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Climate change reflected in financial statements, a role for companies and their auditors

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Of the companies we analyzed, we see that only 8% report transparently about climate risks in the financial statements. Understanding and translating these risks to the financial statements appears to be challenging. In addition, more and more organizations report promising climate ambitions, but the financial consequences are mostly not yet disclosed in the financial statements.
A robust and stimulating role of the auditor to raise this to a higher level is of importance to society. We must move away from the level of informality in relation to understanding and translating these climate risks and ambitions.

Climate change reflected in financial statements, a role for companies and their auditors

Climate action failure is the most severe risk on a global scale over the next 10 years, according to WEF's Global Risks Report 2022[1]. As recognized within SDG 13 Climate Action[2], companies play a pivotal role to 'Take urgent action to combat climate change and its impacts'. A task that requires immediate action by companies. We believe companies should not await regulations, such as the Corporate Sustainable Reporting Directive ('CSRD') and EU Taxonomy for sustainable activities, to have their effect. Companies can already act now.

Looking at the impact on our current financial systems, investors are concerned that responses to climate-related risks of companies in their portfolios are inadequate. Investors struggle to find relevant information to identify climate-related risks to assess possible impacts on the company's operations. Companies are generally willing to give more information and respond to climate-related risks but seem to lack the methodologies to do so. Some companies may underestimate the need to provide information in relation to climate-related risks. Considering that models estimate expected annual damage in the EU to rise from currently €4-5 billion/year to €32 billion/year by the middle of the century[3], we would expect financial statements to reflect these costs more and more, as well as the opportunities for companies that can have a positive impact in response to addressing climate change.

Investors are rightfully concerned. Based on our research, most companies have not yet incorporated climate-related risks in their risk management and have not transparently disclosed these risks in the financial statements. In some cases, we noticed that the financial statement disclosures even seem inconsistent with the management report in the same annual report. Hence, financial markets therefore seem to lack sufficient transparent information about the long-term risks and opportunities. Looking at our own role in society, it is the auditors' role to secure transparent reporting and by doing so 'reducing financial information asymmetry in capital markets'. This also includes relevant information about sustainability, including the impact of climate change.

It is expected that once companies start to incorporate the effects of climate-related risks in the valuation of assets and liabilities and once the financial statements provide adequate and transparent information in relation to these risks and opportunities, this information asymmetry will gradually be reduced. This allows financial markets to better price the effects of climate change in fair market values of companies.

Reporting in relation to climate change must further develop. From conceptual qualitative disclosures to quantitative scenario-based risk assessments and disclosures. One could think of analyses about the business model viability and integration of climate-related risks in risk management. But also, quantitative scenario-based sensitivity analyses used in valuation of assets and liabilities. The audit report should conclude on the true and fair view on companies' financial statements, including the effects of climate change, if important for the users. To help companies report transparently and clearly, we will include the assessment of climate-related risks as an explicit element of the audit of the financial statements.
From financial year 2022, PwC will challenge companies about the transparency of the effects in the financial statements. This includes the translation by management of climate-related risks to the entity's business model, risk profile, viability, valuation of assets and liabilities and financial statements disclosures, both qualitative and quantitative. Due to the urgency of climate change, more transparent reporting in relation to climate-related risks is necessary. A robust and stimulating role of the auditor to raise this to a higher level is of importance to society.

1 WEF, The Global Risks Report 2022
2 https://sdgs.un.org/goals/goal13
3 https://www.ecologic.eu/sites/default/files/publication/2018/2811-coacch-review-synthesis-updated-june-2018.pdf

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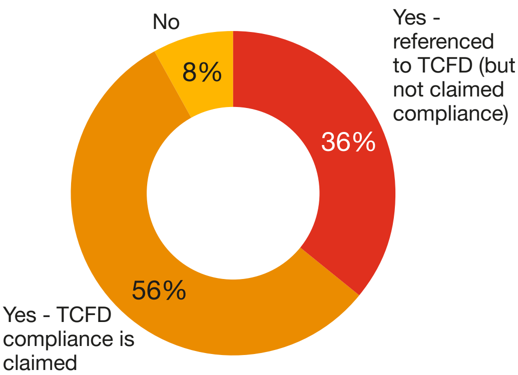
The data shows that almost all AEX companies have included at least some wording about the effects of climate change in the management reports of 2021.

The impact of climate change is generally addressed in management reports

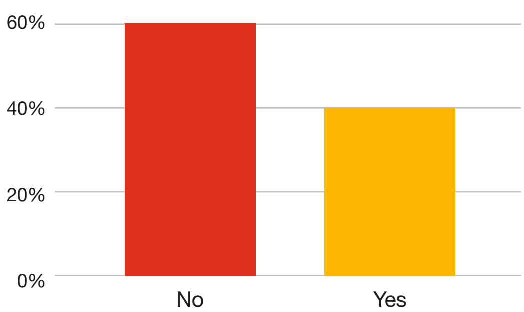
PwC investigated to what extent AEX companies responded to calls from society for more transparent reporting on the effects of climate change and zero emission plans in their annual reporting, consisting of the management report and the financial statements, and to what extent climate-related risks are addressed in the accompanying auditor's report for the year 2021. The data shows that almost all AEX companies have included at least some wording about the effects of climate change in the management reports of 2021. Some are more detailed than others, disclosures vary from full chapters to a couple of sentences.

The Task Force on Climate-Related Financial Disclosures[4] (TCFD) is a widely used voluntary framework to report on the impact of climate change and climate-related risks. The recommendations are structured around four thematic areas that represent core elements of how companies operate: governance, strategy, risk management, and metrics and targets. These four areas are supported by recommended disclosures that build out the framework with information that help investors and others to understand how companies assess climate-related risks and opportunities.
Although more than 90% of AEX companies claimed using the recommendations of TCFD, the number of companies that claims to fully comply with the framework, including detailed scenario analysis, is still limited.

Does the AEX company reference to the TCFD framework and how?



Are scenario analyses included in the management report of companies in 2021?



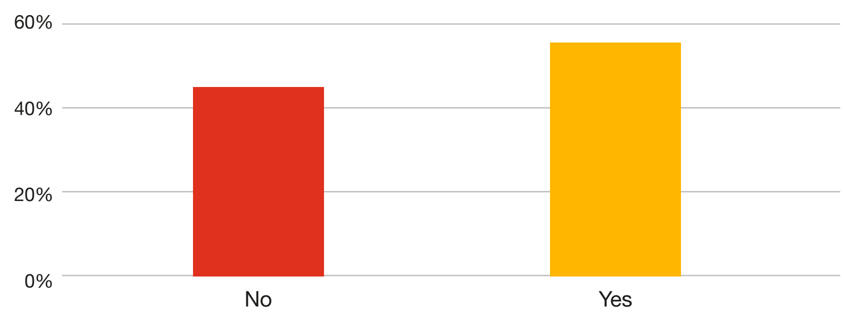
4 https://www.fsb-tcfd.org/

Although 60% of the AEX companies mention climate change in their financial statements, the disclosures are in most cases limited to a couple of sentences, concluding that there is no significant impact on the financial statements identified.

Financial statements include very limited disclosures in relation to climate-related risks

The disclosures in the financial statements in relation to climate-related risks are very limited. Although nearly 60% of the AEX companies mention climate change in their financial statements, the disclosures are in most cases limited to a couple of sentences, concluding that there is no significant impact on the financial statements identified. Only two companies concluded that climate-related risks have a significant impact on their financial statements. These companies have included extensive disclosures in various sections of the financial statements, including detailed assumptions and estimates used in their valuation models. Of the companies we analyzed we therefore observe that only 8% reports transparently on this in their financial statements. The areas in the financial statements where climate-related risks are disclosed differ across companies, but most disclosures are related to valuation of assets (including impairments) and general notes or general accounting policies.

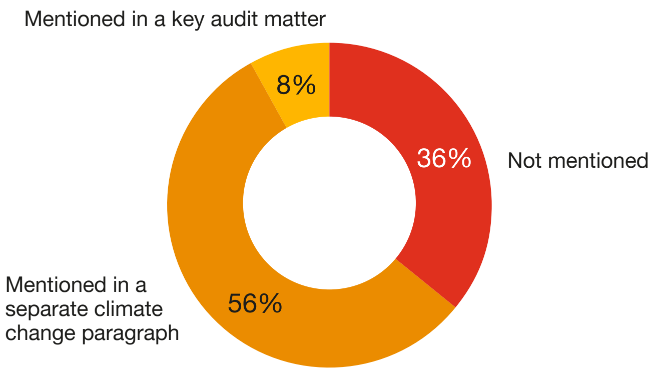
Was climate change included in the financial statements of AEX companies as a topic?



Most auditors' reports make generic references to climate-related risks

Based on the analysis we conclude that most auditor's reports include limited wording about the impact of climate change (64%). Most auditors that have reported on climate-related risks, have done so in either a separate climate change paragraph or as part of the risk assessment paragraph (87%). However, these paragraphs are limited to a high-level description of the procedures performed (mostly discussed the topic with management) and in some cases a conclusion that the topic did not result in a significant risk and/or key audit matter relevant for the financial statements audit. The paragraph has generally not been made company specific.

In what paragraph is climate change mentioned in the auditor's report to AEX companies?



Acceleration on integration of climate-related risks in reporting, including financial statements, is needed.

The two auditor's reports that contained a company specific key audit matter were (not coincidentally) related to the two companies that also have extensive disclosures on climate change in their financial statements and annual report as a whole. The sector that a company operates in seems to play a role here but should in fact not, as climate-related risks are likely to impact a number of sectors.

Limited reconciliation between financial statements and management report when climate-related risks are deemed relevant

For some companies, the large number of climate-related disclosures in the management report signals an importance that would have its impact on the business model of the company affecting its future revenue and expenses. However, this is then often not translated to the financial statements, where these elements are only disclosed to a limited extent. There is hardly (or no) attention given to the impact of climate change to the financial statements while the expectation is raised in the management report that, for example, the impact on valuations of assets would be addressed. Based on this, we conclude that companies have not appropriately translated the climate-related information in the management reports to the financial statements.

There is a number of exceptions noted for companies that have more fully integrated the impact of climate change in risk management and business planning and that have provided more extensive disclosures in relation to the impacts in the financial statements and management reports. These are mainly companies that are active in those industries which have an above average contribution to greenhouse gas emissions, for instance power generation and heavy industry. Acceleration on integration of climate-related risks in reporting, including financial statements, is needed. This starts with conducting an in-depth risk assessment of the impact of climate change on the business including the viability of the business plans. What assumptions were made in relation to climate-related risks and the impact on growth of the business going forward? How do these assumptions compare to what is considered market practice?

Such in-depth analyses should provide sufficient basis for updating the assumptions used in the valuation models of assets and liabilities and more quantitative disclosures thereon. While most companies believe that climate change will only impact their business in the long term, the impact can simply not be underestimated. For example, the useful lives of certain assets generally span over a significant number of years and the valuation of these assets is therefore likely to be impacted by climate-related risks. As a result, a possible change in the estimated remaining useful lives or impairments may be applicable. Whilst the current accounting standards do not specifically call out the impact of climate-related risks, they certainly provide sufficient basis for considering climate-related risks for the impairment of assets, valuation of assets and liabilities and related disclosures.

> Too often we see companies supporting the Paris agreement or setting reductions and net zero targets over longer periods in their communications, whereas the impact thereof on their financial statements has not been disclosed transparently.

How companies should develop reporting

Companies need to cross the bridge towards a future state where climate change is fully embedded in financial statements. Too often we see companies supporting the Paris agreement or setting reductions and net zero targets over longer periods in their communications, whereas the impact thereof on their financial statements has not been disclosed transparently. IFRS and the Dutch accounting standards do stipulate the need to reassess the valuations and useful lives on a regular basis and to provide adequate disclosures about key assumptions for significant estimates.

A first step is to embed and extend the qualitative disclosures in the financial statements. This can be a starting point to move towards quantitative disclosures, allowing room to develop and refine scenarios and sensitivity analyses. Multiple frameworks are already available to guide companies in transparent disclosures that might not change the financial statements but which companies can us to make disclosures more transparent. These will provide investors and broader stakeholders with relevant information they can use for making their decisions. A few examples are:

- IFRS' educational material on effects of climate-related matters on financial statements supports climate change in the application of requirements in IFRS[5];
- TCFD's recommendations explain how climate-related disclosures can be made using governance, strategy, risk management and metrics and targets[6]; and
- SBTi[7] guidance for companies to reduce GHG emissions, also going into financial implications of becoming net zero.

In summary, companies should disclose relevant climate change scenarios and sensitivity analyses with financial impact, including which assumptions are used in valuations.

Working together between multidisciplinary competencies is key

Integrating the impact of climate-related risks is not the job of solely risk management, as including climate-related risk disclosures is not the job of finance alone. Integrating climate-related risks requires multidisciplinary competencies in the company to work together to consider and include the impact of climate change (both financial and non-financial), from understanding the impact to the business to risk assessment and risk management to calculating the financial impacts and the related disclosures in the management report and financial statements. The operational, sustainability and risk management and finance departments need to work together to develop a coherent and consistent view on the impacts in the short, medium, and long term.

5 https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf
6 https://www.fsb-tcfd.org/recommendations/
7 https://sciencebasedtargets.org/net-zero

This also requires attention in the oversight by companies' supervisory boards. We see some good practices at AEX companies. For example, by forming a separate sustainability committee responsible for governance on the broader sustainability progress of the company. Other AEX companies have specifically put climate-related risks on the agenda of the audit committee. Depending on the circumstances, impacts and outcomes of risk assessments, even the full supervisory board may be overseeing the company's response to climate-related risks. In all cases, it is crucial that the topic is embedded in oversight with regards to the strategy and transparent reporting.

What we as PwC commit to

To help companies report transparently and consistently, we will include the assessment of climate-related risks as an explicit element of the audit of the financial statements. From financial year 2022, PwC will challenge companies about the transparency of the effects in the financial statements. Based on our risk assessments, we determine adequate audit procedures to address the identified risks. This includes the assessment of climate-related risks and the impact on the entity's business model, risk profile, viability, valuation of assets and liabilities and financial statements disclosures, both qualitatively and quantitatively. This is part of the auditors' role to secure transparent reporting and by doing so 'reducing financial information asymmetry in capital markets' to include 'sustainability information and climate-related risks. With this, we support the EU's Sustainable Finance Action plan goals:

- Reorient capital flows towards sustainable investments;
- Integration of sustainability in risk management; and
- Foster transparency and long-termism in financial and economic activity.

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In all cases, it is crucial that the topic is embedded in oversight with regards to the strategy and transparent reporting.

It can be challenging to incorporate the impact of climate-related risks and related disclosures in the financial statements. Companies need to start with qualitative disclosures but first steps on quantifying the impact are equally important and this starts with a robust risk assessment that includes the impact of climate change. As auditors, we will start with assessing these risk assessments. Are these Paris aligned? Does the company have SBTi commited targets? Are these ambitions incorporated into business models and are the related risks and opportunities adequately addressed?

If statements with regard to Paris aligned ambitions or climate plans are made, we will corroborate these statements firstly by assessing support for the statements made and secondly by assessing the consistency of the ambition in relation to the viability of the business model, the integration in risk assessment and risk management as well as the quantitative and qualitative statements made in the financial statements. By gathering this evidence, we are able to conclude on the sufficiency of the disclosure in the company's financial statements.

It is possible that a company does not have any Paris aligned ambitions or climate plans. In this case, we still need to challenge the impact of climate change on the company and have discussions with management. Is the viability of the business model still accurately considered in the risks assessments and do valuations sufficiently include the effects of climate change? And are statements made in the management report and financial statements sufficiently detailed and supported by these considerations? In other words, we would expect a disclosure in the management report and, in case of a material impact on the financial position or underlying assumptions of the financial position, disclosures in the financial statements. By performing the above procedures, we are able to conclude on the sufficiency of the disclosures made in the company's financial statements.

> When the impact of climate change on the financial statements is insufficiently disclosed, and this is necessary for a good understanding of the financial position and results, this leads to a modified auditor's opinion.

Following auditing standards, insufficient disclosures may impact the auditor's report if material. Disclosures can be deemed insufficient when relevant information is not included, or incorrectly stated. When the disclosures in the management report are insufficient, the conclusion on the other information will be modified. When the impact of climate change on the financial statements is insufficiently disclosed, and this is necessary for a good understanding of the financial position and results, this leads to a modified auditor's opinion.

The auditor's report is a means to communicate with stakeholders of the company and we think, in light of the current developments, climate change is an important topic. Therefore, PwC will reflect in informative (long-form) auditor's reports on the audit procedures around climate-related risks. Depending on the potential impact for the company and society this will be addressed in a general section of the scoping, or (as part of) a key audit matter. In addition, as auditors we will share our audit procedures on climate change to the extent relevant, in the annual general meeting.

PwC introduces: green figures
Today's world is not so simple anymore and the challenges facing us are complex. When the rules of the game are no longer obvious, you need to see beyond today to deliver outcomes that continue to create value for you, your people, your stakeholders and the communities where you live and work.

Result is therefore no longer just about black or red figures. Stakeholders are increasingly interested in the social value of a company. That is why PwC is introducing green figures. A report in which your social value is recorded. Think of results in the field of climate change.

Conclusion

Organisations can no longer deny the risks related to climate change and the impact these risks will have on their business models. At the same time, we see climate change is often not yet integrated in risk assessments nor sufficiently disclosed in the management report or financial statements. Of the 25 AEX companies we analyzed we observe that only 8% reports transparently on this in their financial statements Hence, investors lack sufficient transparent information about the long-term risks and opportunities.

Understanding and translating these risks to the financial statements appears to be challenging. Reporting must further develop and mature from conceptual qualitative disclosures to quantitative, scenario-based, risk assessments and disclosures. The business model viability, climate integration in risk management and financial statement disclosures should be part of that. One could think of quantitative, scenario-based, sensitivity analyses used in valuation of assets. The significance of climate-related risks for many companies impacts the work of auditors. It is the auditors' role to promote transparent reporting and by doing so 'reducing financial information asymmetry in capital markets' to include 'sustainability information including climate change'.

Given the risks and long-term effects of climate change for organizations and society at large, we as auditors are challenged to embed climate change in our audits in the right way. This challenge is amplified by the complexity, lack of data and high level of judgment which is required.

To help companies report transparently and consistently, we will include the assessment of climate-related risks as an explicit element of the audit of the financial statements. From financial year 2022, PwC will challenge companies about the transparency of the effects in the financial statements as part of our role to contribute to more transparency in the transition towards a more sustainable economy.

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