

Investor Expectations for Paris-aligned Accounts

November 2020



About IIGCC

The Institutional Investors Group on Climate Change (IIGCC) is the European membership body for investor collaboration on climate change and the voice of investors taking action for a prosperous, low-carbon future. IIGCC has more than 250 members, mainly pension funds and asset managers, across 16 countries, with over €33 trillion in assets under management.

Our mission is to mobilise capital for the low-carbon transition and to ensure resilience to the impacts of a changing climate by collaborating with business, policy makers and fellow investors. IIGCC works to support and help define the public policies, investment practices and corporate behaviours that address the long-term risks and opportunities associated with climate change.

For more information visit www.iigcc.org and [@iigccnews](https://twitter.com/iigccnews).

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Summary

Financial statements that leave out material climate impacts misinform executives and shareholders and thus, result in misdirected capital. Company leaders without correct cost and return information are equivalent to pilots without a properly functioning altimeter. In extreme cases, companies on the wrong flight path – like planes – can crash. In the case of climate change, the consequences of misdirected capital are not only harmful for shareholders, but also potentially disastrous for the planet.

Take a coal power company. Does the company presume asset lives that take us beyond 2050 and thus bake in dangerous levels of emissions? Have they taken account of escalating carbon taxes, or the falling costs of competing renewable energy? Might there be impairments in certain fossil fuel-dependent assets? What about end-of-life clean up liabilities; will these need to be brought forward thereby wiping out capital previously reported?

At present there is little evidence that companies are taking decarbonisation or the physical impacts from climate change into account as they draw up their financial statements. This is true even where their strategic report or management discussion detail climate risks as recommended by the Task Force on Climate-related Financial Disclosures (TCFD). Apart from a few notable exceptions, auditors are likewise currently silent on whether financial statements are ‘climate-proof’.

Yet there is no need for such inaccurate financial statements. A recent paper by the International Accounting Standards Board – effectively the global accounting standard setter – sets out how material climate factors must be considered when drawing up accounts¹. Regulators such as the UK’s Financial Reporting Council (FRC) are also reminding directors and auditors that they must ensure material climate factors are properly reflected in financial statements².

Fulfilling existing requirements is just a first step, however. **This paper sets out in unequivocal terms investor expectations 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. Only then will management, investors and creditors have the information they require to deploy capital in a way that is consistent with the Paris Agreement.**

Expectations for directors

To meet this expectation for Paris-alignment, directors should make five disclosures in their annual report and accounts³:

- **An affirmation that the goals of the Paris Agreement have been considered in drawing up the accounts.**
- **Adjustments to critical assumptions and estimates:** An explanation for how critical accounting judgments are consistent with achieving net zero carbon emissions by 2050⁴. If directors choose not to use Paris-aligned assumptions, they should explain why in the Notes to the accounts.
- **Sensitivity analysis:** Results of sensitivity analysis linked to variations in these judgements or estimates. If directors choose not to use Paris-aligned assumptions in their core accounts, they should provide details in the Notes to the Financial Statements on how Paris-aligned assumptions would impact the reported financial statements.
- **Dividend resilience:** Implications for dividend paying capacity of Paris-alignment (e.g. threshold assumptions that would trigger cuts to dividends). This is particularly important where companies have not used Paris-aligned assumptions in their core accounts.
- **Consistency:** Confirmation of consistency between narrative reporting on climate risks and the accounting assumptions, or an explanation for any divergence.

Members of the audit committee should furthermore detail the steps taken to ensure material climate risks are properly considered in the accounts and by the external auditor.

Expectations for auditors

Investors also expect auditors to provide reassurance that the accounts incorporate material climate risks, and whether or not the accounts can be considered Paris-aligned, as follows⁵:

- **Consideration of material climate risks:** Confirmation that critical accounting estimates or judgements reflect material climate risks, in line with accounting standards.
- **Paris-alignment:** Confirmation as to whether or not these critical assumptions and estimates can be considered aligned with a 2050 net zero pathway. If not, the auditor should assess whether Paris-aligned assumptions have been adequately considered and disclosed in the Notes to the Financial Statements. Where Paris-aligned numbers are not provided, the auditor should indicate what reasonable Paris-aligned assumptions would be.
- **Consistency:** Confirmation that there is consistency between the narrative disclosures around climate risks and the financial statements.
- **Dividend resilience:** Confirmation that pertinent capital maintenance/solvency tests have considered climate risks, and dividends are appropriately funded and legal.

Auditors may provide this information through their disclosure of key or critical audit matters, and consider whether this would necessitate a qualification to their opinion on the financial statements.

Investor tools for holding directors and auditors responsible

Investors have several tools to hold directors and auditors responsible for delivering Paris-aligned accounts and audits, including:

- **Engagement:** Shareholders (and creditors) may engage with boards – and particularly the audit committee – and the auditor to press for Paris-aligned accounting.
- **Vote:** Shareholders choose the leadership at their companies, as well as their auditors, so may vote against reappointments where performance is inadequate. In certain markets it may be appropriate to file and/or vote for a relevant shareholder resolution.
- **Divestment:** Shareholders may sell their shares in companies that fail to provide reliable Paris-aligned accounts, thereby raising companies' cost of capital.

Immediate action is possible and necessary

Investor calls for company accounts to be Paris-aligned can – and should – be acted on immediately. No new requirements are needed; in fact, existing rules demand action.

The ability for companies to act swiftly has been powerfully demonstrated in the oil and gas sector by companies BP, Royal Dutch Shell and Total, which following investor engagement, all reviewed their 2019 accounts in light of the Paris Agreement and the accelerating energy transition. All three adjusted critical accounting judgements, resulting in material impairments.

Investors expect others to act also. Few will be untouched by global efforts to deliver net zero carbon emissions, whether in transportation, industry, utilities, infrastructure, real estate or finance. It is time Paris-aligned accounts became the norm, not the exception.



1 Introduction – why accounts should be Paris-aligned⁶

Accounts underpin performance measurement and investment decision making. They tell executives what returns they are getting from the capital invested and, thus, where more capital would be fruitfully deployed. They are the eyes and ears for investors – reporting whether management is doing a decent job or destroying value. They provide a basis for determining performance-related pay, which in turn drives incentives.

Accounts that leave out material impacts (whether in the reported numbers, or in disclosures such as sensitivities) will misinform and thus, result in misdirected capital. Company leaders without correct cost and return information are equivalent to pilots without a properly functioning altimeter. In extreme cases, companies on the wrong flight path – like planes – can crash. In less extreme cases, they may go off-course. Either way, the passengers are let down.

Consequently, great effort goes into ensuring accounts are reliable. Governments set out detailed laws that govern director duties to produce true and fair accounts; and auditor responsibilities to alert shareholders in the event of material misstatements. Trust in financial markets depends implicitly on this system functioning properly.

Today, there is growing evidence that company accounts are leaving out material impacts linked to accelerating climate change and the associated regulatory response – namely, efforts to decarbonise our economies by 2050 in line with the Paris Agreement on climate change⁷. This means there are risks that both capital and profits associated with activities that are harmful to the climate are overstated, driving excessive investment into damaging activities⁸. Obvious examples are coal-fired power utilities, fossil fuel extraction and fossil fuel-powered transportation; but almost all sectors are impacted.

Take, for instance, a power company that generates energy from coal or gas. Has the company ensured asset life assumptions used in their accounts reflect accelerating efforts to decarbonise in line with the Paris Agreement? Have they taken account of escalating carbon taxes, or the falling costs of competing renewable energy? Might there be impairments in certain fossil fuel assets – either tangible or intangible – that need to be recognised? What about end-of-life clean up liabilities, known as asset retirement obligations? Might these need to be brought forward?

Likewise, companies impacted by shifting climate patterns, including extreme weather events and/or sea level rise, among a range of numerous other examples, may be understating these exposures, resulting in excessive capital deployment into areas that will suffer from physical damage.

The dangers of this accounting failure go beyond harm to company shareholders, who are likely to experience capital destruction. Misallocation of capital will lower economic growth, as unaddressed climate change threatens our future social and economic prosperity. Left unabated it threatens our very existence. To confront this threat in line with the global goal of keeping global warming well below 2°C, the Organisation for Economic Cooperation and Development estimates that the world needs to spend roughly \$6.9 trillion a year on low-carbon infrastructure⁹. On the flip side, investment into fossil fuel-based energy needs to be wound down. By leaving out the impacts of climate change from company accounts, we will fail to shift capital to the extent required, and be left unprepared for its consequences.

Against this backdrop, this paper sets out investor expectations for companies to deliver Paris-aligned accounts, and what this means. In other words, accounts that are consistent with getting to net zero carbon emissions by 2050. Such accounts would complement – and are consistent with – improved narrative reporting in line with the TCFD reporting. This paper further sets out investor expectations that auditors sound the alarm where accounts fail to properly reflect material climate risks.

The paper goes on to outline the steps investors can be expected to take to drive Paris-aligned accounting. Alongside engagement with company directors and auditors, investors are increasingly likely to use their votes at company shareholder meetings to ensure accountability on delivery of suitably detailed accounts. In some cases where risks to capital are excessive, they may divest. While investors look to companies and auditors to show leadership on this matter, given the important public interests at stake, there are strong grounds for supportive regulatory action.

2 Paris-aligned accounts – the regulatory backdrop

Every year listed companies in all the main financial markets are required to produce annual reports, including independently audited accounts for shareholders. As noted above, they provide a basis for understanding the goal and strategy of the company in question, as well as tracking performance and capital. Normally, the annual report has two core parts:

- **The narrative discussion** includes the forward-looking review of factors that are likely to have a material bearing on the company, and allow the management team to set out its strategy for delivering value to shareholders.
- **The financial statements** that tell shareholders whether the company is solvent, the level of accumulated capital and the economic returns that their assets have generated^{10 11}.

Narrative disclosures of climate risks

Companies that face material risks from climate change, either from decarbonisation or physical stress, must by law in most jurisdictions report these in their narrative disclosures to shareholders^{12 13}.

One would expect, for instance, that an auto-manufacturer would outline in detail how incoming regulations (and associated technological innovations), aimed at delivering decarbonisation are expected to impact the company's prospects and what steps the management team is taking to manage this headwind.

Likewise, sea level rise and shifting weather patterns are already costing businesses money – whether real estate companies with exposure to coastal property exposed to storm surge; power companies with distribution networks knocked out following hurricanes or wildfires; or agricultural companies exposed to increasingly volatile growing seasons and crop production. Companies facing material impacts should detail this in their risk factors, reflecting up-to-date climatic modelling for how these impacts are expected to evolve, and outline risk management efforts¹⁴.

Detailed guidance for disclosure of climate-related risks for a range of exposed sectors has been drawn up by the TCFD, at the request of the Financial Stability Board in 2015, and is increasingly viewed as 'the benchmark' framework by global regulators. While companies are not yet required to use the TCFD framework, since it is designed to organise material disclosures, companies that choose not to use it still have to comply with local disclosure rules on material information. The result is a rising number of listed-companies have committed to produce TCFD-compliant annual reports.

Financial statements should be 'climate proof'

While we have seen progress in narrative reporting, there have been few visible efforts to reflect climate considerations in financial statements. Yet, just as laws in most major markets require that material climate risks be reported in narrative form to shareholders, there are similar requirements that published financial statements incorporate material and foreseeable impacts.

Indeed, consideration of future events is a key part of most accounting standards to ensure accounts are not misrepresenting capital strength today, e.g. fair value accounting is implicitly forward-looking as it reflects peoples' views today of future cash flows. Impairment testing involves comparing the book value of assets to a net present value of anticipated cashflows from these assets. Because climate risks are likely to result in foreseeable losses and liabilities for many companies, they need to be accounted for¹⁵.

To underline the relevance of climate risks under current rules, in November 2019 the IASB published an article detailing how material climate risks should be considered under existing accounting standards (known as IAS or IFRS)¹⁶. An abbreviated version is provided in the table below¹⁷.

Investors support this IASB paper for setting out explicitly how directors and audit firms should consider material climate risks.

Summary of IFRS potentially impacted by climate risks

IFRS

IAS 1 Presentation of Financial Statements

IASB Comment (abbreviated)

IAS 1 requires disclosure in the notes of information that is not presented elsewhere in the financial statements but is relevant to an understanding of them. Information will be relevant if it could reasonably be expected to influence decisions made by investors. For example, a company may need to explain whether and how it has considered climate-related risks in its impairment calculations even though IAS 36 makes no explicit requirement for such a disclosure.

IAS 36 Impairment of Assets

The carrying amount of assets such as property, plant and equipment, assets recognised in relation to mineral resources, intangible assets and goodwill could be overstated if the impairment calculations do not account for the effect of climate-related risks.

A company's exposure to climate-related risks...could also affect future estimated cash inflows and outflows used for recoverable amount calculations.

IAS 36 requires disclosure of the key assumptions on which cash flow projections have been based and management's approach to determining the value assigned to these key assumptions...Where climate-related risks could significantly affect the recoverable amount of a company's assets, information about how the effect has been factored into recoverable amount calculations would be relevant.

In the extractive industries, investors may look for explanations as to whether a company has considered the effect of climate-related risks in determining whether exploration, or the evaluation of certain areas of interest, should continue.

IAS 16 Property, Plant and Equipment and

IAS 38 Intangible Assets

Other than impairment, climate-related risks may also affect:

- whether some expenses relate to items that satisfy the definition of an asset and can be recognised...; and
- the estimated useful lives of assets, and therefore the amount of depreciation or amortisation recognised each year.

IFRS 13 Fair Value Measurement

IFRS 13 requires companies to disclose key assumptions used where assets are recognised at fair value.

Fair value measurements may incorporate a number of possible scenarios. When the fair value of an asset is affected by climate-related risks including the effect of and potential changes to laws and regulations with respect to managing such risks, a company may need to disclose how it factors climate-related risk into the calculations.

Companies in sectors particularly affected by climate-related risks would need to consider disclosing their assumptions regarding such risks, even if they cannot quantify any effects on the financial statements.

IFRS

IFRS 9
Financial
Instruments and/
IFRS 7
Financial
Instruments:
Disclosures

IAS 37
Provisions,
Contingent
Liabilities and
Contingent
Assets

IASB Comment (abbreviated)

IFRS 9 impairment requirements use forward-looking information to recognise expected credit losses.

For companies applying these requirements, such as banks, determining whether credit risk has increased significantly since initial recognition is a critical step in estimating expected credit losses.

When banks invest in projects or lend money to businesses affected by climate-related risks, they will need to consider how the exposure to climate-related risk affects the expected credit losses of these loans and investments. For example, if a bank's loan portfolio has significant exposure to fossil-fuel-intensive projects, it would identify the extent of this exposure and how climate-related risks could affect the amounts recognised in its financial statements.

Investment funds and insurance companies could also hold investments in industries that may be affected by climate-related risk; and they would therefore be exposed to price risk in relation to these investments.

IFRS 7 requires disclosure of such a company's exposure to market risks arising from financial instruments, its objectives in managing these risks and changes from the previous period. Quantitative information, such as an analysis of investments by industry or sector, could specifically identify sectors exposed to climate-related risks and explain the company's policy of managing its exposure to those sectors.

Companies are required to provide a brief description of the nature of any contingent liability, and where practicable, an estimate of its financial effect and an indication of the uncertainties relating to the outflow of resources for settling the obligation.

Climate-related risks and uncertainties may also affect the best estimate of a provision. Companies must disclose their major assumptions about future events, which may need to include an explanation of how climate-related risks have been factored into the best estimate of the provision. Climate-related risks could have the following effects:

- recognition of an onerous contract provision for the potential loss of revenues or increased costs postulated in climate-related risk scenarios considered in the best estimate;
- an increase of provisions recognised for decommissioning a plant or rehabilitating environmental damage in extractive industries due to regulatory changes or shortened project lives; and
- disclosure of a contingent liability for potential litigation and fines or penalties because of environmental and other regulations, where the company may have broken a regulation, but the probability that it will have to make a payment is lower than 50%.

Source: See footnote 12.

Three points are emphasised in the IASB article:

- Materiality is determined by investor views;
- Material climate risks must be disclosed in the financial statements and associated notes; and
- Disclosure must be company-specific, not boilerplate.

Materiality depends on investor views

First, the IASB highlights that investor views are central to the determination of ‘materiality’, which in turn determines whether climate risks need to be incorporated into financial statement disclosures under IAS 1:

“investor expectations may make some risks ‘material’ and may warrant disclosures in financial statements, regardless of their numerical impact”.

This means that directors must consider what the reasonable investor believes is important.

Material climate risks should be disclosed in the financial statements and associated notes

Second, the IASB explains that where investors believe climate risks are material it is unlikely to be sufficient to simply point them to other documentation:

“disclosures made in other documents will not compensate for the omission of required disclosures in the financial statements and are therefore subject to audit in most jurisdictions”.

Disclosures should be company-specific, not boilerplate

Third, the IASB warns companies that make supplementary information available on climate risk exposures not to use boilerplate language:

“The disclosures in the notes will be most helpful to users of financial statements if the disclosures focus on specific issues and assumptions made that are relevant to the amounts recognised in the financial statements; and if they are not of a boilerplate nature.”

The above guidance from the IASB is important since IFRS are followed in almost all the main financial markets around the world, apart from in the United States which implements US Generally Accepted Accounting Principles (US GAAP). However, the international and US standards are rooted in many similar underpinning concepts¹⁸.

Of particular note is the notion that information that is likely to impact investors’ decision-making be deemed ‘material’. This means that where shareholders have expressly indicated that they wish to have information

on how climate risks – and specifically how Paris-alignment – will impact a business as part of their investment decision-making, then it is reasonable for directors to consider this information material. Equally, directors that ignore investor calls for climate information are at risk of withholding material information.

Regulatory scrutiny rising

In parallel with guidance from the accounting standard setters, regulators are also beginning to scrutinise whether directors are considering climate impacts as they draw up their financial statements.

In October 2019, the Chief Executive of the UK’s FRC in his annual letter to audit committee chairs and finance directors made clear their expectations (emphasis added)¹⁹:

*“... consistent with the UK Corporate Governance Code’s focus on emerging risks, and after considering the likely consequences, companies should, where relevant, report on the effects of climate change on their business (both direct and indirect). Such reporting should cover how the Board has taken account of the resilience of the company’s business model and its risks, uncertainties and viability in the immediate and longer term in light of climate change. **It should also consider the impact on the financial statements, in particular in relation to asset valuation and impairment testing assumptions.**”*

*“We will continue to have a key focus on the adequacy of disclosures supporting transparent reporting of estimation uncertainties. An **understanding of their sensitivity to changing assumptions is of critical value to investors, giving them clearer insight into the possible future changes in balance sheet values and which can inform their investment decisions.**”*

In February 2020, the FRC set out their intention to review implementation of this requirement in coming months²⁰.

3 Investors expect Paris-aligned accounts

Investors naturally expect to see the legal minimum met with the inclusion of material climate risks in the accounting and audit process. Beyond this, however, investors are seeking visibility of the materiality of the global transition to net zero emissions for exposed companies.

This expectation was underlined recently in a global investor statement calling for Paris-aligned accounts coordinated by the Principles for Responsible Investment²¹. This paper builds on that statement to provide more detail on investor expectations and potential investor action²². Key information that investors expect to see is summarised in the right hand column.

Climate-related disclosures companies should make in their financial statements²³

- **An affirmation that climate risks are incorporated into the accounts:** A statement that the directors have taken account of climate change and the goals of the Paris Agreement in signing off the company's financial statements.
- **Adjustments to critical assumptions and estimates:** How critical accounting judgments have been tested against credible economic scenarios that are consistent with achieving net zero carbon emissions by 2050, and any adjustments made to these assumptions²⁴. In the event directors choose not to use Paris-aligned assumptions, for instance due to a belief that the Paris Agreement is unlikely to be implemented fully or to time, they should state this and explain why in the Notes to the accounts.
- **Sensitivity analysis:** Results of sensitivity analysis linked to variations in these judgments or estimates, including one that is Paris-aligned, if this is not used in the accounts themselves.
- **Dividend resilience:** Implications for dividend paying capacity of Paris-alignment (e.g. threshold assumptions that would trigger cuts to dividends). This is particularly important where companies have not used Paris-aligned assumptions in their core accounts.
- **Consistency:** Confirmation of consistency between narrative reporting on climate risks and the accounting assumptions, or an explanation for any divergence.



4 Investors need Paris-aligned audits

The auditor has a duty to provide an opinion as to whether the financial statements presented by management provide a true view of the underlying economic health of the business and is free from material misstatement or omissions. They also vet whether the accounting standards have been properly applied. They often have other obligations depending on the jurisdiction, e.g. checking internal control efficacy. Frequently, auditors must also check that the financial statements are consistent with the narrative information contained in the same annual report, and the legality of any dividends under local company statute²⁵. Where there are doubts as to either material misrepresentation or capital protection linked to particular solvency regimes, auditors have a duty to sound the alarm.

The auditor's role is thus central to delivering reliable accounts that incorporate material climate considerations. The summary below lists key steps investors expect auditors to take to encourage Paris-aligned accounts.

Steps auditors should take to encourage Paris-aligned financial statements²⁶

- **Consideration of material climate risks:** Confirmation that critical accounting estimates or judgements reflect material climate risks, in line with accounting standards.
- **Paris-alignment:** Confirmation as to whether or not these critical assumptions and estimates can be considered consistent with a 2050 net zero emissions pathway and, if not, whether Paris-aligned assumptions have been adequately considered in the Notes to the Financial Statements. If not, the auditor should indicate what reasonable Paris-aligned assumptions would be.
- **Consistency:** Alert shareholders to any inconsistency between the narrative disclosures around climate risks, the company's strategy and the financial statements.
- **Dividend resilience:** Confirm that capital maintenance/solvency tests have appropriately considered climate risks, such as dividend legality. In many jurisdictions these rules are additional to following accounting standards, and often they demand greater prudence when dealing with foreseeable losses and liabilities.

In the event that management chooses not to presume Paris-alignment in their accounting, then auditors need to consider two courses of action:

1. **Supplementary disclosures, including sensitivity analysis:** If management fails to provide sufficient sensitivity analysis in the Notes to the accounts, the auditor should call this out. Where possible, the auditor should provide an indication of what they would consider to be reasonable assumptions taking the net zero transition into account, and the impact such assumptions might be expected to have on the financial statements. This is particularly important where shareholders have made clear that they believe Paris-alignment to be material (see Section 3 above).
2. **Opinion qualification:** Where the auditor determines that managements' assumptions/estimates are not consistent with providing a true and fair view or fair representation of the entity's economic health, they should qualify their audit opinion to alert shareholders to this fact. Depending on the severity of the misrepresentation they may also consider including an emphasis of matter.

The auditor's job of challenging over-optimistic assumptions is particularly important in situations of structural change like decarbonisation since the past cannot be a guide to the future. The presumption, for instance, by an oil and gas company that long-term oil and gas prices will remain at levels experienced in recent years, and continue to increase with inflation into the future, is not consistent with the necessary outcomes required to deliver the 1.5°C goal of the Paris Agreement, and subsequent need to bring fossil fuel demand down to achieve net zero carbon emissions by 2050²⁷. The same may be true of assumed demand for refining, coal-fired power, flights, internal-combustion powered vehicles or other fossil fuel-related goods and services.

There are welcome signs that audit firms are enhancing their focus on climate risks in their audits, especially at oil and gas companies, following engagement by investors (see examples of Shell and BP on page 14).

5 How investors can hold companies and auditors to account

Shareholders have powerful levers, as well as important responsibilities, in holding boards and auditors to account for inadequate climate risk reporting. At a high-level, investors who are unhappy with the level of disclosures or its accuracy may:

- Engage with management, the Board and/or the auditor to press for change;
- Vote against individual directors, the auditor and/or the financial statements (or file shareholder resolutions); and/or
- Divest their shares.

Holders of credit securities may also apply pressure for better risk management through divestiture and engagement, although they will not have a vote on company leadership.

Engagement

Active engagement by shareholders with boards is encouraged in several jurisdictions (e.g. under local stewardship codes) to promote good corporate governance. Shareholders are increasingly engaging with boards around disclosure of climate risks, notably under the Climate Action 100+ initiative, of which IIGCC is a key founding partner. When it comes to ensuring climate risks are being fully reflected in companies' financial statements, investors should seek engagement with:

- the audit committee as the board-level committee tasked with ensuring oversight of reporting and the audit process; and
- the lead audit partner who oversees the independent audit, signs the audit report and reports to shareholders.

Typically, audit committees have a majority of independent directors, and are required to have financial expertise. Too often audit committees perceive climate change to be a 'non-financial' concern, and thus a matter for narrative disclosures but not pertinent to the accounting process. This needs to change and an engagement by investors with audit committees can be helpful in supporting this broader understanding²⁸.

Likewise, while auditors should ensure material climate risks are reflected in companies' financial standards as highlighted above, it can be helpful for shareholders to communicate directly to the auditor any concerns over potential misrepresentation or omissions linked to climate risks. Auditors ultimately work for shareholders – and are also often directly accountable to shareholders at company AGMs (see below under voting) – so should be interested in canvassing shareholder views as part of their audit process.

When initiating an engagement with an auditor, it is worth remembering that auditors must take care that they do not reveal material non-public information for any specific company to a limited subset of investors²⁹. However, there is nothing to prevent shareholders communicating their concerns to the auditor and there have been recent examples of at least one UK audit firm inviting investor input to take account of investor views when planning its audits³⁰. In certain circumstances, it may be appropriate for an auditor to make a public communication on a topic of interest to shareholders. Such communications help to reinforce the auditors' accountability to shareholders, and ensure the auditor has shareholder concerns front of mind as they conduct their audit and consider materiality.

In terms of the location of the climate risk disclosures in the accounts, these should be found in:

- Notes to the financial statements – published with the balance sheet, profit and loss account and cash flow statement, and considered part of the financial statements;
- Audit Committee's report to shareholders – available in certain jurisdictions, this report should incorporate the steps they have taken to consider climate risks, and to ensure the auditor reviews these.
- Auditor report to investors – the auditor may comment on climate risk in its description of key audit matters (KAMs) in Europe, or critical audit matters (CAMs) in the US.

The potential for engagements to drive immediate improvements in climate risk accounting has recently been demonstrated at oil and gas majors Royal Dutch Shell, BP and Total. In all three cases, a collective group of investors wrote in November 2019 to the audit committees and lead audit partners highlighting concerns that material climate risks were not be properly reflected in the accounts³¹.

In the 2019 Annual Report and Accounts, released in March 2020, there was a dramatic increase in attention given to climate risks as a material consideration in the KAMs at BP and Shell. All three companies lowered their long-term oil price assumptions due to anticipated decarbonisation stemming from the Paris Agreement. Total included a statement that it believes its commodity price assumptions are aligned with the Paris Agreement. Further details of the impact of the BP and Shell engagements is provided in the summary overpage³².

Auditors raise their game on climate risks – the cases of BP and Shell

In November 2019, roughly twenty institutional investors wrote to the audit committees and lead audit partners at Royal Dutch Shell and BP seeking reassurance that both companies were taking material climate risks into account in their financial statements.

The investors specifically pointed to the need to ensure key assumptions that underpin the valuation of assets and liabilities on the balance sheet or that feed into items such as depletion, depreciation and amortisation in the profit and loss statement take account of global commitments to decarbonisation. The assumed long-term oil and gas prices, for instance, have a material impact on valuations of assets such as property, plant and equipment (PPE) valuations, one of the largest items on the balance sheet.

The impact of these engagements is clear in BP and Shell's 2019 Financial Statements, published in March 2020.

BP and Shell lowered their commodity price assumptions

Both companies reviewed their accounting assumptions and lowered the long-term oil prices used in impairment testing due to decarbonisation. Shell reduced its oil price from Brent \$70/barrel (bbl) to \$60/bbl from 2022, which is consistent with the price used in its strategy. Shell also lowered its gas price assumption from \$3.5/million British thermal units (MBTu) to \$3. BP reduced its oil price assumption from \$75/bbl to \$70/bbl.

Climate risks are identified in key audit matters and indicate materiality

Alongside these adjustments, the auditors made clear the importance of climate risks their KAMs.

For Shell, EY identifies the energy transition as central to the following items on the balance sheet:

- Estimation of oil and gas reserves – which in turn impacts asset lives and impairment tests, depreciation, depletion and amortisation costs (amounting to \$19.3bn in 2019), and decommissioning and restoration provisions (\$19bn)
- Recoverable amounts of exploration and production assets; and joint ventures and associates (\$165bn and \$23bn, respectively)
- Estimation of future refining margins to evaluate the recoverability of manufacturing, supply and distribution assets (\$56bn);
- Recognition and measurement of deferred tax assets (\$28bn).

Taken together, these items amount to at least two-thirds of total assets on the 2019 balance sheet, equivalent to almost 145% of the reported equity. On the liability side, the decommissioning and restoration provisions currently account for circa 8% of total liabilities; if brought forward due to earlier decommissioning of reserves due to decarbonisation, this could be materially higher – representing a further potential hit to equity.

In their report to shareholders, EY determined that Shell's decision to reduce the commodity price assumptions (to \$60/bbl for oil and to \$3/MMBtu for gas) is corroborated by third party data, taking climate considerations into account. They also considered the consistency of the accounting assumptions with the company's commitment to support the Paris Agreement. They state that they undertook sensitivity analysis for different price assumptions, including those associated with Shell's Sky Scenario – which Shell believes to be Paris-aligned. They explicitly noted, however, that the gas price assumption remains at the high end.

For BP, Deloitte highlighted climate risks as a KAM in its own right, as well as important to other KAMs. They flag that decarbonisation could impact the financial statements through lower commodity prices, shorter asset lives, more immediate asset retirement obligations. They concluded the lower commodity price assumption is the most significant, and identified \$12.3bn of upstream oil and gas PPE assets at highest risk of impairment in a lower price environment, and a further \$33.4bn at lower risk. This is equivalent to just over a third of total PPE, or just over 45% of reported equity.

Significantly, Deloitte concluded management's oil price assumptions were above those consistent with Paris-alignment (which BP's management identified to be c\$50/bbl in its strategic report), and they further note that stress-testing work conducted by management was only consistent with the higher end Paris-aligned price scenarios.

BP moved more boldly in June 2020

Just weeks after publishing its Annual Report, in June 2020 BP announced that it would further lower its oil and gas price assumptions by 20% and 27% respectively, to \$55/bbl and \$2.90/mmBtu. This was to reflect accelerating decarbonisation following the Covid-19 pandemic; it also addressed the auditor's concern that BP's oil price assumptions were above what could be considered Paris-aligned. They estimated this would result in write-downs of between \$13 and \$17.5 billion, or 13-17% of 2019 reported equity, substantially higher than what was indicated in their sensitivity analysis in their Annual Report.

While there are still important questions to be asked about Shell, BP and Total's accounting assumptions, their actions underline three important lessons. First, that incorporating climate risks into financial statements can be achieved quickly and does not require new laws. Second, they evidence how climate risks can have a material impact on companies' reported capital and performance. Third, they have shown there are no regulatory or legal impediments to auditors calling out where management assumptions fall short of Paris-alignment – as was done by both EY and Deloitte for Shell and BP.

Voting

Beyond engagement, shareholders can be expected to use their vote where financial statements fail to meet the expectations set out in this paper. The following resolutions are most relevant³³:

- Director appointments
- Auditor appointment
- Approval of the annual report and/or accounts

Also, depending on the jurisdiction and company, shareholders may submit their own shareholder resolutions for a vote seeking Paris-aligned accounts. The use of shareholder resolutions on climate matters has increased markedly over the past five years and has gained growing levels of support³⁴.

Depending on the jurisdiction, votes may be binding or non-binding. However, even where non-binding, companies that ignore a significant vote against a resolution may risk their credibility.

Holding directors to account

Shareholders have the power to determine who runs their companies through their votes for directors. Frequently, this is a binding resolution, so where a director is not approved according to the relevant threshold as set out in the company's articles of association then he or she must stand down³⁵.

Where climate risks represent a material headwind to a business and the reporting of these risks is deemed inadequate or financial statements are viewed to be misleading, the following directors should expect to be held to account³⁶:

- Chair of the audit committee – the most obvious director to hold accountable for misrepresentation or inadequate climate risk reporting.
- Audit committee members – where the reporting failure is severe or fails to improve over time following engagements on the topic, shareholders may want to vote against the entire audit committee.
- The board chair – ultimately, the annual report and accounts are the responsibility of the entire board, even where the audit committee takes the lead. In particularly problematic cases, it would be legitimate to hold the chair to account for poor reporting.

Shareholders may use any combination of votes and may also decide to ratchet up these votes over time. Examples of voting rules for directors are set out in the Table below.

Holding the auditor to account

As discussed previously, the auditor plays a central role in checking management's accounts on behalf of shareholders. Where reporting of climate risks is deemed inadequate, shareholders may vote against:

- Auditor's reappointment – this is the strongest vote, even where it is not binding.
- Auditor's remuneration – this can be used to reinforce the vote against the auditor, or as a weaker alternative.
- Annual report and accounts – this offers a mechanism to signal concern.

Not all these votes are available in all jurisdictions (see Annex). In the US, for instance, there is generally only a vote for the auditor reappointment, and this is non-binding³⁷. In Europe, investors often have votes on all three items.

Examples for voting rules for the auditor reappointment are included in the summary below. It is worth highlighting that the summary focuses on objective criteria relating to climate risk disclosures in the financial statements, rather than whether or not the actual assumptions or judgements are reliable.



Disclosure versus reliability in accounting

Shareholders need to know what to look for in assessing financial statements to be able to hold audit committees and auditors to account for climate risk accounting. At a high level, there are two core questions that need to be answered in forming a view on the accounting and audit quality:

- **Disclosure:** Is there sufficient disclosure in the financial statements and associated auditor reports to meet investor expectations listed in the box on page 11, e.g. an affirmation that climate risks are incorporated, including the consideration of the Paris Agreement.
- **Reliability:** Have the assumptions and judgments been adequately adjusted to reflect these climate risks, and thus ensure the reliability/accuracy of the accounts themselves?

It is easier to assess disclosure – either there is disclosure or not, so this should be an obvious starting point in any evaluation. However, even if companies disclose that they are considering climate risks, this does not necessarily mean they are doing it well.

The reliability and reasonableness of the accounting assumptions used by a company will require deeper consideration by investors. Is it sensible, for instance, for a power company to be depreciating a coal-fired power plant over 30 years when coal power is expected to be phased out in the particular location before this? What refining margins should oil and gas companies assume to be consistent with Paris? What carbon tax will be expected in a world that needs to achieve net zero emissions by 2050?

All of these questions require forward-looking analysis. Here the auditor plays a critical role. Investors look to auditors not just to ensure the management has adopted appropriate procedures in their accounting, but also to alert shareholders to weaknesses in managements' assumptions. For companies facing material headwinds from decarbonisation, for instance, they should be sounding the alarm if management assumptions are not aligned with Paris and, if not, why they are acceptable.

Raising concerns about the auditor's work

In certain jurisdictions, shareholders have a right to ask a question about a listed company's audit of the financial statements, and have the answer published on the company's website. For instance, in the UK, questions may be asked where at least 100 shareholders, or 5% of issued share capital, makes a request (Companies Act 2006, section 527(1)(a)). Often shareholders may also ask auditors a question at the AGM, if the auditor is present. However, there may be no requirement for the board or auditor to answer.

Divest securities

Where investors perceive material climate risks that are not being properly reflected in the financial statements, and neither engagement or voting has proven effective in driving better disclosure, they may sell the entity's shares and/or credit. Where enough investors take this action, the result will be a higher cost of capital for the company. Normally, this translates into a lower share price than would otherwise be achieved.

Paris-aligned accounting and audit – Potential voting rules^{38 39}

The table below provides examples of voting rules for the audit committee chair appointment, auditor reappointment and annual report and accounts/financial statements.

Resolution	Against vote triggers ⁴⁰	Examples/notes
Audit committee chair appointment – escalate to entire audit committee and/or executive directors (e.g. chief financial officer)	Board affirmation (voting against): where there is no affirmation that climate risks are incorporated in the financial statements, including consideration of the Paris Agreement.	Companies should provide an explicit affirmation in their annual report and accounts/10K (in the US). This may sit in the description of accounting policies and/or audit committee report, depending on the jurisdiction.
	Adjustments to critical accounting assumptions/estimates (voting against): where there is no disclosure of how climate risks have been considered in critical accounting judgments, including those associated with the implementation of the Paris Agreement.	Disclosure may be in notes relating to, for instance: <ul style="list-style-type: none"> • Presentation of the financial statements/key judgements/accounting policies • Impairments • Property, plant and equipment • Intangibles • Fair value measurements • Financial instruments/credit loss provisioning • Provisioning, contingent liabilities and contingent assets
	Sensitivity analysis (voting against): where there is no sensitivity analysis linked to Paris-aligned scenario, if this is not used as the base case.	As above.
	Consistency (voting against): where there is no affirmation that accounting assumptions are consistent with assumptions used in the entity's strategy and capital expenditure planning. AGAINST where there is a lack of consistency between narrative reporting on climate risks and the accounting assumptions.	Compare strategic report/MD&A assumptions on key variables with those used in the accounts, e.g. strategic report uses Paris-aligned oil price of \$50/bbl, but accounts use \$70/bbl; e.g. company commitment to align with net zero emissions by 2050, but who depreciate long-lived fossil fuel related assets over more than 30 years.
	Dividend resilience (voting against): where there is a failure to disclose implications for dividend paying capacity of Paris-alignment (e.g. adjustments to distributable reserves; threshold assumptions that would trigger cuts to dividends).	Dividend rules vary by jurisdiction, but understanding how climate risks impact dividend paying capacity will matter to investors everywhere.

Resolution	Against vote triggers	Examples/notes
	Audit committee action (voting against): where there is no disclosure how the audit committee considered climate risks in its review of the accounts and audit process, and Paris-alignment.	Review Audit Committee report to shareholders available in certain jurisdictions, e.g. UK.
Auditor reappointment (auditor remuneration can be aligned with this vote, or used as a weaker vote)	Auditor action (voting against): where there is no disclosure of how the auditor has taken account of climate risks in their report and whether the key accounting assumptions are aligned with Paris, e.g. in KAMs (EU)/CAMs (US).	Contained within the auditor's report. In the EU and US, auditors are now required to produce more detailed disclosures on the KAMs and CAMs respectively. These disclosures offer an opportunity to set out climate risk considerations.
	Auditor opinion/alert (voting against): where the accounts lack disclosure on climate risks, but the auditors fail to alert shareholders to this weakness – e.g. through a qualified audit opinion and/or KAMs/CAMs.	In the auditor's report.
Annual report and accounts/financial statements	For triggers above.	This is a normally weaker vote than a vote against directors or the auditor. Can be combined with other votes, or used as an alternative to send a signal of disquiet with the accounts.



6 Regulators should require Paris-aligned audited accounts

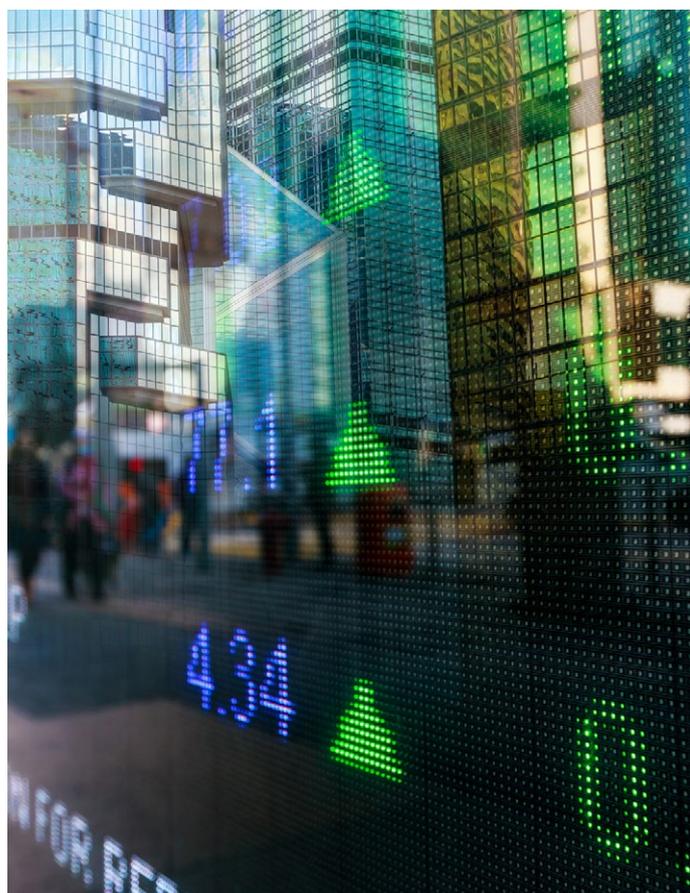
This paper has set out investor expectations of audit committees and auditors to ensure company accounts disclose the financial implications of the global effort to achieve net zero carbon emissions by 2050; and action that investors can be expected to take to hold directors and auditors to account for delivery of Paris-aligned accounts.

Given the public interests at stake, there is a strong argument for regulators to support investor action by mandating Paris-aligned accounting and auditing.

Specifically, governments should require directors to:

- State whether they had adopted Paris-aligned assumptions/estimates in their accounts; and
- If not, provide supplementary disclosures in the Notes to the financial statements as to how the accounts would be impacted if they had used Paris-aligned assumptions/estimates.

Auditors should likewise be required to undertake Paris-aligned audits that test accounts against Paris-aligned assumptions/estimates and flag to shareholders where the assumptions fall short.



7 Conclusion

Reliable accounts sit at the heart of effective corporate governance. They also underpin efficient capital allocation and, thus, sustainable economic growth. Too many company accounts are leaving out material climate-related impacts, and this is not just putting shareholder capital at risk; it could have catastrophic consequences for our planet.

At a minimum, companies must act urgently to address this disclosure gap. Ensuring ‘climate-aware’ accounts is about meeting – in most jurisdictions – basic legal standards. Auditors should alert investors where these requirements are not met.

This paper, however, goes further. It sets out investor expectations for Paris-aligned accounts and audits. In other words, directors and auditors are being called on to provide affirmation that their accounting and audit processes are reflecting global commitments to achieve net zero emissions by 2050; and to make visible how financial statements will be impacted by the implementation of these commitments. Either this is done by adjusted critical assumptions and estimates underpinning financial statements to reflect a Paris-aligned pathway, or by providing necessary disclosures on the financial impacts of the Paris Agreement in the notes to the accounts.

Where directors or auditors fail to deliver on these expectations, investors are committed to acting through engagements, voting, and – in certain cases – divestment.

The ability of companies and auditors to act quickly to deliver Paris-aligned accounts should not be in doubt; recent action by BP, Shell and Total to produce Paris-aligned accounts is testament to the change in approach we need to see replicated by others.

This now needs to be scaled up. Alongside intensifying shareholder action, regulators can help ensure system-wide change. Governments should require that companies produce Paris-aligned accounts and auditors undertake Paris-aligned audits.

This paper comes at a time of rising climate peril. Considerable headway has been made in many areas to shift capital towards climate solutions and away from harmful activities, but the hard truth is the world is still not on a safe pathway. If society is serious about delivering on the Paris Agreement, then economic incentives must be urgently aligned with this goal. Delivering Paris-aligned company accounts is a critical step in ensuring this happens.

Annex – Auditor voting rules

The table below summarises how voting rights vary by jurisdiction and the consequences of rejecting a binding vote.

Country	Voting rights			
	Approval of Annual Report or audited accounts	Appointment of Auditor	Appointment of Directors	Consequences of rejection of binding vote
UK	Advisory vote	Binding vote	Binding vote	Directors and auditors must stand down.
US	No vote	Advisory vote	Binding vote in California, advisory elsewhere	Company may have director resignation policy requiring directors to stand down if they don't receive majority support.
France	No vote on Annual Report Binding vote on audited accounts	Binding vote	Binding vote	Without majority support, the director or auditor does not get elected/re-elected.
Germany and Austria	No vote	Binding vote	Binding vote	Directors and auditors must stand down.
Switzerland and Liechtenstein	Binding vote	Binding vote	Binding vote	Rejected accounts need to be approved at the next general meeting. Directors and auditors must stand down.
Italy	Binding vote (at tier one companies)	Binding vote	Binding vote	Rejected accounts need to be approved at the next general meeting. Directors and auditors must stand down.
Spain and Portugal	Binding vote on audited accounts	Binding vote	Binding vote	Rejected accounts need to be approved at the next general meeting. Directors and auditors must stand down.
Netherlands, Belgium and Luxembourg	Binding for annual accounts	Binding vote to ratify board choice of auditor	Binding vote	Rejected accounts need to be approved at the next general meeting. Directors and auditors must stand down.
Denmark, Sweden, Norway and Finland	Binding vote	Binding vote	Binding vote (majority not required)	Rejected accounts need to be approved at the next general meeting. Plurality voting means the candidate with most votes will be elected even without majority.

Endnotes

- 1 IFRS, 2019, IFRS® Standards and climate-related disclosures
<https://cdn.ifrs.org/-/media/feature/news/2019/november/in-brief-climate-change-nick-anderson.pdf?la=en>
- 2 Financial Reporting Council, 2020, Global pandemics and climate change pose risks to actuarial quality
<https://www.frc.org.uk/news/june-2020/global-pandemics-and-climate-change-pose-risks-to>
- 3 The focus here is on incorporating into financial statements the transition to net zero emissions by 2050. Physical impacts from climate change should also be reflected wherever possible. If the company decides not to assume Paris-alignment, then they should set out how they take account of global warming of 4C or more for assets, liabilities, profits and cash flows, alongside the additional disclosures set out here.
- 4 Examples of which accounting judgements may require adjustment are covered under recent IASB guidance below.
- 5 As noted for directors above, the focus here is on taking account of the transition to net zero carbon emissions by 2050. Auditors should also ensure they consider physical impact risks from climate change, and alert shareholders where there may be omissions. This is likely to be particularly important where the central accounting assumptions assume an elevated level of Global Warming.
- 6 This paper builds on a Sarasin & Partners' briefing published by IIGCC in 2018 "Voting for better climate risk reporting"; an ongoing collective investor engagement with the Big Four audit firms in the UK; and dialogues with the UK's FRC; as well as ongoing engagements with audit committees at fossil fuel-exposed companies.
- 7 Global accounting standards today seek to ensure valuations on balance sheets reflect current economic realities, e.g. through the use of fair value accounting. Accounting assumptions or estimates that ignore structural changes to demand that come from Paris-alignment will tend to misrepresent companies' economic position.
- 8 In economic terms, mispricing of risks evident in accounts is a classic market failure – which impedes Adam Smith's invisible hand from working and ultimately leads to sub-optimal economic growth.
- 9 OECD, 2017, "Investing in Climate, Investing in Growth", OECD Publishing, Paris,
<http://dx.doi.org/10.1787/9789264273528-en>
- 10 This paper refers to accounts or financial statements interchangeably.
- 11 It is important to note that several aspects of global accounting standards are forward-looking to ensure accounts are not mis-representing capital strength today. See below for a fuller discussion.
- 12 In the EU, the Transparency Directive (2004/109/EC) and Accounting Directive (2013/34/EU) set out requirements for public entities to publish a management report each year. This report should include a "description of principal risks and uncertainties" and financial and non-financial information necessary to provide a "fair review of the development and performance" of the company. The UK further required from October 2015 that companies provide long-term viability statements that address long-term risks to solvency. In the US, listed corporations must disclose "known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance" (Item 303 of Regulation S-K) and the SEC has issued interpretive guidance as to how this relates to climate change disclosures.
- 13 For instance, the SEC requires material risks and impacts to be disclosed, whatever the source. See 2010 Commission-level interpretative statement:
<https://www.sec.gov/rules/interp/2010/33-9106.pdf>
- 14 In the UK, directors are also required under the Corporate Governance Code (Paragraph C.2.2) to provide a viability statement that articulates "how they have assessed the prospects of the company" over the company's "investment and planning periods". For companies investing in long-lived assets that could be impacted by climate risks, this should be disclosed to shareholders.
- 15 Where these impacts are difficult to quantify or uncertain in timing – which is often the case for climate-related impacts – accounting standards may permit them to be omitted from the numbers, but a note is required to alert users under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. In addition, capital maintenance/solvency rules (including those in the UK and EU) frequently demand that directors account for foreseeable losses or liabilities even where the timing is unclear and magnitude hard to measure. This is to reduce the risk of overstatement of capital and then insolvency. See, for instance, Directive 2012/30/EU (particularly Article 17).
- 16 IFRS, 2019, IFRS® Standards and climate-related disclosures (November 2019), available here:
<https://cdn.ifrs.org/-/media/feature/news/2019/november/in-brief-climate-change-nick-anderson.pdf?la=en>
- 17 In December 2019 both KPMG and Deloitte published detailed papers outlining how directors should go about ensuring they were properly considering climate risks in the accounting process, which builds on the IASB framework. These can be found here:
<https://home.kpmg/content/dam/kpmg/uk/pdf/2020/01/climate-in-the-annual-report.pdf>;
<https://www.iasplus.com/en-gb/publications/uk/a-closer-look-climate-change>
- 18 A good overview of the similarities is provided by EY here:
https://www.ey.com/en_us/assurance/accountinglink/us-gaap-versus-ifrs--the-basics---december-2019

- 19 Letter from the FRC to the Audit Committee Chairs and Finance Directors (30 October 2019), available [https://www.frc.org.uk/getattachment/71345784-8f60-438b-a474-fc7c79ace9e3/Year-end-letter-\(003\).pdf](https://www.frc.org.uk/getattachment/71345784-8f60-438b-a474-fc7c79ace9e3/Year-end-letter-(003).pdf)
- 20 FRC assesses company and auditor responses to climate change (20 February 2020) available here: <https://bit.ly/33hWJU5>
- 21 Accounting for climate change outlined by Principles for Responsible Investment, available <https://www.unpri.org/sustainability-issues/accounting-for-climate-change>
- 22 This paper builds on a number of existing indicators that investors believe climate risks are material, from the tens of trillions of assets backing the TCFD and its calls for more quantitative data on climate risks facing businesses, to the growing calls from investors for companies to confirm that the Paris Climate Agreement and the physical impacts from climate change are being properly captured in their financial statements and associated notes. In January 2019, investors representing around \$1 trillion in assets wrote to the UK's Big Four audit firms outlining their concerns and expectations that the auditors provide comfort that they are considering climate risks (see <https://sarasinandpartners.com/stewardship-post/incorporate-climate-risks-into-company-accounts/>). In November 2019, investors started writing to audit committee chairs at exposed companies seeking information on how they are ensuring climate risks are considered in the accounting process (see <https://sarasinandpartners.com/stewardship-post/paris-aligned-accounting-is-vital-to-deliver-climate-promises/>)
- 23 These disclosures pertain to companies where climate risks are material. The focus here is on incorporating into financial statements the transition to net zero emissions by 2050. Physical impacts from climate change should also be reflected wherever possible. If the company decides not to assume Paris-alignment, then they should set out how they take account of global warming of 4C or more for assets, liabilities, profits and cash flows, alongside the additional disclosures set out here.
- 24 Examples of which accounting judgements may require adjustment are covered under recent IASB guidance above.
- 25 Under US auditing standards, for instance, auditors are required to read the document that contains the financial statements. If they become aware of a discrepancy, they must bring it to the attention of management, and if management does not resolve the perceived discrepancy, then the auditor must include an additional explanatory statement in the auditor report making it clear that the auditor has not audited any disclosures other than those in the financial statements. <https://pcaobus.org/Standards/Auditing/Pages/AS2710.aspx>
- 26 As noted for directors above, the focus here is on taking account of the transition to net zero carbon emissions by 2050. Auditors should also ensure they consider physical impact risks from climate change, and alert shareholders where there may be omissions. This is likely to be particularly important where the central accounting assumptions assume an elevated level of Global Warming.
- 27 Detailed analysis of European oil and gas company accounting assumptions and failure to reflect decarbonisation may be found here: <https://www.sarasinandpartners.com/docs/default-source/esg/are-oil-and-gas-companies-overstating-their-position.pdf?sfvrsn=2>
- 28 A list of key climate-related disclosures that audit committees should be encouraged to provide is provided in the box on page 11.
- 29 Of course, if the auditors identify any material information that they have a duty to report, they should do so publicly.
- 30 Starting in 2018, KPMG sought out investor input on specific matters that could help it plan its audits and met with large investors in the public companies it audits to receive their input at a company, industrial sector and market-wide level.
- 31 These letters can be downloaded from <https://sarasinandpartners.com/stewardship-post/paris-aligned-accounting-is-vital-to-deliver-climate-promises/>
- 32 The focus of these examples is on BP and Shell as the auditors provided detailed disclosure. In the case of Total, while the directors included disclosures on Paris-alignment, the auditors (EY and KPMG) do not mention climate risks.
- 33 In some jurisdictions, shareholders also have powers to ask the company to publish a statement on a matter relating to the forthcoming audit.
- 34 This has been an effective tool to press companies to improve disclosure on climate risks, for instance (see <https://www.majorityaction.us/asset-manager-report>).
- 35 One important exception is the US, where director elections are generally non-binding. However, in the US the custom is that if a director suffers a defeat (or low support), the board will replace the director.
- 36 These voting priorities are intentionally focused on the accounting and auditing expectations set out in this paper. Of course, investors will also need to consider how they ensure remuneration committees are accountable for Paris-aligned remuneration, or Nomination committees for ensuring there is sufficient climate-expertise on boards.
- 37 Nonetheless, a heavy defeat for an auditor sends a strong signal to the audit committee, and can be supplemented by a vote against the audit committee members.
- 38 These criteria apply to companies that are materially exposed to climate risks. There is no predetermined list of companies that will be materially impacted, as in principle all companies are exposed; however, the materiality of decarbonisation is likely to be higher for heavier carbon emitters, e.g. those in the energy, transportation, heavy industry, materials, buildings and land-based sectors. Financial companies are also impacted through their financing of these sectors.
- 39 Please refer to the Annex for how voting will vary by jurisdiction.
- 40 The rules may be implemented individually or in combination.

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