Audited Financial Statements and Climate-Related Risk Considerations

September 2021

CAQ

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BACKGROUND

The increase in demand for company-prepared climate-related information has prompted governments and regulators around the world to take a closer look at climate-related reporting requirements to understand whether changes are needed to meet stakeholders evolving information needs. Most recently in the United States, the Securities and Exchange Commission (SEC) issued a request for public input on climate change disclosures.[1] The SEC received more than 550 unique comment letter responses to its request for input and approximately 75 percent of the responses supported mandatory SEC climate disclosure rules.[2] SEC Chair Gary Gensler stated on July 28, 2021 that he has *"…asked SEC staff to develop a mandatory climate risk disclosure rule proposal for the Commission's consideration by the end of the year."*[3]

We are at a pivotal moment for climate and other environmental, social and governance (ESG) reporting. The current market-driven disclosure system for climate and other ESG-related matters could become more prescriptive and driven by regulatory activities. Without knowing what specifically will be included in the SEC's forthcoming rule proposal related to climate-related disclosures, or when any proposed new rules might be effective, or if they will even impact SEC submissions that contain financial statements, it is important for users of the audited financial statements to be aware of what climate-related reporting is currently required under US Generally Accepted Accounting Principles (GAAP). Understanding current financial statement requirements can be a useful starting point for investors and others as they consider how and where to obtain their desired climate-related information to make capital allocation decisions and bridge any information gap that may exist today ahead of future rulemaking by the SEC or others.

The public company audit profession is supportive of a continued dialogue among all stakeholders in the corporate reporting ecosystem to support the presentation of consistent, relevant, comparable, and reliable climate-related measures and disclosures. This publication is intended to support such a dialogue by providing a foundational understanding

1 https://www.sec.gov/news/public-statement/lee-climate-change-disclosures

2 SEC.gov | Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar

3 ibid

of how the key elements of the current accounting and auditing requirements in the United States are required to be applied by company management and auditors with respect to climate-related risks and the audited financial statements.[4]

CLIMATE-RELATED RISKS AND THE FINANCIAL STATEMENTS

Management is responsible for preparing the financial statements of the entity in accordance with US GAAP, including assessing whether they reflect all required disclosures, including climate-related if applicable. Although today US GAAP does not include explicit references to climate-related risks, companies are required to consider them when the effect could reasonably be material to the financial statements. The financial reporting requirements for climate-related risks will vary from company to company and depend on several factors, including the nature of the company's business, its industry, geographic footprint, types of underlying transactions and the significance of the climate-related risk to the entity's business, among others.

Forward-looking climate-related risks that could potentially impact an entity's financial statements typically fall into one of the following categories: (1) physical risks (e.g., the risk that an entity's facilities will be damaged by a severe weather event or that a company will need to relocate its facilities away from low-lying coastal areas) or (2) the risks associated with the transition to a low-carbon economy (e.g., regulatory risk associated with required changes to a company's business and/or the impact of a company's net-zero commitments on management's evaluation of impairment or the useful lives of assets).[5]

The time horizon for which climate-related risks come to fruition also will vary by company and industry; therefore, while risks may exist, the impact on the current-period financial statements may not be material.[6] Some climate-related risks may directly affect amounts and/or information reported and disclosed in the financial statements, while others may only indirectly affect information included or disclosed in the financial statements, and still others may have no impact on the financial statements at all.

We have observed a growing trend in companies making commitments to be carbon neutral or carbon negative by a specified date in the future. This trend seems to span across many industries, from energy companies that historically relied on fossil fuels committing to substantially reduce their carbon emissions, to automotive manufacturing entities committing to phase out production of traditional vehicles that are powered by fossil fuels. The impact of such commitments on a given company's financial statements and audit will vary depending on a number of factors including actions management has taken, or plans to take, to achieve those commitments; the timing of those actions; and the costs associated with them. Consider a hypothetical example to illustrate how management might consider climate-related risks when preparing financial statements.[7]

4 This resource is intended as general information and should not be relied upon as being definitive or all-inclusive, or as a substitute for the applicable accounting and auditing standards, requirements, guidance, or other laws and regulations.

5 To the extent climate-related risks manifest themselves into risks of material misstatement such that there could be accounting or disclosure impacts, management also would be responsible for modifying its internal controls over financial reporting (ICFR) to properly identify and consider such risks. In situations where the auditor is engaged to perform an ICFR audit, the auditor also would consider the company's ICFR and assess whether the company's controls are designed and operating effectively to prevent or detect a material misstatement in the company's financial statements.

6 Management's assessment of the materiality of climate-related risks is a key consideration in determining the financial reporting requirements, and one that can involve significant judgment. Under US GAAP, "*The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.*" *FASB, Statement of Financial Accounting Concepts No. 8, Conceptual Framework for Financial Reporting, As Amended*

7 The examples included herein are for illustrative purposes only and should not be relied upon as being definitive or all-inclusive. See the FASB Staff Education Paper, *Intersection of Environmental, Social, and Governance*, for additional considerations as to how climate-related risks may intersect with financial reporting requirements.

EXAMPLE #1

Company Z, a public domestic manufacturing entity, has publicly announced a commitment to achieve net-zero carbon emissions by 2030. In the prior year the company disclosed in the Risk Factors section of its Form 10-K risks related to

+ compliance with any potential new state and federal legislative and regulatory initiatives aimed at reducing carbon dioxide and other greenhouse gas emissions, and
+ increased investor interest in corporate sustainability initiatives.

Management's activities and conclusions

+ The company's board of directors approved management's decarbonization plan, which detailed the actions that the company plans to take in order to achieve net-zero carbon emissions by 2030.
+ Management has already begun to implement the decarbonization plan, which includes assessing the impact to operations, customer base, and expected long-term cash flows.
+ In connection with the assessment, the company reviewed significant factors that will impact its operations. This included a determination that the company will need to incur significant capital expenditures to retrofit certain long-lived assets to meet their internal emissions targets and a decrease in expected sales volume to produce and deliver product in a low-carbon economy.
+ Based on review of the decarbonization plan and input from specialists, management estimated that its net-zero commitment and the potential changes to any emissions regulations will result in approximately 30 percent of its physical manufacturing assets needing to be retrofitted by 2030.
+ Management also evaluated its decarbonization plan and concluded that it will result in a significant change in the manner in which certain of its physical manufacturing assets will be used.
+ As a result, management determined that impairment indicators existed for some of its manufacturing assets and evaluated the recoverability of the related asset groups. In carrying out impairment testing,
    - management concluded that the undiscounted cash flow projections directly associated with the use and eventual disposition of the manufacturing assets (asset group) did not exceed their carrying amount; and
    - therefore, management estimated the fair value of the manufacturing assets (asset group) to determine the impairment charge.

Financial statement impacts

+ Management recorded a material impairment charge in its financial statements that represented approximately 20 percent of its property, plant and equipment (PP&E) account to reduce the carrying amount of the manufacturing assets (asset group) to their fair value. In addition, management updated the estimated useful lives of the assets, which were originally expected to be in service until 2050, and management also updated the expected salvage values to appropriately recognize depreciation in future periods.
+ In addition to recording the impairment charge in its financial statements and making other required disclosures, including outside of the financial statements such as in the management's discussion & analysis (MD&A), management disclosed in accordance with US GAAP (1) a description of the impaired assets and the facts and circumstances that led to the impairment; (2) the amount of the impairment, as it was not presented separately on the face of the income statement; (3) the method used to determine the fair value of the assets; and (4) the segment in which the impaired assets are reported.

EXAMPLE #2

Let's continue the above example with the same fact pattern except let's now assume that management's commitment is to be net-zero by 2050 and its activities and conclusions are as follows:

Management's activities and conclusions

+ The company does not expect any significant impact to the demand for products or services as a result of the transition to a net-zero carbon emissions production model by 2050.
+ Management estimates that the capital expenditures required for its manufacturing facilities to comply with the 2050 net-zero commitment do not need to commence until 2035.
+ Management incorporated its projections into its cash flow analyses and concluded that the impacts did not materially affect the company's asset impairment calculations.
+ Based on the above considerations, management concluded that the future cash expenditures are not material to the company's current-year financial statements.

Financial statement impacts

Management determined that its commitment to achieve net-zero did not have a material impact on its current-year financial statements and additional disclosures would not change or influence the judgment of a reasonable person. While the future capital expenditures needed to meet the company's net-zero carbon commitment will be a direct impact on the financial statements in the future, they do not materially impact the company's current financial statements as a whole and therefore likely would not require separate disclosure in the financial statements today.

CLIMATE-RELATED CONSIDERATIONS AND THE FINANCIAL STATEMENT AUDIT

Risk assessment

Public Company Accounting Oversight Board (PCAOB) auditing standards require the financial statement auditor to perform a risk assessment, which includes the auditor obtaining an understanding of the company and its environment. The auditor's risk assessment includes consideration of relevant industry, regulatory, other external factors and the company's objectives, strategies, and business risks that might reasonably be expected to result in risks of material misstatement.[8] The risk assessment encompasses climate-related risks and their potential impact on an entity's financial statements.

When assessing the potential impact of climate-related risks, the auditor might consider it necessary to conduct inquiries of management, including personnel outside the finance department (e.g., chief sustainability officer, office of general counsel, risk and compliance or sustainability committees) to understand how and when management expects climate-related risks could impact the entity and how management plans to consider such risks in the preparation of the financial statements.[9]

The auditor also would consider other sources of information outside of the financial statements that may further inform the auditor's risk assessment as to the potential impact of climate-related risks. Such sources of information might include an entity's press releases or other forms of public-facing communications, earnings calls, other sections of the Form 10-K outside of the financial statements (e.g., MD&A, discussion of legal proceedings, risk factor disclosures), sustainability report(s), board and committee minutes and/or other industry-specific publications. For entities that are more significantly impacted by climate-related risks, auditors might consider it necessary to engage a climate specialist to assist the engagement team

8 PCAOB AS 2110.07-.09, *Identifying and Assessing Risks of Material Misstatement*, also includes other matters that the auditor is required to consider when performing risk assessment.

9 Such inquiries could be conducted in conjunction with the inquiries required under PCAOB AS 2110.54, *Identifying and Assessing Risks of Material Misstatement*.

As part of risk assessment, the auditor might consider questions in the following areas, among others, to understand the potential impact of climate-related risks on the entity's financial statements:

Management's consideration of climate-related risks

For example:

+ What statements has the company made externally about its climate-related commitments and what impact has that had on the preparation of the financial statements?
+ What is management's process for identifying and assessing climate-related risks and their impact on the financial statements?
+ How has management considered the timeline of its decarbonization plan in the preparation of the financial statements? What is the level of estimation uncertainty related to management's decarbonization timeline?

Legislation/regulation risk(s)

For example:

+ What current and future regulations may impact the entity (e.g., greenhouse gas emission regulations, potential increases in taxes on current products, future climate-reporting obligations)? What is the expected timeline for when such regulations might take effect? Are such regulations expected to impact current asset valuations now and/or in the future?

Transition risk(s)

For example:

+ How are potential changes in customer demand preferences, such as the desire for more sustainable products, expected to impact the demand for the company's current product portfolio? Have such demand considerations been factored into the underlying assumptions in the company's asset valuation models?
+ Do the company's estimated future cash flows properly consider the risks related to transitioning to a low-carbon economy (e.g., risk associated with developing a new manufacturing process or lower-emission alternative products)?

Supply chain risks

For example:

+ Does the company have key suppliers that may be impacted by climate-related risks? If so, has management considered how such supplier risks will ultimately impact the company, if at all?

with the risk-assessment process. Further, based on the risk assessment, auditors are required to understand the methods, assumptions, data, and relevant processes and controls used by management to develop accounting estimates. This encompasses climate risks to the extent they are relevant to those estimates.

General audit considerations

The auditor's overall objective of a financial statement audit—as set forth by existing PCAOB auditing standards—is to obtain reasonable assurance that the financial statements are free of material misstatement whether due to error or fraud and to assess whether the financial statements were prepared in accordance with US GAAP in all material respects. Most climate-related information that is publicly available today is disclosed outside the audited financial statements, such as on a company's website or in a separate sustainability report. PCAOB standards do not require the financial statement auditor to perform procedures over climate-related disclosures when they are made outside of documents that contain the audited financial statements. Financial statement auditors do, however, have a responsibility to consider the appropriateness of management's consideration of the financial statement implications of potential risks of material misstatement, which encompasses climate-related risks.

Throughout the audit, the auditor also evaluates any contradictory information that comes to the auditor's attention in evaluating the sufficiency and appropriateness of audit evidence in response to risks of material misstatement, which encompasses those related to climate.

Critical audit matters

A critical audit matter (CAM) is any matter communicated, or required to be communicated, to the audit committee that relates to an account or disclosure that is material to the financial statements and that involves especially challenging, subjective, or complex auditor judgment.[10] Climate-related risk assumptions often represent just one of many inputs considered in the development of management's accounting estimates that may require complex auditor judgment.

Given that climate-related risks do not represent financial statement accounts or disclosures, they likely would not represent a CAM in and of themselves; however, depending on the nature of an entity's business, climate-related considerations may be included in a CAM in the auditor's report. Climate-related assumptions could represent principal considerations that lead the auditor to determine that a matter is a CAM if auditing such assumptions is especially challenging and requires complex auditor judgment. In situations where climate-related risks relate to principal considerations for a matter being a CAM, the description of the principal considerations may include discussion of climate-related risk; however, there are no requirements for the auditor to communicate their consideration of climate-related risks (e.g., as part of risk assessment or otherwise) in the auditor's report.

In example #1 above, company Z's impairment analysis likely included assumptions related to future market and economic conditions and long-term demand for company Z's products that the auditor may have determined were especially subjective and/or complex and contributed to a CAM. While climate-related assumptions also were included in company Z's impairment analysis such as the disposition values of some of its high-emission manufacturing assets and the impact of the entity's net-zero commitment on the manufacturing assets' useful lives, the auditor may have determined that auditing the climate-related assumptions was less subjective and/or complex than auditing the other aforementioned assumptions. As a result, the auditor may conclude that the climate-related assumptions were not the principal considerations for auditing the valuation of PP&E being especially challenging, subjective, or complex and therefore did not include them in the CAM description.

Other information

Auditors have a responsibility to read other information included in documents that contain audited financial statements, such as climate-related disclosures included in the description of

10 PCAOB AS 3101.11, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

the business, discussion of legal proceedings, risk factors, and MD&A, and consider whether such information, or the manner of its presentation, is materially inconsistent with information appearing in the audited financial statements.[11] For example, if a company discloses climate-related emissions targets and any progress in achieving them in these sections within its Form 10-K, current PCAOB standards require the financial statement auditor to read the presented climate-related information for consistency with the financial statements and consider whether they are aware of a material misstatements of fact.[12] While the auditor would take action if there are any such inconsistencies or misstatements, the auditor does not provide assurance over that information.

CONCLUSION

The CAQ looks forward to continuing its contributions to the dialogue as to how, if at all, financial reporting requirements around climate-related risks, including auditor responsibilities on such requirements, should adapt to meet the evolving information needs of investors and other stakeholders.

11 PCAOB AS 2710.04, *Other Information in Documents Containing Audited Financial Statements*

12 A material misstatement of fact is a high threshold, and given the nature of climate-related information, it may be highly unlikely the auditor would be aware of a misstatement of fact since such information is outside the scope of an audit of financial statements and internal control over financial reporting.