Financial Reporting Council

Financial Reporting LAB

FRC Climate Thematic

Audit – How are auditors taking account of climate-related challenges?

November 2020

Introduction

Throughout 2020, the FRC has undertaken a thematic review of climate-related considerations by boards, companies, auditors, professional associations and investors. This report forms part of that review and addresses the question ‘how are auditors taking account of climate-related challenges?’

Other aspects of the FRC’s findings can be found at the following links:

- The consolidated findings across corporate reporting and audit can be found here.
- The detailed findings on governance can be found here.
- The detailed findings on corporate reporting can be found here.
- The detailed findings on professional oversight can be found here.
- The detailed findings on investor reporting and better practice reporting under the Task Force on Climate-related Financial Disclosures can be found here.

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We asked: How are auditors taking account of climate-related challenges?

Why is this important?

Climate change is a crisis affecting everyone. It will impact most entities to some degree, either directly, or indirectly through their supply chain, customer base, financing, insurance and laws and regulations. The auditor's objective is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and report on whether the financial statements are prepared, in all material respects, in accordance with the financial reporting framework. If climate change impacts the entity, the auditor needs to consider whether the financial statements appropriately reflect this. This requires consideration of factors presenting a potential risk of material misstatement of the financial statements as a result of climate change. For example, if an entity has any manufacturing facilities in areas subject to increased flood risk, this may impact the entity's impairment calculations, or an entity may have assets that are at risk of obsolescence as a result of greener policies or products. Where risks are identified, auditors need to determine an appropriate audit response to determine if they have a material impact on the financial statements.

What did we do?

Climate change considerations are still relatively new to auditors. Embedding these into the audit process requires knowledge acquisition as well as a mindset shift. We benchmarked the seven largest audit firms to assess how established their processes and procedures were to enable this shift, looking at the resources available to support teams in evaluating and responding to the impact of climate change on audited entities. We also assessed how firms' quality control procedures took account of climate change considerations.

We reviewed a sample of audits, predominately taken from the four largest audit firms, to understand how audit teams had responded to climate risks in practice when performing their audit procedures to determine if an entity's financial statements present a true and fair view.

What did we find?

The quality of support, training and resources provided to the audit practice varied considerably across firms. Firms also need to do more to ensure that their internal quality monitoring has appropriate regard for climate change considerations.

Audits reviewed indicated that auditors need to improve their consideration of climate-related risks when planning and executing their audits.

Background

The challenges of climate change

The Paris Agreement aims to strengthen the response to climate change by "Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels, recognising that this would significantly reduce the risks and impacts of climate change", amongst other aims.

A serious reallocation of resources would be required to meet these goals, and therefore companies can be exposed to a wide range of risks and opportunities. To the right is a high-level overview of some of the physical and transitional risks and opportunities companies will face. Climate change considerations are obviously relevant for entities across many industries and will therefore be relevant for their reporting and the audit of their financial statements.

Reporting requirements in relation to climate change – financial statements

There is no standalone International Financial Reporting Standard (IFRS) which addresses climate change specifically. However, the requirements of IFRS standards provide a clear framework for incorporating the risks of climate change into companies' financial reporting. These apply, for example, to measurement uncertainty associated with forward-looking assumptions and estimates, and the related disclosures.

In November 2019, a member of the International Accounting Standards Board (IASB provided an overview of existing IFRS requirements, including requirements for risk-related disclosures, and guidance on the application of materiality in the article 'IFRS Standards and climate-related disclosures' (IASB Article).

The article does not have the status of a standard and does not provide a complete 'checklist' of relevant requirements but does provide helpful insight into how climate change should be considered when addressing certain requirements.

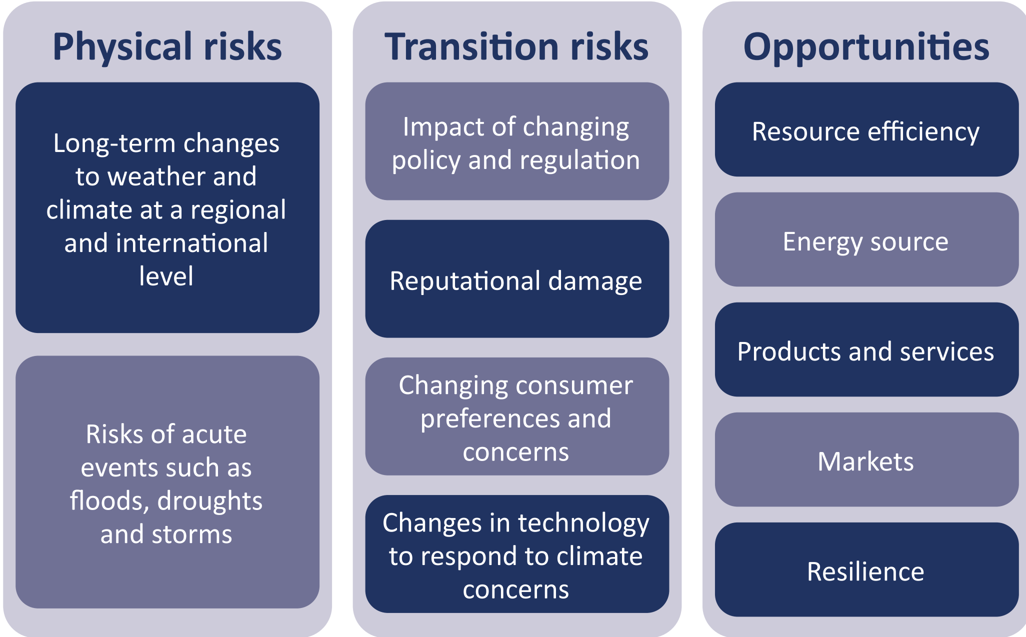


Figure 1: Possible physical risks, transitional risks and opportunities companies may face, as identified by the Task Force on Climate-related Financial Disclosures (TCFD).

Another part of the FRC's review considered how companies are reporting on climate-related challenges. This used the IASB document as a guide to the financial decisions that companies may be making. The IASB Article can also be helpful for auditors in evaluating their own assessments of a company's risks, and how the audit process may need to take account of climate-related challenges.

> ***"There are so many issues… external information, data, but also going concern. Can you sign off on accounts in good faith without having a view on the financial impact [of climate change]?"*** *– Investor*

> ***"It's important [the financial statements are] accurate, and for some companies it's critical they are fairly presented, because climate change presents significant nearer-term risk"*** *– Investor*

Requirements of International Standards on Auditing (ISAs)

As highlighted by the recently produced Staff Audit Practice Alert, mentioned to the right, a number of ISAs already, where applicable, require a consideration of climate-related issues in the process of an audit of financial statements.

Each company, and each audit, may be differently affected by climate-related considerations, but the ISAs that may be most relevant include those covering the risk assessment (ISA 315), the auditor's response to the assessed risks (ISA 330), and the auditor's responsibilities relating to Other Information (ISA 720).

Lab finding – investor expectations of audit

We have engaged with a range of investors throughout the course of this thematic. These 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.

Investors' expectation of the integration of climate-related considerations within financial statements, and therefore the important role of the auditor, continues to grow.

Our engagement with investors throughout the course of this thematic developed the Lab's 2019 work on climate-related corporate reporting, which found that investors were very supportive of the Task Force on Climate-related Financial Disclosures' (TCFD) reporting framework. Investors' views and examples of better practice TCFD reporting can be found here.

***"It has been interesting to see the recent asset write-downs and the extent to which they have been driven by aligning the assumptions in the back half – it's a really, really important role for auditors in terms of that alignment. The company should describe the future it sees, then how does that feed into assumptions about the value of the assets?"** – Investor*

***"When looking at environmental, social and governance data there is very little independent verification, and there should be as we're increasingly using it in investment decisions"** – Investor*

Accounting for climate change

A number of investor groups recently issued an open letter expressing their support for accounting that takes account of the IASB 'In Brief' document, and consequential activity by auditors. The PRI, UNEP FI, UN-convened Net-Zero Asset Owner Alliance, IIGCC, IGCC and AIGCC in an open letter, support the IASB opinion and, in light of their expectations of auditors, are calling for auditors to "sign off financial statements which are consistent with the IASB opinion in the letter and the spirit, which include showing the key assumptions that have been made with regard to climate-related risks". The investor letter also includes expectations of reporting, and these expectations, including some relevant insights from the FRC's Corporate Reporting Review team, can be found here.

International Auditing and Assurance Standards Board (IAASB) Staff Audit Practice Alert

In October 2020 the IAASB published a Staff Audit Practice Alert to highlight areas of focus related to the consideration of climate-related risks when conducting an audit of financial statements in accordance with the ISAs. The Practice Alert intended to help auditors understand the requirements of the current ISAs and how that material relates to the auditor's consideration of climate-related risks in an audit of financial statements. It outlines the ISAs that may be most relevant for a consideration of climate-related issues.

The Brydon review

In 2019 Sir Donald Brydon released his review of audit, 'Assess, assure and inform: improving audit quality and effectiveness –final report of the independent review'. This review includes a number of recommendations for the future of audit and the profession, and also includes references to climate change. For example, climate change is referenced as a topic that may be considered within a 'resilience statement', or as an area on which directors may choose to get further assurance. The Government is due to consult on possible changes to respond to the recommendations of the Brydon Review and the FRC looks forward to considering the ongoing implications of climate change on audit and assurance in this context.

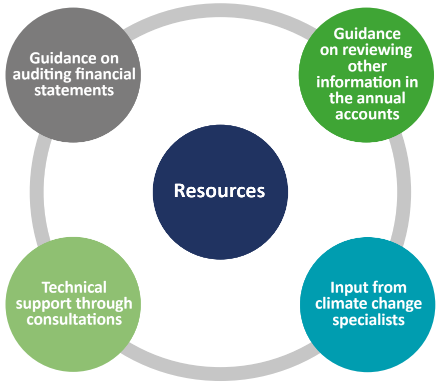
Benchmarking – headline finding:

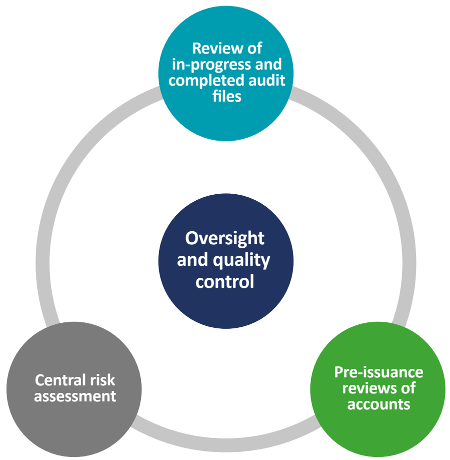
The quality of support, training and resources provided to the audit practice varies considerably across firms. Firms also need to do more to ensure that their internal quality monitoring has appropriate regard for climate change considerations.

Overview of benchmarking work

Our benchmarking work over the firmwide procedures firstly considered the resources available within audit firms to support audit teams to consider and address the impact of climate change. This focused on the level of training, guidance and access to specialists provided to the audit practice.

Secondly, we considered the extent of the firms' oversight and quality control processes, such as central risk assessments to identify entities at heightened risk of climate change, and reviews of in-flight and completed audits to identify good practice and areas for improvement.



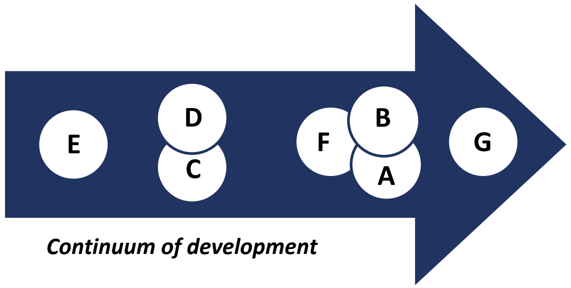


Benchmarking results

Overall, we noted a wide range in the development of the firms' responses with regard to climate change considerations. We have mapped where we think the seven largest firms fall on a continuum of development.

Continuum of development in respect of firmwide processes

Firms in the earliest stages of development have only just started to identify the impact of climate change risks on audits. They have only provided generic guidance on the significance of climate change considerations with some detail on the impact this should have on the financial statements and other information included in companies' reports. Firms in this stage have limited oversight of how teams are responding to climate change risks in practice as this is not a focus of their internal quality control processes.



Continuum of development

Firms that are more developed have detailed guidance on the impact of climate change considerations on different elements of companies' reports across different industries. These firms have specialist and technical resources available to support teams, but do not have any central process to identify audits with significant climate change risks or monitor how teams are responding to such risks. These firms' quality control processes are identifying some matters relating to these risks, but this is not a focus of these processes and there is no specific guidance or resources to support reviewers in this area.

The firm that is most advanced has a suite of guidance and resources to support audit teams and has embedded climate change considerations into their audit training and methodology. It has guidance on when audit teams should involve specialists and central review programs to identify audits with significant climate change risks and to review teams' work in this area. This firm has made climate-related issues a focus of its quality control processes and has undertaken targeted reviews.

The firms' developmental stages are partly driven by the complexity and risks of their portfolio of audited entities, the extent of a firm's resources and the level of support and direction provided by the global networks. Each firm needs to assess the significance of climate change on its portfolio of audited entities, considering the range of possible impacts on companies.

From our discussions with international regulators, we note that this is a development area for firms globally, with firms' global responses continuing to evolve and expand as this becomes an area of increased audit and regulatory focus.

Benchmarking results: Resources

Our benchmarking review of the resources available to audit teams to assist them in evaluating and addressing the impact of climate change focused heavily on the guidance and training provided by the firms. In doing so, we examined separately the training and guidance provided on auditing the financial statements and that provided on reviewing other information. We also considered the extent of work programmes and templates that had been designed by the firms to help teams perform procedures to a consistent standard.

Guidance on auditing financial statements

Climate change risks can affect many aspects of a company's financial statements. It will be unique to each entity, and vary in impact. Accordingly, audit teams need to ensure that climate change is taken into account in their risk assessment process and their planned audit work. Depending on the facts and circumstances of an entity, climate-related issues may have an impact on specific audit areas such as the valuation of assets; assumptions used in impairment testing; depreciation rates; decommissioning provisions and other similar liabilities; and financial risk disclosures.

Four firms have provided detailed guidance on how climate change may affect the different areas of the financial statements, with consideration of how climate-related issues interact with the accounting standards.

AREA	A	B	C	D	E	F	G
Has the firm provided detailed guidance on how climate change should be considered when identifying and responding to financial statement risks?		•		•		•	•
Has the firm provided guidance on financial statement impact on an industry-by-industry basis?		•				•	•
Has the firm produced any work programs, or embedded steps into existing work programs, to support teams in assessing the impact of climate change on the financial statements?	•						•

Three firms have provided audit teams with guidance, on an industry-by-industry basis. Such guidance can provide a useful framework for audit teams to assess if they have identified and responded to all relevant climate-related issues and to challenge management on the extent of the impact on the financial statements.

However, there is a significant range in the number of industries being considered, with one firm only focusing on high-risk industries whilst another firm has provided guidance for 15 industries to help teams understand the pervasive nature of climate change risks. Some other firms have provided guidance for only a single industry, such as insurance, banking or oil and gas, based on their assessment of the highest risk industry within their audited entity portfolio.

One firm produced a detailed template memo for use by teams auditing oil and gas companies, to guide their assessment of forward-looking commodity price assumptions and disclosures with respect to climate change. However, this firm had not produced similar templates for other industries.

Another firm produced a high-level climate change consideration memo, for use on all audits, to encourage teams to document how they assessed the impact of climate-related issues on financial statement balances and disclosures, including judgements and estimates, and their audit response to any risks identified.

Since the benchmarking exercise, three firms informed us that they are developing template workpapers to guide audit teams' risk assessments and responses to climate change. Four firms also plan to provide or extend their industry-specific guidance and workpapers to support audit teams in higher risk sectors.

Summary

Providing guidance to audit teams on auditing financial statements through a climate change lens is a moving target. It needs to be regularly updated as the impact of climate change evolves and crystallises. At the time of benchmarking, we noted a number of firms need to provide audit teams with more guidance on how climate change can impact the identification and assessment of risks of material misstatement of financial statements for companies in different industries. They should ensure that all audit teams consider climate change risk, not just those auditing entities in sectors deemed obviously highly exposed to climate risk.

Firms should develop more ways to embed climate change considerations into their audit methodology and software to ensure that audit work is of a consistent quality. For example, this could involve developing or updating audit manuals, workpaper templates, checklists or practice aids that can be applied appropriately to the individual facts and circumstances of each audited entity.

Providing working papers and templates can help to ensure that audit work is performed with a consistent level of quality and rigour across the audit firm. Without this direction, audit teams may not identify all areas of the financial statements that may be affected by climate change and may not follow through this assessment with sufficiently rigorous audit work. This is particularly a risk where audit teams are under time pressure or are leveraging the audit work performed in the prior year. Such working papers and templates provide valuable top-down direction for audit teams and increase audit efficiency and the consistency of audit quality, provided they are completed appropriately, and responses are tailored to the specific circumstances of each audited entity.

Good practice we identified included:

- Industry-specific guidance on the impact of climate change across all sectors.
- Guidance clearly considering how climate change risks affect the application of the different accounting standards.
- A high-level climate change consideration memo for all audits to evidence their risk assessment considerations and audit response.
- For one industry, producing a detailed working paper template to support certain audit teams in assessing the impact of climate change.

"One of the challenges for auditors is ensuring the completeness of risk considerations on climate change, for example on provisions – are they properly challenging management? There are some industries like energy where it's obvious, but I have a sense that there are certain industries that may be a bit naïve and for whom the penny hasn't dropped. The auditor could rightfully challenge" *– Investor*

Communication within the audit practice

Firms are using a wide range of channels to communicate regulatory updates and audit guidance to staff and partners. Regular communication helps ensure that audit teams are alert to potential climate-related issues and aware of the need to exercise professional judgement and scepticism when discussing these risks with management and designing audit responses. This can be particularly useful where management of audited entities are slow to recognise the need to consider the impact of climate change on their business and the audit.

Three firms have used podcasts and webinars to communicate information, which two firms have supplemented with regular email updates to the audit practice and additional updates to audit partners. One of these firms also issued targeted email communication to the audit partners on audits identified as particularly exposed to climate-related issues. Another of these firms has created an integrated climate change approach for audit staff and provided training on how to use this. This firm has also begun engagement-based team learnings to prompt discussion within specific audit teams. This firm, and one other, are also planning to create specific climate change focused intranet sites to facilitate communication with the audit practice.

Some firms are, through the tone and frequency of their communications, making it clear that this is a significant issue and an area of focus. However, other firms need to do more to set this tone and communicate it to audit teams.

Risk assessment within audits

Firms vary in how much guidance and support they give audit teams in considering how climate change affects the risk assessment for an audit. Two firms have provided detailed guidance on an industry-by-industry basis to help teams understand what risks could be relevant to an audited entity and several firms are planning to develop such guidance going forward.

The firms have not provided explicit guidance on when teams should identify a significant risk or key audit matter in respect of climate-related issues. However, several of the firms have a centralised process to review key audit matters before audit reports are signed and two firms were able to provide examples of where teams had identified key audit matters that related to climate change risks. The other firms were not able to provide any such examples as they do not track key audit matters reported on this basis. Therefore, it was not possible to assess how frequently the different firms are reporting key audit matters relating to climate change risks.

One firm is planning to introduce a new climate change risk assessment workpaper with industry-specific content that will also include a risk scorecard. This scorecard will provide guidance as to when teams should involve a specialist or consult for technical advice. This firm also plans to set a rebuttable presumption that all listed audits will have climate change risk as an assumption in at least one significant accounting judgement or estimate.

Guidance on reviewing 'other information'* in the annual report

Companies need to ensure that their strategic report, viability statement and principal risks adequately reflect their exposure to climate-related issues and how they are monitoring and managing these risks. Companies may also be seeking to comply with the TCFD recommendations. Alongside the launch of this review, the FRC has published a statement outlining its position on non-financial reporting frameworks, which can be found here.

Auditors need to ascertain whether such disclosures are consistent with their understanding of the business and are sufficiently complete for the information to be fair and balanced.

Audit teams therefore need adequate training and guidance to be able to evaluate whether appropriate narrative reporting disclosures have been made with regard to the nature and impact of climate change risks.

Our assessment of the relative consideration of 'other information' across the firms can be seen in the table to the right.

Six audit firms have provided guidance on the importance of climate-related reporting and what companies should be reporting on. However, the level of detail and depth in this guidance varies significantly. For example, one firm did not include details of the TCFD recommendations that companies are increasingly encouraged to comply with, whilst other firms have just shared the key messages from the FRC Lab report on climate-related corporate reporting. However, two firms have provided detailed guidance on each area of the 'other information' in the accounts.

AREA	A	B	C	D	E	F	G
Has the importance of climate change reporting in the 'other information' been communicated to the audit practice?	●	●	●	●		●	●
Has the firm provided guidance to audit teams on what companies should be reporting in their 'other information'?	●	●	●	●		●	●
Has the firm provided guidance on how climate change disclosures might be included in each element of the 'other information'?		●					●
Are there templates for reviewing 'other information' that include reference to climate change?	●	●	●				
Has the firm provided any industry-specific guidance or templates for reviewing 'other information'?				●		●	●
Has the firm provided examples of good disclosures?						●	●

*Other information means financial or non-financial information, other than the financial statements and audited parts of the Directors' Remuneration Report, included in an entity's Annual Report. In the UK the other information typically includes the Strategic Report, the Directors' Report, the Corporate Governance Statement and the Directors' Remuneration Report. It may also commonly include statements from the Chair, Chief Executive Officer, Chief Financial Officer and other committees.

Three firms included reference to climate change in the template workpapers they issue to audit teams for the review of ‘other information’ in the annual report. However, in some instances these references were very brief and only required teams to confirm that they had considered climate change when reviewing the ‘other information’, without prompting specific considerations and review procedures to ensure sufficiently detailed work. Another firm included detailed expected procedures in their practice aid for reviewing ‘other information’. This can help to ensure consistent and reliable audit work.

Two of the firms shared examples of good practice in front half reporting within the guidance provided to audit teams.

Three firms have provided industry-specific guidance on what types of climate change risks audit teams should consider in assessing the completeness of the principal and emerging risks identified by management of an audited entity. One firm had provided this for the industries identified as high-risk by the TCFD. The other two firms had provided this more broadly, with one firm having guidance for 15 industry groups in order to challenge teams across their audit practice to consider the significance of climate-related issues.

Another firm produced an industry-specific workpaper to support teams in reviewing how entities in the insurance sector have complied with specific guidance on the impact of climate change for the ‘other information’ with respect to risk assessment, risk disclosures and risk management disclosures. However, this firm had not provided similar workpapers for any other industry sectors.

Several firms are currently working to extend their current guidance to provide greater insights for specific industries and for the TCFD recommendations. The firm that did not provide any guidance or resources has since appointed two sustainability reporting experts to lead on understanding the application of the TCFD recommendations and develop training, guidance and support for audit teams.

Summary

Most firms are developing guidance in this area and some are beginning to incorporate climate change considerations into audit templates. However, firms should continue to make their guidance more granular and comprehensive and to provide audit teams with more examples of good climate risk disclosures and sustainability reporting.

Good practice we identified included:

- Inclusion of climate change considerations in the template workpapers used to review ‘other information’.
- Providing guidance to audit teams on the TCFD recommendations and the importance of climate-related reporting.
- Detailed guidance on different areas of front half reporting and what needs to be considered.
- Sharing examples of good disclosures.
- Industry-specific guidance on potential climate change risks.

All the firms have realised that climate change is an area of increasing focus and scrutiny for investors and regulators. For most of the firms this is an area where they intend to increase effort and investment going forward. For example, since the benchmarking exercise one firm has created a climate risk team to identify where further resources and guidance are needed and another has appointed a UK Head of Environmental, Social and Governance factors in Audit and Assurance.

Input from climate change specialists

Assessing the potential impact of climate change on an audited entity can require specialist knowledge and skills. We benchmarked the firms' use of specialists in their audit assessments.

AREA	A	B	C	D	E	F	G
Does the firm have climate change and sustainability specialists?	•	•				•	•
Does the firm use other specialists to support audit teams on climate change?	•						•
Is there any guidance on when specialists should be used?							•

Four firms have climate change and sustainability specialists available within the firm. Another firm has the ability to reach out to its global practice for specialist support, although in practice it could not provide examples of when this had occurred. One firm did not think it needed climate change specialists based on its audit portfolio.

Two firms identified that, in addition to their climate change and sustainability specialists, they also make use of transaction advisory, valuations, actuarial and regulatory compliance specialists when responding to climate-related issues.

Only one firm provided guidance to audit teams on when they should involve specialists, advising teams to involve specialists on audits identified as high-risk through the central or team risk assessment process and on audits where management has identified climate change as a principal risk. This may mean that, in other firms, audit teams may not realise when they need specialist input and so may not be able to identify and respond to climate-related issues. Another firm is planning to implement such guidance, using a climate risk scorecard, going forward.

Some firms used climate change specialists in developing the guidance and templates for audit teams. One firm has provided climate change training to other specialists within the practice, specifically specialists in auditing the impairment of non-financial assets, to ensure that climate change is considered throughout the audit.

The firms provided examples of support that climate change specialists provide, which included:

- reviewing and challenging of management's disclosures;
- reviewing compliance with the TCFD recommendations;
- reviewing non-financial key performance indicators reported;
- reviewing the audit team's risk assessment; and
- climate stress-testing for insurance entities.

Only one firm could provide statistics on how often audit teams use specialists. Such data is useful in identifying and monitoring themes requiring specialist input.

One firm has plans to increase its range of climate change specialists. Two of the firms, which previously did not have any climate change specialists, have since chosen to hire specialists, with one firm hiring an Environmental, Social and Governance Director.

Summary

Some firms have a range of internal specialists. However, only one firm provided clear guidance to audit teams on when they are expected to involve a specialist.

Good practice we identified included:

- Use of a broad range of internal specialists to support audit teams on multiple aspects of climate change risks.
- Specialists involved in the development of guidance and templates for use by the audit practice.
- Targeted climate change training for impairment specialists.

Technical support through consultations

The audit team has to consider, for each difficult or contentious matter, whether it has the expertise and experience to resolve this without consultation or whether there is a need to consult with internal technical specialists. The more complex or significant a matter is, and the greater the degree of judgement to be applied, the more likely it is that consultation is required. Complexities in assessing the impact of climate change on an entity, or the appropriateness and adequacy of the company's disclosures and reporting, are areas where audit teams may need to consult. There may be particular cases where the audit team can benefit from the knowledge of similar accounting or audit issues that have been raised previously.

AREA	A	B	C	D	E	F	G
Are there climate change subject matter experts in the central consultation team?		•					•
Is there guidance on when audit teams should consult in respect of climate change?							
Does the firm track consultations raised in respect of climate change?							

None of the firms have set guidance as to when audit teams should consult on climate change and its impact on the financial statements or other information included in the accounts. By contrast, firms have provided guidance on when to consult in some other areas of challenge, most recently with respect to COVID-19.

None of the firms specifically track consultations raised in respect of climate change and only one firm was able to identify consultations specifically raised in respect of climate-related issues. This could indicate that audit teams are not consulting on this topic, which could point to a lack of awareness of the accounting and reporting challenges and complexities.

Going forward, two firms intend to track consultations raised in respect of climate change. Another firm intends to include a question on climate change as part of all risk panels conducted in respect of going concern risks, to ensure that climate change is considered for all companies that are flagged as having a higher going concern risk.

Two firms have climate change subject matter experts embedded within their technical accounting and reporting teams to ensure that any consultations arising can be addressed appropriately.

Summary

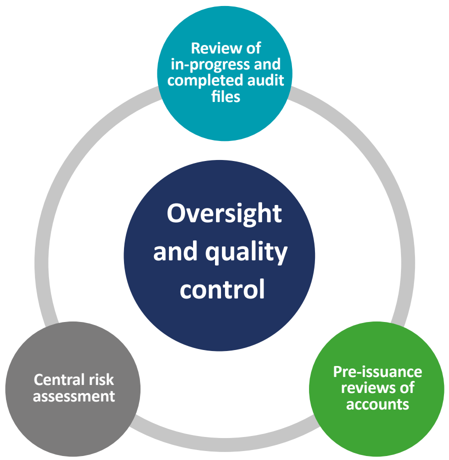
No firm has guidance on when audit teams should consult in respect of climate change. None of the firms track consultations raised in relation to climate change and only one firm was able to identify any consultations specifically raised in respect of climate change. This was also the only firm to flag climate change as an area of focus for central quality reviews, and to identify findings and good practice points in relation to the audit work over climate change.

The other firms should enhance their oversight of this area so that they can recognise where audit teams need further support and training and also identify examples of good and bad practice that can be used for training purposes.

Good practice we identified was:

- Two firms have climate change subject matter experts within their technical accounting and reporting teams.

Benchmarking: Oversight and quality control



We focused on the quality control procedures used by firms to ensure that audit teams are addressing the impact of climate risk appropriately on each audit. Firms typically have a suite of such procedures, which include use of engagement quality control reviewers (EQCRs), central reviews of the audit either during (in-progress review) or after (completed review), and pre-issuance reviews of the annual reports.

Review of in-progress and completed audits

Internal monitoring of audits allows firms to ensure that the audit work being performed is sufficient to support the audit opinions being issued. Therefore, the individuals responsible for reviewing audits should have sufficient guidance and training so that they can identify if climate change risks have been considered appropriately by the audit team where these could have a material impact on the audited company.

All firms have a general internal review program, whereby audits are selected for in-progress and completed reviews. When performing such reviews, the reviewers should consider the sufficiency of climate-related considerations. However, only one firm provided specific training or practice aids to support EQCRs and in-progress reviewers in considering such issues, though several firms are planning to introduce this in the near future.

One firm had also undertaken a thematic review of in-progress audits focused on climate change, covering 10 engagements across various industries. This firm was also able to identify climate-related findings from other reviews of in-progress and completed audits. This firm is planning to provide training to the audit practice based on the findings of these reviews.

None of the other six audit firms were able to identify any examples of climate-related findings raised through reviews of in-progress and completed audits. It is unclear if this is due to not identifying findings relating to climate change or not tracking findings on this basis.

Summary

None of the audit firms provided specific climate-related guidance or training to the individuals reviewing completed audits. Only one audit firm had either developed specific resources, or updated existing resources, for reviewers of in-progress audits and EQCRs to help them incorporate climate change considerations into their reviews.

Providing specific resources and training to EQCRs and central reviewers can be useful as these reviews are usually targeted on the highest risk areas of the audit and may be time pressured. Specific resources can help facilitate effective reviews, especially when the impact is as complex, wide-reaching and evolving as that presented by climate change.

Good practice we identified included:

- Providing training to quality control reviewers.
- Thematic review of a sample of in-progress audits focusing on climate change.

Pre-issuance reviews of annual reports

For listed and other higher risk audited entities, firms often require annual reports to be subject to a pre-issuance review by a technical reviewer outside of the audit team. This review is intended to ensure compliance with corporate reporting requirements and assess the completeness of the financial statement disclosures and the clarity and understandability of the accounts.

When an entity's annual report is subject to a pre-issuance review by a technical reviewer outside of the audit team, and the audit team has identified the entity as one that is impacted by climate change, the pre-issuance review should include an evaluation of whether the annual report appropriately reflects climate-related issues and, where applicable, complies with the TCFD recommendations.

Three firms had provided reviewers with tailored climate change guidance and training that considered the financial statements and the other information included in the accounts. The other firms had only shared with the reviewers the templates provided to the whole audit practice for the review of other information in the accounts or reminded the reviewers of the importance of considering climate change when reviewing the other information in the accounts.

Several firms were able to provide examples of instances where pre-issuance technical reviews had successfully identified aspects of the front half of the accounts that needed to be enhanced, such as challenging the completeness of the principal risks.

One firm had performed a climate-related review of the annual reports of FTSE 350 audited entities that had not been selected for a deep dive quality control review. It had raised a broad range of challenges in respect of TCFD disclosures, consistency of information reported, depth and clarity of climate-related disclosures and transparency in financial statement disclosures of how climate-related issues had been considered.

Another firm is planning a similar focused review exercise going forward.

AREA	A	B	C	D	E	F	G
Has the firm provided reviewers with specific training and guidance on how they should consider climate change when reviewing the front and back half of the accounts?	•	•					•

Summary

Some firms are providing these reviewers with specific training and guidance on how they should consider climate change when performing a pre-issuance review of accounts, including guidance on how specific financial statement line items and accounting standards may be impacted.

Good practice we identified included:

- Specific training and guidance provided to the individuals responsible for pre-issuance reviews.
- Specific pre-issuance reviews focused on climate change.

Central risk assessment

Firms should consider employing central risk assessment procedures on an ongoing basis to identify which audits may be higher risk with respect to climate change, and may require additional oversight and support. This is important as climate change will influence the short, medium and long-term stability and business plans for many companies and so is a key factor when considering their risk level and the level of public and investor scrutiny they will attract.

Only one firm explicitly considered companies' exposure to climate change risks as part of their central risk assessment process. However, three other firms are beginning to include climate-related risk factors within their central risk assessments.

One firm explained that, based on the composition of their audit portfolios, climate change was not considered a risk factor for identifying higher risk audited entities. It was not clear how they had made this assessment on the basis of their portfolio and if this was driven by a sufficiently detailed understanding of how climate-related issues could impact different industries.

One firm explained that they did not see climate change as being particularly relevant for their portfolio of audited entities, noting that, for example, their portfolio did not include the highest carbon emitters. This indicated a concerning lack of understanding of the range of ways in which entities can be exposed to risks arising from climate change and, therefore, the significance that climate change considerations should have across audit practices. This firm has since recognised that they do audit entities in the financial services and non-financial services groups identified as higher risk by the TCFD.

Review of audits – headline finding:

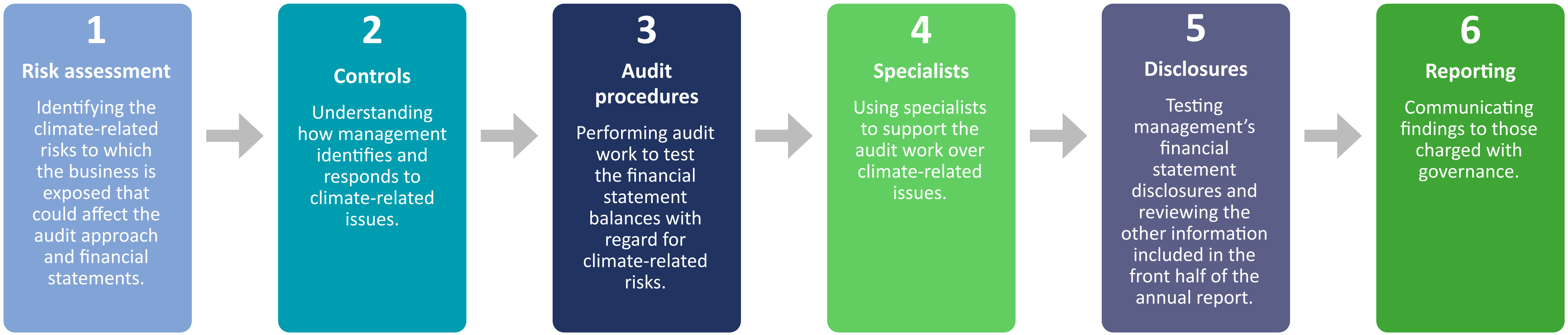
Audits reviewed indicated that auditors need to improve their consideration of climate-related risks when planning and executing their audits.

Review of audits

We reviewed 17 audits, mostly from the largest four audit firms, to assess how auditors had responded to the impact of climate-related considerations in practice. Our selection of industries was deliberately broad to include audits in industries that may not yet have been the focus of climate-related concerns.

How might climate change impact an audit?

Auditors need to understand how climate-related issues could impact the entity's annual report and how this needs to be incorporated into the audit work being performed. This understanding needs to be tailored to the individual circumstances of each entity and the materiality of the audit. This is set out in six key stages depicted below.



1. Risk assessment: Identifying the climate-related risks to which the business is exposed that could affect the audit approach and annual report.

Risk assessment → Controls → Audit procedures → Specialists → Disclosures → Reporting

Understanding the potential effect of climate change on the annual report and the related effect on the audit of the financial statements is key. Such an understanding and risk assessment must be specific to the audited entity and should consider the full range of possible effects, including through the supply chain, customers and other related parties. This must be supported by granular evidence justifying conclusions reached.

Overall view of risk assessments

We have shown to the right a sliding scale of how well climate-related risk assessments were performed. We have mapped the proportion of files that were at different points on this scale, with the size of the circle representing the proportion of files with the particular quality of risk assessment. Below are examples of areas where we felt improvement was needed to strengthen the risk assessment.

Consideration of principal and emerging risks

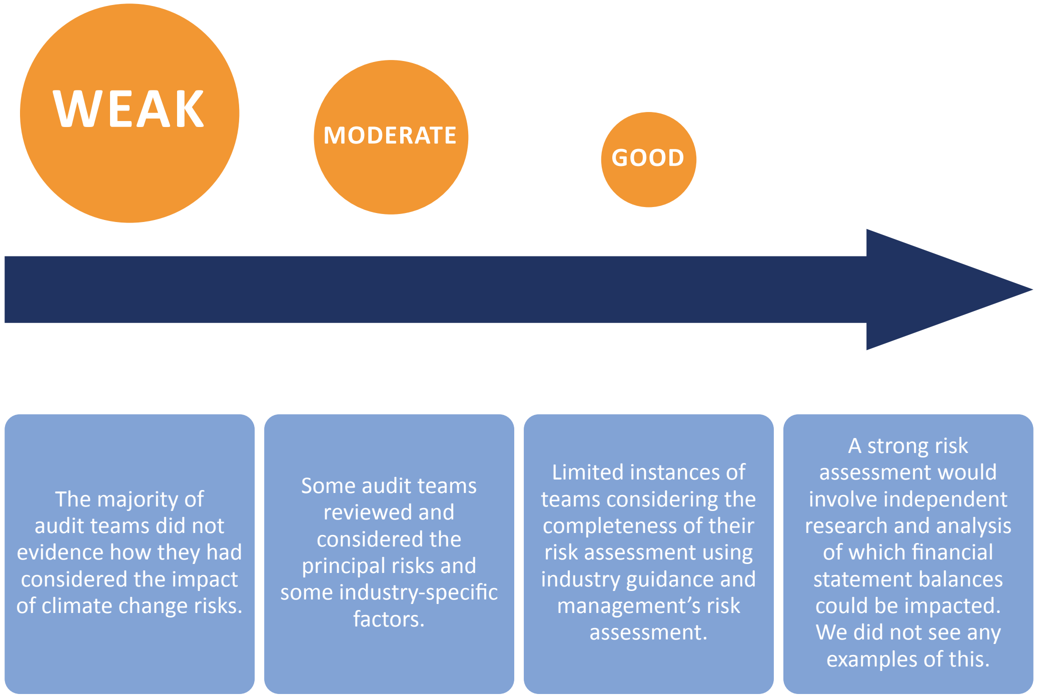
For all audits selected in our sample, management of the audited entities had reported that they had identified a principal or emerging risk relating to climate change. However, we saw few instances where the audit team had identified implications for the financial statements arising from these risks. In many instances it was unclear how the audit team had considered the principal or emerging risks when determining their audit risks and audit approach.

Independent analysis

Performing independent research (e.g. on consumer trends or changes in legislation) may be advantageous when assessing an entity's exposure to climate change. We found no evidence of audit teams considering this. Such analysis could have helped teams to assess the completeness of the principal and emerging risks identified by management.

Granular and complete risk analysis

For over half of the audits we found auditors had not considered climate change when identifying and assessing the risks of material misstatement to the financial statements. Audit teams had neither considered the range of physical and transition risks to which the entity might be exposed nor the risks that climate change might pose for its customer base or supply chain over different time horizons. For example, one audit team had not considered if the impact of extreme weather on supply chains could affect cost forecasts, even though this was reported as a principal risk.



Understanding environmental legislation

Audit teams had not performed detailed assessments of the range of existing and upcoming environmental legislation that could impact entities across territories. Where groups operated internationally it was not clear that the audit team had considered legislation in all territories or considered what changes to legislation were upcoming or likely.

Sufficiency of evidence

We noted instances of audit teams concluding that climate-related risks were not material without adequate evidence. For example, one team concluded that environmental protection legislation did not pose a material risk without analysis of the relevant legislation, such as considering for how long equipment could be used. Another audit team concluded that an entity was sufficiently diversified to mitigate climate change risks without analysis of the significance of different business lines and their exposure to climate-related risks.

Identification of environmental breaches

Audit teams did not consistently consider the risk of unidentified environmental breaches, even in instances where entities had previously experienced allegations of environmental incidents, such as toxic spills or water contamination.

Timeliness

In the few cases where audit teams had assessed climate-related risks on the file, there was insufficient evidence that this assessment was started at the planning stage and therefore in time to affect the audit testing being performed. It is important that risk assessments are started upfront so that teams can then respond to these risks through their work.

Updating of risk assessment

Where significant events in the year lead to changes in an entity's business and strategy, the audit team should update its risk assessment. We noted an example where an entity had decided to delay the use of greener technology and the audit team had not considered whether this might hinder the entity's ability to respond to changing consumer sentiment.

Use of firms' risk assessment templates

Some firms have developed detailed templates to be used for climate-related risk assessments. However, some teams had not made appropriate use of their firm's template as they had not responded to the prompts in sufficient depth. We also noted that some teams had not used the available template, even where they were auditing entities in higher risk sectors or with principal risks relating to climate change. This could have contributed to the less robust and comprehensive risk assessments observed.

Lack of comprehensive risk assessment

Overall, audit teams were not performing comprehensive risk assessments to identify the range of financial statement balances that could be affected by climate change risks. For example, none of the audit teams had considered expected credit losses, the valuation of financial instruments or decommissioning provisions.

In many instances audit teams explained their climate change risk assessments better to us during the course of our thematic work than on the audit file. This shows that audit teams are able to develop more robust risk assessments but are not prioritising and embedding this in their audit process.

Good practice we identified included:

- We saw some instances of audit teams making use of industry-specific guidance provided by their firm to guide their risk assessment.
- In very limited cases, we saw good cross-referencing of audit risks through to the principal risks reported by management, with audit teams thereby ensuring that they had considered all climate change risk factors identified by management in their audit risks.

2. Controls: Understanding how management identifies and responds to climate-related issues.

Risk assessment → **Controls** → Audit procedures → Specialists → Disclosures → Reporting

Auditors should understand management's process for identifying and responding to the impact of climate change in order to assess its adequacy and understand the reliability of management's principal or emerging risks and planned risk responses. Entities without effective processes may be more adversely affected by climate change, due to mitigating actions not being identified and taken, and their accounts may be more likely not to account for, or disclose, climate change risks appropriately.

Lack of review of entities' climate change risk management process

The majority of audit teams did not review management's processes or controls for identifying and responding to climate-related issues, even where management reported that they had developed, or were developing, climate change risk management and oversight procedures and climate-related response strategies.

Consideration of deficiencies in entities' climate change management processes

Even in such cases where they did identify deficiencies, the audit teams did not assess their significance for the audit or report them to those charged with governance.

Completeness of management's risk assessment

Most audit teams reviewed management's risk register and agreed this through to the principal risks disclosed, but they did not assess the completeness of the risks captured on the register based on their own understanding of the environment, industry and entity.

Good practice we identified included:

- In a very small number of cases, audit teams reviewed management's process to ensure the completeness of their climate-related issues and disclosures, or to ensure that operating plans, which were the basis of going concern and impairment assessments, incorporated climate change risks. This allowed these audit teams to place more reliance on management's assessment of risk.

3. Audit procedures: Performing audit work to test the financial statement balances with regard for climate-related risks.

Risk assessment → Controls → **Audit procedures** → Specialists → Disclosures → Reporting

In some instances, audit teams identified, in their risk assessments, that financial statement balances might be affected by climate change, but failed to address these risks appropriately in their audit testing of these balances. In other instances, audit teams' lack of consideration of climate-related issues in their testing was driven by their risk assessments not identifying the need to perform such procedures. Below are examples of areas where we would have expected audit teams to have considered climate change in their testing.

Impairment

Assets, including goodwill, need to be impaired if they are held at a higher cost than the value they can generate. When assessing potential impairments, audit teams often did not consider how climate-related issues could lead to lower future value through falls in future sales or higher costs due to changes in consumer sentiment, regulation, or macroeconomic factors. When considering plausible downside scenarios, audit teams did not consider if the scenarios incorporated likely climate-related risks.

Impact of climate change commitments

Audit teams did not always consider how climate-related commitments made in the front half of the accounts should imply changes in business forecasts underpinning the valuation of tangible, intangible and deferred tax assets. For example, where entities had committed to becoming carbon neutral the audit team had not assessed if the actions needed to achieve this were reflected in the forecasts used.

Decommissioning provisions

Audit teams did not always perform sufficient audit work to assess the completeness of potential decommissioning costs to restore any sites to certain minimum standards.

Inventory

Where entities had significant inventory, audit teams did not always consider how changing regulation or consumer sentiment could decrease the saleability of this inventory, even where the auditors had identified that consumer tastes were changing or that updates to regulation were forthcoming.

Expected credit losses

Audit teams should consider how climate-related issues could impair debtors' ability to repay debts as they fall due, particularly where entities have medium to long-term debtors concentrated in high-risk geographic territories or business sectors. Audit teams did not consider these factors when testing expected credit losses.

Liabilities

Audit teams did not perform work to assess the possibility of additional liabilities due to environmental breaches, even where companies operated in highly regulated sectors.

Useful economic lives

Audit teams often did not consider how changing regulation, weather patterns or business activity might shorten the useful economic lives of tangible and intangible assets.

Warranty provisions

Audit teams did not consider how changes to weather patterns could affect warranty provisions, even where long-term warranties were given.

Good practice we identified:

- One audit team considered climate-related risks in the sensitivity analysis performed to assess the use of the going concern assumption. The team considered the possibility of environmental breaches, operational disruptions and significant changes to commodity pricing on going concern.

4. Specialists: Using specialists to support the audit work over climate-related issues.

Risk assessment → Controls → Audit procedures → **Specialists** → Disclosures → Reporting

Audit teams may use specialists to review disclosures, contribute to the climate-related risk assessment or support on specific areas of audit testing such as valuations or provisions. Specialists may have experience in areas such as environmental legislation, oil and gas prices or sustainable development.

Appropriateness of follow up on specialists' considerations

A small number of audit teams used climate change specialists to review disclosures. These specialists raised numerous points, for example the potential impact of extreme weather, competition from renewables and the likelihood of changing commodity prices. However, the audit teams did not always fully consider and respond to the specialists' comments and it was not clear if the specialists followed up on how their points were resolved.

Scoping of specialists' work

Where disclosure specialists were used, it was not clear how the audit team had scoped the work to be performed by the specialists or how they had communicated this scope to the specialists.

Assessing the need for specialist input

On the audits where no specialists were engaged, the audit team had not evidenced any assessment as to whether specialist input was needed or would add value.

Good practice we identified included:

- One audit team used a specialist to support the fossil fuel reserve valuation work, in particular the work over refining margins and oil and gas prices.
- One audit team used a specialist to review the prior year annual report and provide insight to those charged with governance on how climate related issues should be considered and disclosed.

5. Disclosures: Testing management's financial statement disclosures and reviewing the other information included in the front half of the annual report.

Risk assessment → Controls → Audit procedures → Specialists → **Disclosures** → Reporting

Sufficiency of analysis supporting checklists

Most teams reviewed the front half of the annual report. The audit firms provide checklists for reviewing the front half, most of which included instructions to check that the climate-related disclosures are in line with expectations and the financial statements. However, most audit teams just concluded that this was the case with no analysis or thought process evidenced.

Completeness of disclosures

The majority of the audit teams did not consider if further climate-related disclosures were needed within the financial statements, which may have been driven by the failure to identify how climate-related risks could affect the financial statements. For example, disclosures may be needed to show how valuations or impairment decisions are sensitive to assumptions regarding the outcome of climate change or to explain how key judgements are being made that relate to such assumptions. These disclosures can be essential for users of the accounts.

IFRS 7 disclosures

Audit teams did not consider how climate-related risks should affect companies' required disclosures of what risks arise from the financial assets and liabilities they hold and how they manage these risks.

Insurance risk disclosures

Audit teams on insurance entities did not consider whether climate-related risks needed to be reported in the insurance risk disclosures required.

Consideration of TCFD recommendations

In some instances, entities reported that they had partially or fully adopted the TCFD recommendations, but the audit team had not referred to these when reviewing the annual report.

Viability statement review

All audit teams reviewed the viability statements disclosed. However, it was not clear how teams had considered the potential impact of climate-related risks and ensured these were incorporated into the downside scenarios used. This was the case even for entities in industries that expect to be impacted by changing consumer sentiment, weather patterns and/or regulation, such as the 'fast fashion' or agriculture industry. Audit teams also did not consider how disruption to supply chains and production of raw materials could impact viability.

Review of climate-related commitments

Where companies included climate-related commitments in their front half reporting, audit teams did not consider if the plans were in line with the business activities they had observed during the audit. Audit teams should have checked that they had not noted any capital expenditure or business development activity in the year that would be incongruous with these plans. For example, where a company committed to improving the sustainability of its farming or manufacturing processes, the audit team should have considered if the capital expenditure in the year was consistent.

Good practice we identified included:

- A limited number of audit teams reviewed how each principal risk relating to climate change had been considered in the scenario analysis performed by management to support the viability statement. However, in these instances it still was not clear how the team had assessed that the estimated impact of these risks was reasonable.
- A very limited number of audit teams performed a review of the front half reporting against the TCFD recommendations. However, in most instances this was a high-level review only, with no challenges or insights raised.
- A small number of audit teams used climate change specialists to review disclosures. In one instance this review was particularly thorough and included consideration of both the front half of the annual report and potential financial statement disclosures such as impairment sensitivity.

6. Reporting: Communicating findings to those charged with governance.

Risk assessment → Controls → Audit procedures → Specialists → Disclosures → **Reporting**

Quality of communications

Most teams only used boilerplate wording to report to those charged with governance that climate change was an area of focus in the year. Two audit teams did confirm that climate change had been considered when identifying audit risks and performing audit work but detail was limited. This is consistent with an Audit Committee Chair survey we conducted where only five per cent of respondents said that their audit team had communicated to them about climate change.

Good practice we identified included:

- One audit team included environmental disclosures as a specific point in the representation letter, so that management confirmed that all material impacts due to environmental matters were disclosed.
- One audit team benchmarked the climate change and environmental, social and governance disclosures in the entity's accounts versus comparable companies. This was presented to the audit committee for consideration.
- One audit team presented to those charged with governance on how climate-related issues could be disclosed in the front and back halves of the annual report. This contributed to those charged with governance identifying a principal risk in relation to climate change in this entity for the first time.

Appendix – Scope

Audit Quality Review (AQR)

The AQR team performed benchmarking across the seven largest audit firms* to assess their firm-wide response to the need to consider climate change risks in their audit practice. AQR also reviewed 17 audits, predominately taken from the four largest audit firms. The purpose was to understand how the audit teams had responded to climate-related issues when performing their audit procedures to ensure that an entity's financial statements present a fair and true view. AQR's process is outlined below.

Information gathering

- AQR requested information from the seven largest audit firms regarding the guidance, resources and specialists they provide to support audit teams in climate change considerations and the consultation and review processes then used to oversee audit teams.
- This information was requested in March 2020 and provided in April and May 2020.

Benchmarking

- AQR reviewed the information provided and benchmarked the firms against one another.
- AQR identified commonalities and outliers within the information provided.

Review audit files

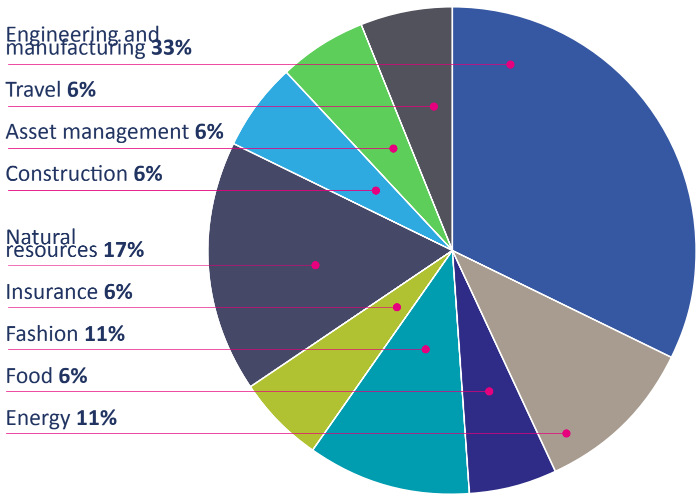
- AQR selected a sample of audits predominantly across the largest four audit firms.
- AQR reviewed how climate change risks had been identified and responded to in these audits.

Identifying findings

- AQR identified examples of good practice and areas where we believe that firms need to develop further.

*The audit firms within scope were BDO LLP ("BDO"); Deloitte LLP ("Deloitte"); Ernst & Young LLP ("EY"); Grant Thornton UK LLP ("Grant Thornton"); KPMG LLP ("KPMG"); Mazars LLP ("Mazars") and PricewaterhouseCoopers LLP ("PwC").

The graphic below outlines the industry distribution of the seventeen audit files assessed by AQR.



The Lab

The Lab insights included at the start of this report arise from interviews carried out with investors throughout 2020. These built on the Lab's 2019 report entitled Climate-related corporate reporting – Where to next?, and asked investors to share their views on the integration of climate-related considerations into corporate reporting and audit.

Financial Reporting Council

Information about the Financial Reporting Council can be found at:
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