Sustainability-related disclosures and financial statements - what is required and the auditor's role

Investors and other stakeholders increasingly expect a company's financial statements and sustainability-related disclosures to provide an integrated picture of its performance. This has prompted discussion on whether financial reporting standards result in financial statements that contain the information required by investors to assess climate- and other sustainability-related risks and opportunities.

We believe there is an information gap between the information currently required to be measured and disclosed by companies in their financial statements under the requirements of IFRS Accounting Standards, and that which some investors desire. Standard setters have initiatives underway to help address the current information gap, for example, greater connectivity between sustainability-related corporate disclosures and financial statements.

We disagree with the assertion, by some, that current financial statement reporting by preparers and assurance practices by auditors don't meet the requirements of existing professional standards to take climate change impacts into account. Each of the GPPC networks is fully committed to meeting professional obligations and following relevant standards, laws and regulations. However, each member of the corporate reporting ecosystem has an important role to play in driving progress around the reporting of climate impacts – standard setters, regulators, preparers, those charged with governance, investors and auditors.

Role of the auditor in relation to financial statements

There are important distinctions between the responsibilities of management and auditor.

IFRS Accounting Standards establish a baseline of information that is required to be prepared by management. Management is responsible for providing financial statements and disclosures that comply with IFRS Accounting Standards.

The auditor's role is to perform procedures to provide reasonable assurance that financial statements prepared by management, including disclosures, are presented fairly in accordance with the requirements of the applicable financial reporting framework.

In most jurisdictions, auditors cannot provide original information about the company in their audit opinion, nor can auditors require companies to make additional disclosures or reflect information in their financial statements, that go beyond requirements of the standards.

In order to remain objective and independent, the auditor should not take on responsibilities that belong to management. In other words, the auditor should not substitute as the original source of information that should come from management.

Difference between what IFRS Accounting Standards require and what some might expect

'Fair value' determination is an example that illustrates why climate-related factors may not be addressed in the manner some might expect.

Under the IFRS Accounting Standards used by companies to prepare financial statements, fair value is a market-based measurement – using assumptions that market participants would use, reflecting market conditions as of the measurement date. Under IFRS Accounting Standards a quoted price in an active market provides the most reliable evidence of fair value, and if one is available then, it must be used to measure fair value.

Fair value is used as a recognition and measurement basis in a number of areas under IFRS Accounting Standards. For example, non-financial asset impairment testing considers the higher of fair value less costs of disposal and value in use, which must be determined using reasonable and supportable assumptions.

When fair value is used as the basis for the impairment determination, it is required to reflect market data/ expectations, which is not an entity-specific measurement, and which may be different than what is needed to meet the Paris goals as some may expect.

Further examples of why certain climate-related factors may not be addressed under current professional standards and obligations are included in Appendix A.

Connecting standards

The International Accounting Standards Board (IASB) has recently launched a project to explore whether and how companies' financial statements can provide better information about climate-related risks; they will be looking at:

- stakeholders' concerns about inconsistent application and insufficient information;
- whether the IFRS Foundation's educational material on the effects of climate-related matters on financial statements and the application of the International Sustainability Standards Board (ISSB) standard on climate-related disclosures help to address these concerns; and
- consider whether and what actions might be needed.

This project is part of a package of connectivity measures announced by the IASB and ISSB chairs.

The GPPC networks have been responsive to investors' concerns by taking a leading role in engaging with the financial reporting and auditing standard-setters and other interested parties. We want to help improve the connectivity between the financial statements and the rest of an annual report and help shape standards governing disclosure of the information that investors need. The GPPC supports improved connectivity between financial statements and the rest of the annual report to help investors assess the impacts of climate-related risks and opportunities on a company's prospects.

The effects of climate change have potentially far-reaching implications for many businesses, some that will result in new and material risks that must be managed. Ensuring that those risks are transparently identified, reflected and disclosed will help investors make better-informed decisions.

The GPPC networks urge stakeholders to continue to work together to bring about the change required to address the needs of global capital markets, stakeholders and society.

Appendix A – Examples of why certain climate-related factors may not be addressed under current standards and obligations

- *Long-term goals in respect of climate do not necessarily translate into a current impact on the financial statements as they do not yet meet requirements for recognition. For example, standards only permit a recognition of a liability as a result of a past event (when a liability is incurred). Obligations cannot be recognized for anticipated restructurings until there is an obligation to restructure. Similarly, an expression of a general commitment to align to Paris or offset emissions is unlikely to give rise to a liability recorded in the financial statements.*

- *Companies are only required to disclose information about the assumptions they make about the future and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.*

- *Even though climate-related factors may be present and may reduce the value of a company's assets, no write downs will be required if the carrying amounts of those assets are recoverable though the estimated cash flows over their remaining useful lives. If a reduction in useful life is warranted (i.e. due to a change in the ways finite lived assets are used), such changes are typically accounted for prospectively resulting in a shorter useful life and higher depreciation expense over the remaining useful life rather than a single 'catch up' charge the current period.*

- *Prices under different Paris scenarios are not necessarily market prices/fair values which accounting standards typically require to be used.*

- *The impact of climate risk cannot be readily or easily disaggregated from the key assumptions that are commonly used in financial statements such as discount rates, growth rates or market-based commodity price assumptions.*