



## Reflecting climate-related matters in financial statements

### 1. Introduction

In June 2023, the International Sustainability Standards Board (ISSB), published its inaugural sustainability reporting standards, marking an important step towards comparable and reliable corporate sustainability reporting. A key aspect of high-quality reporting is ensuring consistency between information disclosed in financial statements and information communicated in other parts of the annual report or in a separate sustainability report. Ensuring connectivity and consistency of information is high on standard-setters' agendas.

This Viewpoint focuses on climate change and explores whether climate-related matters are adequately reported, specifically in financial statements. Among the broad range of sustainability issues, climate change is a material topic for companies in nearly all economic sectors, and on which reporting is relatively more advanced. For several years, investors have encouraged companies to account for material climate-related risks and decarbonisation commitments in their financial statements. To help companies and auditors, standard-setters have clarified how climate-related matters may impact key accounting assumptions under existing standards. Yet, despite some companies paving the way for more "climate conscious" accounting, progress remains overall relatively limited. This Viewpoint discusses why accounting for climate change matters to investors, identifies potential obstacles impeding progress, and makes suggestions for constructive dialogue between investors and companies on this matter.

### 2. Investors expect climate-conscious accounting and auditing

The number of large publicly listed companies with net zero emissions targets aligned with the Paris Agreement has more than doubled in three years, from 417 in 2020 to 929 in 2023.<sup>1</sup> While investors have welcomed these commitments, many are also concerned that long-term net-zero targets, and shorter term milestones, are not always adequately reflected in a company's financial statements. A lack of reference to net zero targets suggests that either 1) it may not be a genuine commitment, which would raise concerns over greenwashing or 2) the accounts may not reflect the true financial position of the entity.

Investors have also long called for the anticipated impacts from government policies to accelerate decarbonisation (transition risks) or the physical impacts from climate change (physical risks) to be adequately accounted for.<sup>2</sup> For instance, if a government announces a ban on the sale of petrol and diesel cars, investors would expect a company to update its cash flow projection for assets that can only be used to make those types of cars, to reflect lower projected cash inflows from those assets.

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<sup>1</sup> Net Zero Tracker, [Net Zero Stocktake](#), June 2023

<sup>2</sup> International Federation of Accountants, [Corporate Reporting: Climate Change Information and the 2021 Reporting Cycle](#), September 2021, "If [corporate actions] result in material financial implications, they should be reflected in a company's financial reporting."

Beyond these investor concerns that accounts may not provide a faithful representation of financial position of an entity due to a lack of consideration of climate change impacts, there are important market-wide implications. There is a need for better climate-related disclosures, including in financial accounts, to ensure markets reflect the true economic costs of climate-related risks to society and capital is allocated towards sustainable activities and companies<sup>3</sup>. The longer climate-related risks are not adequately reflected in corporate reports, the greater the danger of mispricing in the market, misallocation of capital, and system-wide disruptions.

In response to these concerns, investors have been calling for climate change impacts to be explicitly considered in corporate financial accounting. Investors wish to understand whether and how climate-related risks and commitments have affected the measurement of assets, liabilities, profits and cash flows. These calls were emphasized by a number of investor groups in a joint statement in September 2020.<sup>4</sup> In November 2020, detailed investor expectations for what this entails were published by the Institutional Investor Group on Climate Change (IIGCC), representing investors managing more than €50 trillion.<sup>5</sup> This was followed by targeted engagement with companies and auditors, which continues today.<sup>6</sup> In 2021, the Climate Action 100+ initiative, representing over \$60 trillion in AUM, added pilot metrics on accounting and audit to their benchmark for assessing company performance on climate change. These metrics often guide investor stewardship activities, specifically company engagement and voting decisions.

There is also evidence of shareholder activism on this topic, through shareholder proposals requesting climate-related risks be reflected in financial statements. For instance, in May 2022, 52% of ExxonMobil's shareholders supported a resolution at their Annual General Meeting (AGM) asking the board to publish an audited report assessing how the company's financial position would be impacted by a 1.5°C pathway.<sup>7</sup>

Investors have also expressed their expectations of auditors, who have a crucial responsibility in verifying the reliability of corporate disclosures. In particular, when finding potential misrepresentations, auditors are obliged to disclose this in their written opinions presented to shareholders.

In the 2020 IIGCC report<sup>8</sup>, investors set out their expectations of auditors by asking for confirmation:

- that critical accounting estimates or judgements **reflect material climate-related risks**, in line with accounting standards.
- whether these critical assumptions and estimates can be considered Paris-aligned, and, if not, whether **Paris-aligned assumptions** have been adequately considered and disclosed in the Notes to the Financial Statements.
- there is **consistency** between the narrative disclosures on climate-related risks and the financial statements.
- pertinent capital maintenance / solvency tests have considered climate risks, and **dividends** are appropriately funded and legal.

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<sup>3</sup> Financial Times, [A long-awaited release from Emmanuel Faber's ISSB](#), 26 June 2023

<sup>4</sup> PRI, [Investor groups call on companies to reflect climate-related risks in financial reporting](#), September 2020

<sup>5</sup> Natasha Landell-Mills, Institutional Investor Group on Climate Change (IIGCC), [Investor Expectations for Paris-aligned accounts](#), November 2020

<sup>6</sup> IIGCC, [Net Zero Engagement Initiative](#), March 2023

<sup>7</sup> ExxonMobil, [Notice of 2022 Annual Meeting and Proxy Statement](#), April 2022

<sup>8</sup> IIGCC, [Investor Expectations for Paris-aligned Accounts](#), November 2020

Auditors may provide this information through their disclosure of Key or Critical Audit Matters and consider whether this necessitates a qualification to their opinion on the financial statements.

### **3. Standard-setters and regulators have underlined requirements for climate impacts to be reflected in accounting**

In 2020 and 2023, the IFRS Foundation published educational material examining how climate factors might impact key accounting assumptions under individual IFRS Standards.<sup>9</sup> This built on an article published in 2019 by International Accounting Standards Board (IASB) Member Nick Anderson. The article concluded that climate risk has the potential to be linked into a range of accounting considerations, such as:

- asset impairment, including goodwill;
- changes in the useful life of assets;
- changes in the fair valuation of assets;
- effects on impairment calculations because of increased costs or reduced demand;
- changes in provisions for onerous contracts because of increased costs or reduced demand;
- changes in provisions and contingent liabilities arising from fines and penalties, and
- changes in expected credit losses for loans and other financial assets.<sup>10</sup>

The Financial Accounting Standards Board (FASB) in the United States published its own Staff Paper covering climate change in March 2021.<sup>11</sup>

More recently (in March 2023), the IASB added a project to its work programme to explore whether and how companies can provide better information about climate-related risks in their financial statements.<sup>12</sup>

Regarding audit, the International Audit and Assurance Standards Board (IAASB) issued a staff practice alert in 2020, reminding auditors of their responsibility to consider material climate risks in an audit of financial statements, just as they would other material factors.<sup>13</sup>

Regulators have also reinforced the message to both companies and auditors that they must, under existing rules, ensure that financial reports cover material climate-related risks. For instance, both the UK's Financial Reporting Council (FRC) and the European Securities Markets Authority (ESMA) issued statements to warn of their increasing scrutiny of company accounts on this matter.<sup>14</sup> In October 2023, ESMA also published a report providing guidance to help companies and auditors consider climate-related matters in IFRS financial statements.<sup>15</sup> The US Securities and Exchange Commission (SEC) proposed a rule which, if

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<sup>9</sup> IFRS Foundation, [Educational material on the effects of climate-related matters](#), November 2020; [republished](#) in July 2023

<sup>10</sup> Nick Anderson, [IFRS Standards and climate related disclosures](#), November 2019

<sup>11</sup> FASB, [Staff Educational Paper - Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards](#), March 2021

<sup>12</sup> IFRS, [IASB initiates project to consider climate-related risks in financial statements](#)

<sup>13</sup> IAASB, [The Consideration of Climate-Related Risks in an Audit of Financial Statement](#), October 2020

<sup>14</sup> UK FRC, [Areas for supervisory focus 2022/2023](#), December 2021 and [CRR thematic](#) review of TCFD disclosures and climate in financial statements, July 2022; ESMA, [European common enforcement priorities for 2022 annual financial reports](#), October 2022, and [European common enforcement priorities for 2023 annual financial reports, October 2023](#), October 2023

<sup>15</sup> ESMA, [Disclosures of Climate Related Matters in the Financial Statements](#), October 2023

adopted, would require detailed disclosures in companies' financial statements on how they have accounted for material climate factors.<sup>16</sup>

The Financial Stability Board has established the Network for Greening the Financial System (NGFS) to help guide central banks on assessing and managing climate risks in the financial system. A rising number of prudential authorities are undertaking climate stress testing of banks' capital strength, including the European Central Bank, the Bank of England, the Bank of Canada, the US Financial Stability Oversight Council, and the Federal Reserve.

In parallel, standards and regulatory requirements on broader climate-related reporting are evolving rapidly at national and international levels. In the European Union, companies subject to the Corporate Sustainability Reporting Directive (CSRD) will have to report according to European Sustainability Reporting Standards (ESRS). At global level, the International Sustainability Standards Board (ISSB) issued its two inaugural standards in June 2023 - IFRS S1 on General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 on Climate-related Disclosures - building on existing frameworks, such as the Taskforce for Climate-related Financial Disclosures recommendations. National authorities are now considering implementing these standards in their national regulatory frameworks. In August 2023, the International Auditing and Assurance Standards Board (IAASB) issued its Exposure Draft of a proposed standard for sustainability assurance, designed to enhance the trust investors, regulators, and other stakeholders can place in corporate sustainability information. Furthermore, an ethics framework for sustainability reporting and assurance (including standards of independence for all providers of sustainability assurance) is being developed by the International Ethics Standards Board (IESBA) with a view to its approval and issuance by the end of 2024.

Under the ISSB standards, enabling users of information to understand the connections between sustainability-related financial disclosures and financial statements is a key requirement. More generally, the relationship between sustainability reporting and financial statements is currently a topic of research and discussion among standard-setters. The Chairs of the IASB and the ISSB highlighted the importance of ensuring connectivity of information in a recent article.<sup>17</sup> The European Financial Reporting Advisory Group (EFRAG) has set up a dedicated "Connectivity Advisory Panel" and the UK Endorsement Board (UKEB), which adopts and endorses IFRS Accounting Standards for use in the UK, is also conducting research on this topic<sup>18</sup>.

#### **4. There is room for significant improvement**

A number of companies are making efforts to provide disclosures on how climate-related matters have been considered in the preparation of financial statements, disclosures on critical accounting assumptions and, in certain cases, 1.5°C sensitivities in the Notes to the accounts. In a report published in October 2023, ESMA identified examples of selected companies

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<sup>16</sup> US SEC, [Proposed Rules to Enhance and Standardize Climate-Related Disclosures for Investors](#), March 2022

<sup>17</sup> IASB and ISSB Chairs, write in an [article](#) "Sustainability-related financial disclosures and financial statements complement each other. For example, sustainability-related financial disclosures may explain the sustainability-related risks and opportunities arising from an entity's activities and its assets and liabilities. Such disclosures may also provide early indications of matters that will subsequently be reflected in financial statements. For example, a company's commitment to net zero emissions could, over time, result in liabilities being reported in the financial statements", March 2023

<sup>18</sup> UK Endorsement Board, [A Study in Connectivity Analysis of 2022 UK Company Annual Reports](#), September 2023

integrating climate-related considerations in their financial statements, with illustration across nine sectors. EY also presented useful illustrations in an August 2023 report<sup>19</sup>.

Despite some companies paving the way for more “climate conscious” accounting, progress remains overall relatively limited. This has been underlined by two reviews of the largest listed carbon-intensive companies’ financial statements, undertaken by Carbon Tracker in 2021 and 2022. The 2022 ‘Still Flying Blind’ report<sup>20</sup> highlights that of 134 companies responsible for up to 80% of corporate industrial greenhouse gas emissions, 98% did not provide sufficient evidence that their financial statements include the impacts of climate-related matters. The report also observes that 96% of the audit reports reviewed did not sufficiently indicate whether and how the auditors considered the impact of climate issues.<sup>21</sup> A similar critique was expressed in 2023 by the UK-based Corporate Reporters Users Forum.<sup>22</sup>

The latest ESMA annual report on corporate reporting enforcement and regulatory activities highlighted that “there is significant room for improvement in relation to disclosures of climate-related matters in IFRS financial statements”. The report noted that “[regulatory authorities] considered that information regarding climate-related matters in financial statements was often incomplete or altogether missing. This observation is particularly concerning when the issuer operates in a sector which is expected to be highly impacted by climate risks or is located in areas where climate risks are expected to be relevant.”<sup>23</sup>

Potential obstacles to faster progress may include:

- **An uncertain future.** To some extent, current disclosures in financial statements reflect a lack of clarity amongst some companies as to how they intend to deliver on their net zero commitments. The disconnect between net zero commitments, credible action plans and capital deployment is highlighted by the Climate Action 100+ recent assessment of companies.<sup>24</sup> In 2022, the International Federation of Accountants (IFAC) also conducted a review of emissions reduction targets and transition plans of the 40 largest exchange-listed companies in 15 jurisdictions.<sup>25</sup> It found that the nature and scope of companies’ targets and transition plans (in terms of emissions covered, timeframes, and use of carbon offsets) varied widely. Just 24% of companies that reported a target and a transition plan quantified the future expenditures associated with its implementation.

There is also uncertainty over government policies and the physical impacts of climate change, both of which matter to critical forward-looking assumptions that companies make.

Notwithstanding these uncertainties, investors expect company boards to provide their best estimate for climate-related financial impacts. Key uncertainties should be disclosed in the Notes to the accounts, alongside (where relevant) sensitivities for critical accounting assumptions. Over time, we anticipate that we will see more and more detailed scenarios for individual sectors that help to provide a reference point for considering future financial

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<sup>19</sup> EY, *Applying IFRS Accounting for Climate Change*, August 2023

<sup>20</sup> Barbara Davidson and Rob Schuwerk, *Flying Blind: the absence of climate risks in financial reporting*, Carbon Tracker Initiative and PRI, October 2022

<sup>21</sup> Carbon Tracker, *Still flying blind: The Absence of Climate Risk in Financial Reporting*, October 2022

<sup>22</sup> Sue Harding, Corporate Reporting Users Forum, *Getting visibility on the financial statement effects of climate change*, January 2023

<sup>23</sup> ESMA, *Report: 2022 Corporate Reporting Enforcement and Regulatory Activities* March 2023

<sup>24</sup> Climate Action 100+, *Net Zero Company Benchmark* shows continued progress on ambition contrasted by a lack of detailed plans of action, October 2023

<sup>25</sup> IFAC, *Getting to Net Zero: A Global Review of Corporate Disclosures*, November 2022



impacts. Also, the methodologies for establishing and disclosing transition plans are developing rapidly, with for instance the UK Transition Plan Taskforce's Disclosure Framework, published in October 2023.

- **Time-frame.** Climate change impacts might often be considered as too far into the future to be relevant to financial statements, which report on the past 12 months' performance. While accounts provide a point-in-time view of recent financial performance, they incorporate several forward-looking assumptions, which often look many years into the future. Impairment testing for assets, for instance, requires assumptions around future cash flows those assets will generate, as one of the key factors for determining whether they need to be written down. A failure to incorporate foreseeable losses and liabilities could also result in a misrepresentation of the entity's embedded value.
- **1.5°C sensitivity analysis,** Investors often seek sensitivity analyses to help them understand the potential financial consequences of a 1.5°C pathway promised by global leaders. Whilst some might not consider a 1.5°C pathway the most likely scenario and thus not a basis for drawing up company accounts, it is a reasonable scenario to consider given the existence of the Paris Climate Agreement, signed and ratified by 195 countries. In many cases, this can take the form of disclosures in the Notes to the accounts, and not the core accounts themselves. This is consistent with most accounting frameworks globally.
- **Regulatory enforcement.** Standard-setters have limited authority if their standards are not endorsed and enforced by regulators. In many markets, regulators may lack the resources to promote the need for companies to disclose climate-related matters in financial statements in an effective way. In some jurisdictions, this might also be politicised by those who may oppose enhanced corporate climate-related reporting.
- **Conflicts of interest and independence.** Company boards should identify and manage conflicts of interest, to ensure unbiased board decision-making. The board should affirm that the company's annual report and accounts present a true and fair value of the company's position and long-term prospects, as highlighted in the ICGN Global Governance Principles.<sup>26</sup> Similarly, external auditors must discharge their obligations under professional standards with quality, integrity, and independence. When it comes to sustainability reporting, including in financial statements, ethical behaviour and independence of both preparers and auditors are key to ensure the integrity and reliability of the reporting. We welcome the work of the International Ethics Standards Board (IESBA) in this area.
- **Capacity-building.** In the journey towards the integration of climate-related considerations in financial statements, there is a need to develop knowledge and build capacity across the entire financial ecosystem of companies, auditors, investors, standards-setters and regulatory authorities. Investors encourage all capital market participants to be transparent about their progress in building this capacity.

## 5. Stewardship dialogue

ICGN encourages investors to engage in a constructive dialogue with investee companies, with the objective of creating long-term value on behalf of beneficiaries or clients. We

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<sup>26</sup> ICGN, [Global Governance Principles](#), 2021

encourage investors to continue developing their understanding of how climate considerations might impact companies' financial statements and to engage with company boards on this matter.

Company boards have a key oversight role to play in ensuring that climate considerations are integrated into governance, strategy, risk management and reporting. ICGN encourages corporate boards to be open to engaging with investors and be transparent about the challenges the company is facing in its journey towards better climate-related reporting. More generally, more constructive dialogue between investors and audit committees would be valuable. In the UK for instance, over three-quarters of FTSE 350 audit committee chairs report that they engage with investors less than once a year, if at all.<sup>27</sup>

Questions that investors may consider asking company boards include:

- What measures have you taken to ensure that audit and risk committee members have the skillset to oversee climate change risks?
- How do your different company departments collaborate to ensure the integration of climate change considerations into governance, strategy, risk management and reporting (including in financial statements)?
- Can you confirm that climate-related risks and any commitment made by the company to reduce greenhouse gas emissions have been considered in drawing up the accounts?
- To what extent is climate change being incorporated into key accounting assumptions about areas such as impairments, depreciation and asset decommissioning? How is this likely to change in future?<sup>28</sup>
- Could you provide visibility on how a 1.5°C pathway and a faster warming pathway would impact the reported financial statements in the form of sensitivity analysis presented in the Notes to the accounts?
- Can you please outline the steps taken to ensure material climate-related risks are properly considered by the external auditor?

Beyond engaging with company boards, investors have several stewardship tools at their disposal to voice their concerns when companies have not adequately reflected climate change in financial statements. They can, for instance, take part in a collaborative engagement with other investors, vote against the chair of the audit committee and its members, or file a shareholder resolution asking for disclosures on how climate change have been considered in the preparation of financial statements. Investors may also decide to ask questions to the external auditor if permitted, or to vote against its reappointment. Engagement with regulators and standard-setters might also be a constructive approach, asking for more guidance to help companies in their integration of climate-related considerations in financial statements.

## 6. Conclusion

Reliable corporate reporting is crucial to support informed board decisions on capital allocation, sound investment decisions and well-functioning markets. As companies globally develop a better understanding of climate-related risks and opportunities, and set targets to reduce their greenhouse gas emissions, investors expect to see how these matters have been

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<sup>27</sup> KPMG, [2023 FTSE350 audit committee survey](#), August 2023

<sup>28</sup> UK FRC, [Audit committees and assurance: conversation starters](#), October 2023

reflected in company accounts. Investors also expect external auditors to consider climate-related matters in their audit of financial statements.

Company boards have a key oversight role to play and should seek to implement best practices, even if this is a complex and fast-evolving field, with uncertainties. We encourage boards to be open to discuss this topic with investors and be transparent about the challenges companies are facing in their journey towards better climate reporting, aiming for consistency and connectivity between climate-related disclosures and financial statements. Moreover, we encourage auditors to ensure the application of guidance related to climate change risks in planning and performing audits on financial statements. Finally, we encourage standard-setters and regulators to continue providing guidance to companies and auditors in this journey, with illustrative examples, and explore whether existing accounting standards would benefit from targeted amendments.

### **About ICGN Viewpoints**

ICGN Viewpoints provide opinions on key corporate governance and stewardship issues and are intended to generate debate, whilst not defining a formal ICGN position on the subject. This Viewpoint was drafted by Natasha Landell-Mills and Ronnie Lim of ICGN's Financial Capital Committee and by George Dallas, ICGN Education and Research Advisor, with a contribution from Andrew Hobbs from the ICGN Financial Capital Committee. We encourage dialogue by contacting ICGN's Global Policy Director, Severine Neervoort, [severine.neervoort@icgn.org](mailto:severine.neervoort@icgn.org), or Carol Nolan Drake, Senior Policy Manager, [carol.nolandrake@icgn.org](mailto:carol.nolandrake@icgn.org).