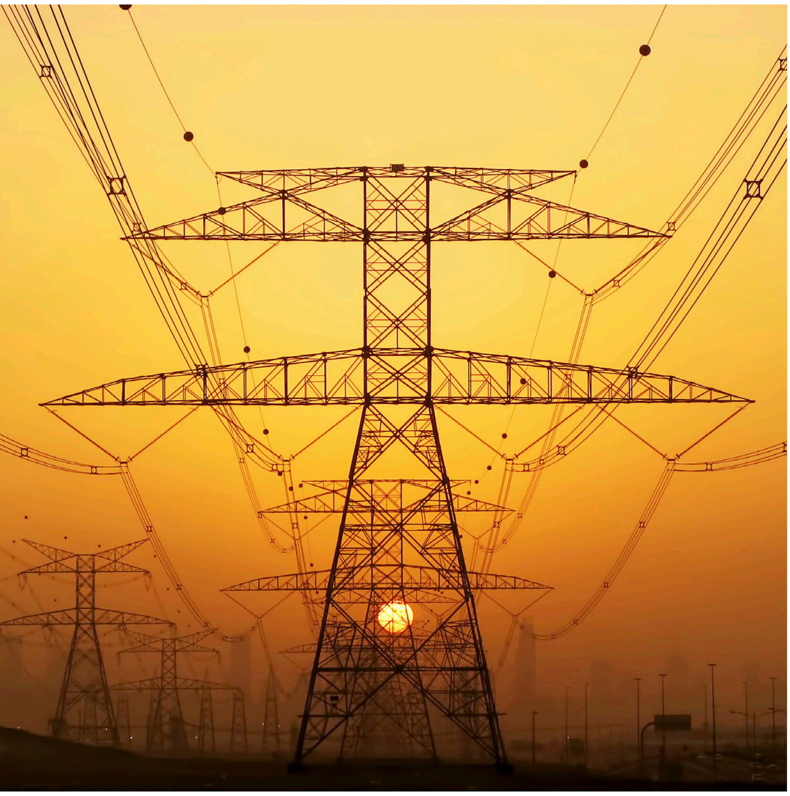
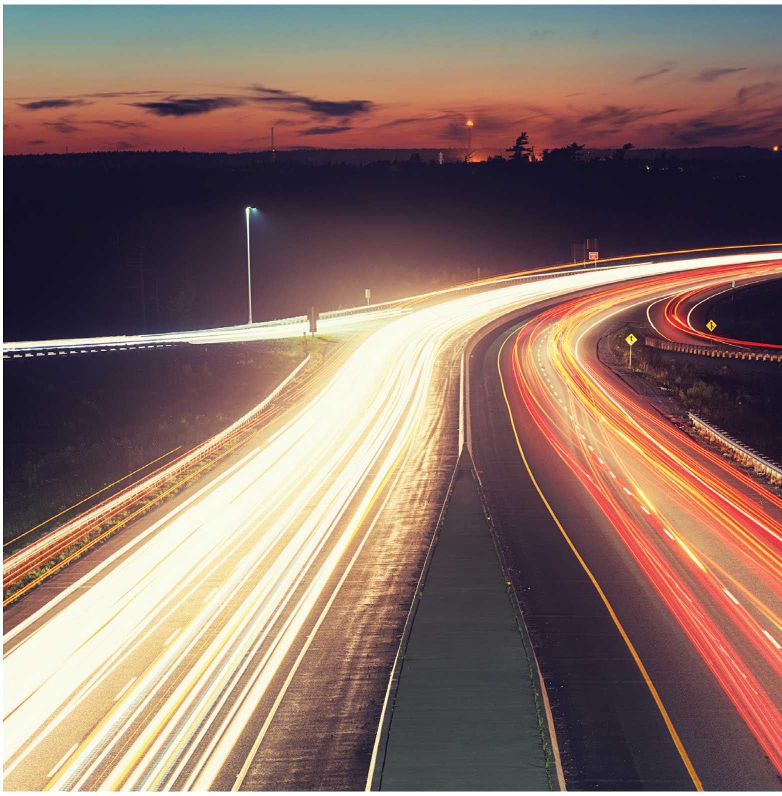
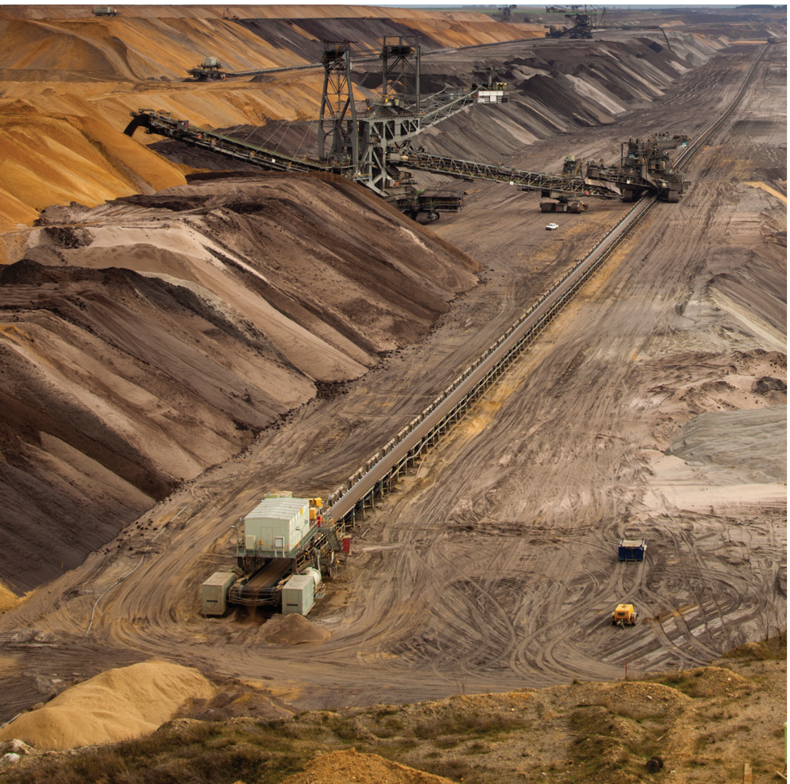
IIGCC
Institutional Investors Group on Climate Change

Voting for better climate risk reporting: the role of auditors and audit committees

Discussion paper for investors







Preface

Climate change is now widely recognised as a risk that long-term investors can no longer afford to ignore[1]. In April 2018, Mark Carney, the Chair of the Financial Stability Board and Governor of the Bank of England, warned of the "catastrophic impact" unmitigated climate change may have on financial markets and emphasised that reporting information on climate risk is crucial to addressing the problem, stating that while "not everyone will agree on the timing or scale of the adjustments required, [provision of the] right information allows sceptics and evangelists alike to back their convictions with their capital"[2].

As investors we are acutely aware of the exposure many of the companies we invest in have to the risks associated with climate change. In 2017 the IIGCC, together with four global partners, launched the Climate Action 100+ initiative – a five year engagement programme now supported by over 280 investors with $29 trillion in assets – to secure appropriate management and disclosure of climate risk from the 100 largest listed global carbon emitters. One of the three core aim of this initiative is to support the adoption of climate risk reporting in line with the FSB's Taskforce on Climate-related Financial Disclosure (TCFD) Recommendations. These guidelines – covering disclosure of climate strategy, governance, risk management, metrics and targets within financial filings – are voluntary. However, the TCFD notes that in many jurisdictions disclosure associated with material risks – including those related to climate risks – is already required in the financial filings; and that the TCFD recommendations should be seen as a useful tool in "complying more effectively with existing disclosure obligations."

In this context, this discussion paper explores the existing roles and responsibilities of auditors and audit committees in ensuring appropriate disclosure on climate-related risks, where material, in the annual financial filings. They undoubtedly have a crucial role to play in ensuring investors – both shareholders and bondholders – receive appropriate information on climate risk to enable informed investment decision-making.

Further, it sets out certain options that we as shareholders specifically have at our disposal in the execution of our voting rights. We can already see a number of investors incorporating climate considerations into their voting policies. It is by no means a complete review of the how voting rights can be used to promote better climate risk disclosure but the first paper in a broader series that the IIGCC Corporate Programme will be producing on voting strategies.

The purpose of this paper is to catalyse a deeper discussion on the role and responsibilities of auditors and the audit committees overseeing them, expectations of disclosure of material climate-related risks within current regulations and legislation, and how shareholders can use voting rights to highlight expectations on climate risk disclosure.

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1 For example, see University of Cambridge (2015) Unhedgeable risk: how climate change sentiment impacts investment, (accessible here: https://www.cisl.cam.ac.uk/publications/publication-pdfs/unhedgeable-risk.pdf)

2 See the full text of Mark Carney's 8 April 2018 Speech here: https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/a-transition-in-thinking-and-action-speech-by-mark-carney.pdf?la=en&hash=82F57A11AD2FAFD4E822C3B3F7E19BA23E98BF67

Summary

Audited report and accounts sit at the heart of systems of corporate governance around the world. They underpin executive accountability to shareholders. It is thus vital that these accounts provide a reliable – and not overstated – view of capital and performance.

The effort to decarbonise the global economy could result in liabilities and / or losses for a range of companies, including those dependent on fossil fuel consumption for earnings. The physical impacts of climate change could also impact the value of property and infrastructure, as well as entire economies. In most markets, these impacts, as far as they are material and foreseeable, must be reported in company annual report and accounts. They must be set out in the discussion of future risks (the 'narrative' part of the annual report), and they need to be reflected in financial statements where leaving them out could result in misrepresentation. These are fundamental and long-standing legal protections for shareholders.

Investors are therefore considering whether all companies, but in particular fossil fuel dependent companies, are providing a full and fair disclosure of climate risks.

The Task Force for Climate-related Financial Disclosures (TCFD) has recently produced a valuable framework to help guide company disclosures, but the fact that this framework is voluntary should not distract attention away from the legal requirement for companies to disclose.

Where shareholders believe reporting fails to meet their expectations, then they can consider adopting a voting strategy, supplemented by proactive engagement, that targets:

- **The Audit Committee** – in the first instance the Chair, but also other members, could be held accountable
- **The auditor** – who provides opinions to shareholders on whether the annual accounts provide a true and fair view of the economic position of the company; and (in some jurisdictions) whether risk reporting and other narrative information is consistent with those accounts and has been prepared in accordance with relevant legal requirements
- **The annual report and accounts** – in some jurisdictions there is a vote on annual report and accounts and not supporting this resolution is an option in the case of inadequate disclosure.

In certain jurisdictions shareholders have the right to ask publicly ask for a clarification on audit matters prior to the AGM. A pertinent question could be how climate risks are considered in the audit.

Taken together this voting and engagement strategy provides valuable levers for ensuring appropriate climate risk disclosure. It should encourage auditors and audit committees to be more responsive to shareholders' requirements, and this in turn should drive better management disclosure.

Context

Every year listed companies produce annual reports and accounts (ARAs) for shareholders. These provide a basis for holding executives to account, and thus sit at the heart of good corporate governance. Normally, the ARA has two core parts:

1. **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.
2. **The financial statements** that tell shareholders whether the company is solvent, the level of accumulated capital, and the profit that their assets have generated.

The ARA is commonly the primary legal document produced by companies for investors, and as such is generally audited by an independent external audit firm.

Material climate risks must be disclosed in the narrative

Companies that face material risks from climate change, either from decarbonisation or physical stress, are required by law in many jurisdictions to report these in their narrative disclosures to shareholders[3].

It is arguable that a number of companies are not fully reflecting these risks in their ARAs. Decarbonisation of the economy – driven by regulations to meet the goals of the Paris Climate Accord as well as, for example, technological improvements in clean energy – present transition risks across sectors such as those in fossil fuel exposed sectors. Yet ARAs often make only passing reference to the risks. Few publish detailed sensitivity data, for instance, so shareholders can fully interpret the magnitude of these risks.

Foreseeable losses and liabilities should be reflected in financial statements

In large financial markets, such as the UK and in the European Union, financial statements must be prudently drawn up to prevent overstatement of capital, and thereby protect capital and avoid falling foul of solvency rules. This commonly means that accounts are required to include foreseeable losses and liabilities.

If decarbonisation is expected to lead to a structural reduction in the long-term oil price, for instance, this should be reflected in asset impairment tests at fossil fuel companies. If it is not, there is a danger that companies are overstating assets. Likewise, where companies are understating liabilities, such as Asset Retirement Obligations, as a result of overestimating reserve life, they may also be overstating capital.

Misrepresentation could impact a wide range of sectors

Beyond the fossil fuel extractive sector which is most obviously impacted by transition risks associated with the decarbonisation of the economy, risks of misrepresentation may exist for any company expected to be negatively and materially impacted by decarbonisation or disruptive technological shifts linked to the energy transition. Examples may include auto companies that have significant assets linked to the internal combustion engine; real estate companies where the building stock fails to meet strict energy efficiency requirements; or any industrial company that is materially dependent on fossil fuels.

[3] In the UK a new rule requiring a long-term viability statement was introduced last year. This requires that directors confirm to shareholders the business's ability to meet foreseeable obligations as they fall due over a time frame linked to the normal investment and planning horizon. This offers another place for directors in affected sectors to outline how the company will be resilient to decarbonisation.

Annual report mis-statement can result in capital misallocation

There are two levels at which capital may be misallocated where ARAs are misleading:

1. Investors may mis-allocate capital between companies; and
2. Companies themselves may misallocate capital to alternative projects.

In the case of company misallocation, the failure of ARAs to properly report climate risks is not just a problem for today's reported equity value, but it can affect the value of the business tomorrow. Poor capital discipline could mean larger future impairments (as bad investments are written down), and limit the future dividend paying capacity of these businesses.

Holding companies to account for climate disclosure

Shareholders have powerful levers to hold Boards and auditors to account for inadequate climate risk reporting. These include their votes for directors – particularly those sitting on the Audit Committee; votes for the auditor who signs off the accounts; and votes for the ARA. In some jurisdictions, shareholders also have powers to ask the company to publish a shareholder statement or concern on a matter relating to the forthcoming audit. More detail on these voting and associated engagement options available to shareholders is outlined below, most of which have been under-utilised.

Holding directors to account for climate risks

One of the most important shareholder powers is their ability to appoint or reject a director. Frequently, this is a binding resolution (one obvious exception is the US, where director elections are generally non-binding), 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 down. This vote awards shareholders the power to determine who runs their companies.

Voting & engagement options:

Where climate risks represent a material headwind to a business and the reporting of these risks is deemed inadequate, it would be appropriate to consider whether to vote against individual directors. Potential votes include against:

- The Chair of the Audit Committee – the most obvious director to hold accountable.
- The Audit Committee members – where the reporting failure is severe, shareholders may want to consider voting against the entire Audit Committee.
- The Board Chair – normally, the accounts are the responsibility of the entire board, even though the Audit Committee takes the lead. In severe cases, it would be legitimate to hold the Chair to account for an inadequate ARA.

Of course, shareholders could decide to ratchet up these votes over time, and use any combination of votes.

Prior to taking a voting decision, shareholders should consider initiating a dialogue with the Audit Committee Chair / Chair to communicate exactly why reporting is a concern and press for changes.

Holding the auditor to account for climate risks

In most markets, shareholders have a vote to appoint their auditor (please see Annex 1 summarising the auditor voting rules in key markets). Normally, this is a binding vote, and an important power alongside shareholders' authority to select directors. Yet, it is rarely used.

The auditor normally has a duty to provide an opinion as to whether the financial statements presented by management provide a true and fair view of the underlying economic health of the business, and/or is free from material mis-statement. They also vet whether the accounting standards have been properly applied. They may also have other obligations depending on the jurisdiction, e.g. in the UK they must provide an opinion, based on the work undertaken in the course of the audit, on whether the Strategic Report and other narrative information is consistent with the financial statements, and has been prepared in accordance with applicable legal requirements.

At its core, the audit offers shareholders a defence against misrepresentation by management.

When it comes to reporting of climate risks, the auditor plays a central role. The auditor should stress test management's accounting assumptions and estimates to ensure these provide a reliable view of capital and performance. The auditor may also test the robustness of management's scenario analysis, risk management and risk reporting.

The job of challenging over-optimistic assumptions is particularly important in situations of structural change like decarbonisation, where the past cannot be a guide to the future. The presumption, for instance, that long-term oil and gas prices will remain at levels experienced in recent years, and continue to increase with inflation into the future, does not sit comfortably with international commitments under the Paris Climate Accord to bring carbon emissions down to net zero by around 2070, and increasingly robust regulatory action as well as technological advances that are impacting demand. The same may be true of assumed demand for electricity, cars, or other fossil fuel related goods and services.

Voting & engagement options:

Where climate risks represent a material headwind to a business and the reporting of these risks is deemed inadequate, it would be appropriate to consider voting against:

- the auditor's reappointment;
- the auditor's remuneration; and/or
- the ARA.

Not all these votes are available in all jurisdictions (see annex).

A vote against the auditor is the strongest vote, as it is normally binding and ensures auditor accountability. Given the importance of the auditor's positive opinion on management's accounts, pressure on the auditor is potentially extremely effective lever for encouraging appropriate reporting

Shareholders may also wish to consider voting against the ARA where this vote is available (e.g. in the UK). This does not directly hold individuals responsible – either directors or the auditor – to account. Nevertheless, it would send a message of concern, especially if combined with engagement with the Audit Committee and/or auditor.

With regard to auditor engagement, auditors cannot speak with shareholders about material non-public information (and are often therefore reluctant to speak with shareholders on specific companies). However, there is nothing to prevent shareholders communicating concerns to the auditor. Indeed, such communication would help to reinforce the auditors' accountability to shareholders, and ensure the auditor has shareholder concerns front of mind as they conduct their audit.

Right to raise concerns about the auditor's work

In certain jurisdictions, shareholders have a right to ask a question or raise a concern about a listed company's audit of the forthcoming financial statements, and have this published on the company's website, sent to the auditors and added to the agenda of the upcoming AGM. This is a right available for UK-listed companies where at least 100 shareholders, or 5% of issued share capital, makes the request (Companies Act 2006, section 527(1)(a)). It is unclear whether this power has ever been used, but it offers another avenue for raising concerns about the lack of proper challenge on climate risk reporting.

Appendix one – voting rights across different jurisdictions

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 AR 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.

Reference: ISS

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Acknowledgements

We would like to thank the lead author of this paper: Natasha Landell-Mills, Sarasin & Partners LLP.

We would also like to acknowledge the review of: Thibaud Clisson (BNP Paribas Asset Management), Michael Herskovisch (BNP Paribas Asset Management), Cristina Cedillo Torres (Robeco), Lucian Peppelenbos (APG), Stephanie Maier (HSBC Global Asset Management), Murray Birt (DWS), Carlota Garcia Manas (Church of England) and Adam Matthews (Church of England).

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Institutional Investors Group on Climate Change

IThe Institutional Investors Group on Climate Change (IIGCC) is a forum for collaboration on climate change for investors. IIGCC's network includes over 150 members, with some of the largest pension funds and asset managers in Europe, representing over €21 trillion in assets. IIGCC's mission is to mobilise capital for the low carbon future by amplifying the investor voice and collaborating with business, policymakers and investors.

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