition.[43] This transition must not be used as an excuse for continued delay and failure by the FRC to fulfil its current remit. In the interim period, it is essential that the FRC has proper regard to its responsibility to oversee and enforce against audit failings.[44] Alongside further thematic reviews on climate reporting[45], the FRC must deliver a step-change in its oversight and enforcement of corporate reporting and audit failures relating to climate change now, so that the vital opportunity to safeguard accurate reporting and meaningful audit of company financials for 2021, 2022 and 2023 is not missed.

[39] 'Key matters for 2021/22 reports and accounts' (FRC, 27 October 2021).
[40] See 'FRC announces areas of supervisory focus for 2022/23' (FRC, 3 December 2021).
[41] Including the Chancellor's plans to make the UK the world's first net-zero aligned financial centre. See 'Chancellor: UK will be the world's first net zero financial centre' (HM Treasury, 3 November 2021).
[42] See footnote 11.
[43] See the FRC's '2021/22 Strategy, Plan and Budget'.
[44] See regulations 3(1)(a) and 3(1)(k)-(m) of SATCAR.
[45] See text to footnote 40.

Key asks of the FRC

2.4. Accordingly, we call on the FRC to:

2.4.1. undertake, in line with the FRC's announced supervisory focus for 2022/23, a comprehensive annual assessment (for current and future financial years) of company reporting and audit to assess progress on the issues identified in the FRC's 2020 Climate Thematic Review and the CT Report, and report publicly on the results of that annual assessment;

2.4.2. identify corporate and auditor laggards on climate-related financial reporting and audit, and take meaningful enforcement action against them; and

2.4.3. report publicly on enforcement action taken and its results, where it is within the FRC's discretion to do so.[46]

2.5. In our view, the enforcement action requested in paragraph 2.4.2 should include, at a minimum, robust "constructive engagement" with each of the big four auditors over the systemic climate-related failings identified in the CT Report to encourage them to improve their audit practices. In addition, we strongly urge the FRC to make every effort to open publicly announced investigations (under its audit enforcement procedure[47]) into specific instances of inadequate audit practices by each of the big four in relation to climate change – the CT Report provides many examples of such failings, which should be used for targeted review. The publication[48] of these investigations would help to maintain public confidence in the audit profession and its regulation and protect investors who are exposed to the specific audit failures being investigated[49], and in our view is justified.

2.6. As explained below, effective enforcement by the FRC will also require effective oversight of the recognised supervisory bodies ("**RSBs**") to which the FRC has delegated audit monitoring and enforcement powers[50] for entities other than public interest entities.

Measures to support effective enforcement

2.7. In general, the FRC retains responsibility for monitoring, investigation and enforcement of the audit of public interest entities (**PIEs**) but delegates the monitoring, investigation and enforcement of the audit of other entities (**non-PIEs**) to the RSBs.[51] In order to ensure effective oversight of the audit of non-PIEs (including in respect of climate-change impacts), it is imperative that the FRC exercises its powers to oversee whether and to

[46] Under the FRC's publication policy for the Audit Enforcement Procedure.
[47] See the FRC's Audit Enforcement Procedure landing page, and the March 2021 reissue of the FRC's Audit Enforcement Procedure, including rules 4-7 on the decision to investigate, and Part 3 on the conduct of investigations.
[48] The list of publicly announced audit investigations by the FRC is available here.
[49] See paragraph 11 of the FRC's publication policy – these are grounds for the FRC to determine that publication is necessary.
[50] The RSBs are the Association of Chartered Certified Accountants, the Institute of Chartered Accountants Ireland, the Institute of Chartered Accountants in England and Wales (**ICAEW**) and the Institute of Chartered Accountants of Scotland. The 2016 delegation agreements between the FRC and these bodies can be found here.
[51] See the 'Respective Roles of Government, the FRC and the Accountancy Profession' (FRC); 'Oversight of Audit' (FRC); and clause 2 of each of the RSB delegation agreements.

which standard the RSBs are performing their delegated supervisory tasks, by conducting a targeted review of each RSBs ability to effectively regulate audit performance in relation to climate change (including through periodic assessments under the delegation agreement between the FRC and each RSB[52]).

2.8. Where failings are identified, capacity building within the RSB and enhanced FRC oversight may be required. In cases where RSB oversight remains inadequate, the FRC should consider reclaiming monitoring, investigation or enforcement powers it has delegated to the relevant RSB, as the FRC is empowered to do when it considers there are public interest reasons for carrying out the relevant task itself.[53] Given the significant investor and wider public interest in meaningful accounting and auditing for climate-change risk, we consider that this would be more than justified.

3. Conclusion

3.1. For the reasons set out above, the FRC must urgently step up its enforcement of auditor performance in relation to climate change, to ensure that it meets its own objectives and remedies the widespread corporate reporting and audit failures identified.

3.2. We would welcome the opportunity for a constructive discussion of these issues with you in support of the FRC's effective oversight of the audit profession. 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,

Joanne Etherton

Acting Head of Climate, ClientEarth

[52] See 'Oversight of Audit' (FRC); and, for example, appendix 4 of the delegation agreement between the FRC and the ICAEW.

[53] Pursuant to paragraph 2(d) of the Secretary of State's 17 June 2016 direction to the FRC, the FRC may perform a task related to the monitoring, investigation or enforcement of auditors and audit work and not delegate it, or reclaim it (as applicable), if the FRC considers there are public interest reasons for carrying out the task itself.

Encl.

ClientEarth letter to Deloitte on climate change and audit

ClientEarth letter to KPMG on climate change and audit

ClientEarth letter to EY on climate change and audit

ClientEarth letter to PwC on climate change and audit