

## Annex IV: Investor expectations: Integrating climate-related risks and uncertainties in financial statements

Investor Expectations: Integrating Climate-related Risks and Uncertainties in Financial Statements		
Expectations for Companies	<b>Affirmation that the financial consequences of decarbonisation and physical impacts from climate have been considered in drawing up the accounts</b>	Companies should, for instance, assess the financial consequences of expected transition-related regulations; technological change; achieving climate targets /commitments; resilience strategies/ adaptation plans; and legal / reputational risks. <sup>1</sup> If management concludes that climate change is not material to critical forward-looking assumptions, estimates or judgements, they should explain why and provide sufficient detail of the key accounting elements reviewed, as this in itself is material information.
	<b>Connectivity to narrative reporting</b>	It is vital to ensure consistency between narrative reporting on climate risks (including the entity's TCFD/ISSB report) and the accounting assumptions. Any significant divergence should be explained.
	<b>Critical assumptions and estimates</b>	Companies should disclose how climate change and decarbonisation have informed relevant critical accounting judgements, including quantitative disclosures wherever possible. For instance, where an accelerating transition to cleaner energy is expected to reduce demand for a company's products, the impacts for assumptions used in impairment testing should be disclosed and explained.
	<b>Sensitivity analysis</b>	Given the high level of uncertainty associated with climate change and decarbonisation, investors expect companies to disclose which climate-related scenarios, assumptions or sensitivity analyses have been used in preparing critical accounting assumptions and estimates, and how these affect the financial statements. Where alternative plausible assumptions or scenarios could lead to materially different outcomes, companies should describe or, where feasible, quantify such sensitivities. Investors may refer to faster decarbonisation (preferably 1.5°C) and hotter world (say >3°C) scenarios when assessing resilience, but the primary expectation is that companies clearly identify and justify the scenarios they apply. <sup>2</sup>
	<b>Dividend resilience</b>	Investors have an interest in both capital strength and dividend paying capacity of companies. <sup>3</sup> They therefore expect companies to disclose how climate-related assumptions and scenarios used in preparing the financial statements have been considered when assessing dividend capacity, and to explain whether alternative plausible pathways could materially affect this assessment.
	<b>Consideration of material climate risks</b>	Confirmation that the auditor has considered climate-related factors in conducting its audit, with a description of which climate impacts are most material to their audit, and the steps taken to derive comfort that these factors have been adequately considered in the financial statements.
Expectations for Auditors	<b>Connectivity</b>	Confirmation that there is consistency between the company's narrative disclosures around transition and climate risks and achieving its own targets/strategy (including TCFD/ISSB reporting) and the financial statements.
	<b>Climate factors included in reported KAMs/CAMs where relevant</b>	Where climate factors are material to the audit, auditors should set out in a stand-alone K/CAM, or as part of other K/CAM(s), how this was considered, and whether management's assumptions and estimates are appropriate.
	<b>Sensitivity analysis</b>	Where management provides sensitivity to changes in critical assumptions or estimates linked to different climate or transition pathways, the auditor should review this analysis and comment on its reliability. Where management has not provided a sensitivity analysis but, given the level of uncertainty around the particular assumption/estimate, the auditor believes this would be appropriate to give investors a fairer view of the outlook and resilience for the business, the auditor should make this clear.
	<b>Dividend resilience</b>	In keeping with local laws and regulations where auditors are required to notify investors of non-compliance with dividend or capital maintenance requirements, investors expect auditors to confirm that they have considered material climate-related impacts, where they are relevant, in making this determination.

<b>Expectations for Audit Committees</b>	<b>Description of steps taken to ensure that management meets investor expectations detailed above</b>	If management concludes that climate change, transition or an entity's own climate commitments are not material to critical forward-looking assumptions, estimates or judgements, the Audit Committee should detail why they are comfortable with this determination. Audit Committees should furthermore assess appropriate consideration of climate-related matters in the current-year financial statements and ensure that investors can clearly see how sensitive key items in the accounts are to plausible changes in assumptions. Where the Audit Committee took steps to challenge management on these assessments, this should be outlined.
	<b>Description of steps taken to ensure the auditor meets investor expectations detailed above</b>	Investors wish to see the Audit Committee instruct the auditor to review the materiality of climate-related factors; confirm that financial statements take the current temperature pathway and transition trends into account; and check appropriate sensitivities have been undertaken and disclosed.
	<b>Dividend resilience</b>	Given that the Board ultimately signs off on dividend payments or other distributions, investors would welcome an explicit statement outlining how the Audit Committee has satisfied itself that climate-related factors were considered prior to approval.
	<b>Viability statement</b>	Linked to the point above, in certain jurisdictions such as the UK, <sup>4</sup> the Board is required to publish a longer-term viability statement, detailing how they satisfied themselves that the company would remain viable for the foreseeable future and continue as a going concern. <sup>5</sup> For entities that face structural changes in their markets due to climate-related trends, investors would like to understand how these factors were incorporated into the viability assessment.

**Basis for Investor Expectations:** Accounting standards require the disclosure of material information and significant judgments and/or assumptions made in preparing financial statements. If climate change is determined to be material, companies should disclose its impact, and if the impact is deemed immaterial, they should justify why.

It is important to note that, while dividend resilience and sensitivity analysis may be mandated under specific financial reporting standards or jurisdictions, the application of 1.5°C and hotter world pathway scenarios, generally represent best practices strongly encouraged by investor groups and climate reporting frameworks.

**Why set separate expectations for audit committees?** Audit committees provide independent, board-level oversight of financial reporting and the external audit. Separate expectations clarify their accountability for ensuring material climate-related matters are addressed in the financial statements and the audit. This strengthens governance over these matters including connectivity and closing gaps between narrative climate disclosures and audited accounts.

These expectations focus on oversight actions unique to audit committees: this includes challenging management's materiality judgements, directing and overseeing the auditor's work, testing dividend resilience, and integrating climate into viability assessments.

## Endnotes

- 1 While future commitments or capital expenditure plans may not directly impact current financial statements, they are material to understanding a company's transition strategy and climate risk profile and may suggest related adjustments to the asset and liability amounts in the balance sheet, such as impairment charges, useful lives and depreciation changes, or changes in the measurement of decommissioning obligations.
- 2 Providing a range of sensitivities allows investors to better understand potential financial impairments under different transition pathways. Oil and coal majors have demonstrated that significant impairments would be registered even under less aggressive scenarios like well below 2C, which can provide insights into financial risks. Sensitivity analysis in the financial statements would mirror scenario analyses expected in TCFD reporting but normally focuses on flexing just one input at a time, such as assumed long-term commodity prices or the discount rate used in impairment testing.
- 3 In most jurisdictions, local company law and/or solvency frameworks set rules around dividend distributions. These are typically rooted in statutory financial statements.
- 4 FRC, Thematic Review: Viability and Going Concern, 2021
- 5 Under IAS 1 (paras 25–26), management must assess an entity's ability to continue as a going concern when preparing financial statements. The UK Corporate Governance Code (Provision 31) extends this by requiring boards to report on the company's longer-term viability and ability to meet liabilities over the period of their assessment.