



Counting the cost of the climate crisis

As global temperatures climb, the associated impacts from the climate crisis will become increasingly difficult – and more costly – to manage. How are companies accounting for this risk in their balance sheets? Justin Bazalgette explains why it is important for investors to have confidence in the bottom line.

Setting the scene

In September 2020, investor groups representing over US\$100tn issued an open letter to companies on accounting standards.¹ It called on them and their auditors to fully reflect the effects of climate change commitments made by the company in their declared results. They asked for compliance with new guidance from the International Accounting Standards Board (IASB) on the need to reflect climate-related risks in financial reports.² The International Auditing and Assurance Standards Board also made it clear that climate must be included as part of audit.³

However, although the six largest accountancy firms have committed to embracing the materiality of climate change for audit purposes,⁴ investors remain concerned that companies continue to understate the effects of climate-related risks.⁵ There is also a lack of clarity in how companies and auditors have included climate in drawing up and assessing the accounts. This could result in major write downs of assets as – faced with the devastating impacts of global warming – policymakers scramble to accelerate the low carbon transition.

Oil and gas companies secure funding for new projects on the basis of projected future earnings and an assessment of the value of their existing reserves. These assumptions are also critical in telling investors about the future viability of a business.

Is it worth going ahead with a major North Sea oil development, for example? What price might the future barrels of oil produced ultimately retail at? Can the banks funding the investment be confident these funds will be repaid in full? Or might those assets be impaired or even 'stranded' as governments are forced to respond to catastrophic climate breakdown, and the investment written down?

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¹ [Investor groups call on companies to reflect climate-related risks in financial reporting | News and press | PRI \(unpri.org\)](#)

² [in-brief-climate-change-nick-anderson.pdf \(ifrs.org\)](#)

³ [IAASB Issues Staff Audit Practice Alert on Climate-Related Risks | IFAC](#)

⁴ [Six largest accountancy firms commit to embracing materiality of climate change for audit purposes \(responsible-investor.com\)](#)

⁵ [Investors tell Big-4 auditors they risk AGM rebellion over climate accounting | Reuters](#)

These dilemmas are of particular concern to investors in fossil fuel companies, but few industries can consider themselves wholly insulated from the effects of the low carbon transition or the physical risks of climate change. Aside from more frequent extreme weather events, we could see belated and drastic policy responses from governments, input shortages caused by failed harvests or marine biome collapse, and rising sea levels.

It is for these reasons that investor groups and standard-setters have called on companies to follow best practice guidelines and fully reflect climate-related risks in their financial statements. That means companies should disclose how climate change and decarbonisation commitments are being captured in their accounting assumptions and judgements. Are their accounts aligned with a 1.5°C world, as set out in the Paris Agreement? Will the company be materially impacted by climate change risks?

The aim is to challenge the disconnect between a company making bold net-zero pledges and the business-as-usual reporting still found in some company accounts. Here, the assumptions made around climate may not be transparent and it will not be clear what climate scenario has been used, how it has been assessed in the accounts, and what impact it had on the assumptions made to finalise the accounts.

Why are some companies reluctant to disclose this information? The main argument used by companies is that the information is not materially impacting their accounts. But if they do not provide transparency on the assumptions made to come to this conclusion, investors are left with high levels of uncertainty. The challenge from investors and regulators is that the judgement should be made on what is material to stakeholders. This is particularly pertinent for the biggest carbon emitters, which have to take the most action to meet their net-zero pledges.

Flying blind

Investors and their representatives have come together within Climate Action 100+ (CA100+) to review disclosures by the world's biggest carbon-emitting companies and to engage with company management. The aim is to press for sufficient information to confirm that appropriate financial adjustments have been made in the accounts to support the delivery of the company's climate commitments. However, over the past two years none of the CA100+ assessed companies have provided sufficient information to pass this test, leaving investors at risk of "flying blind", as one report has put it.⁶

What is assessed?

The Climate Accounting and Audit Alignment Assessments carried out by the Carbon Tracker Initiative assess three main areas:

- 1 The audited financial statements demonstrate how material climate-related matters are incorporated, the quantitative climate-related assumptions and estimates, and that these are consistent with the company's other reporting.
- 2 The audit report demonstrates how the auditor has assessed the material impacts of climate-related matters and identifies inconsistencies between the financial statements and the company's other reporting.
- 3 The audited financial statements are based on achieving the Paris Agreement goal of limiting global warming to no more than 1.5°C, or include a sensitivity analysis on the potential implications.

How does climate risk impact a company's financial health?

Investors are concerned about the potential financial implications arising from climate-related and other emerging risks, which include:

- 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
- changes in expected credit losses for loans and other financial assets
- investment in the business infrastructure to ensure that the company's business model is robust enough to withstand the potential physical manifestations of climate change, along with appropriate sensitivity analysis.



⁶ Still Flying Blind: The Absence of Climate Risk in Financial Reporting – Carbon Tracker Initiative

Investors need this information to assess the economic resilience of a business to climate change and the energy transition. Without it they have less chance of understanding whether management is properly preparing the company for this transition. This impacts the quality of their investment decision-making and increases the risk that capital will be misallocated, with poorer outcomes for underlying beneficiaries.

To get to net zero by 2050 to support a 1.5°C Paris-aligned pathway, companies will need to make significant changes to their current business models, potentially impacting their financial statements. For example, electricity utilities will need to phase out coal and gas-fired power stations and convert to renewable energy, impacting asset lifespans and requiring significant investment in new infrastructure. The automotive industry will need to convert its manufacturing lines – into which it has invested significant amounts of capital – from internal combustion engine models to hybrid and all-electric models. While the precise timing of this will be based on customer sales and tightening policy frameworks in specific markets, the trajectory is clear.

Industrial companies in the construction and chemical sectors will need to assess the impact of switching to renewable fuels and how to significantly reduce the carbon emissions of their operations and their supply chains. Oil and gas companies, which have historically included the future potential value of undeveloped oil fields in their overall reserve calculations, could face significant write downs in low carbon scenarios. Many companies in this sector are planning significant changes to their business models over time.

Investors also want to know how carbon pricing has been handled and what levels have been included. A sensitivity analysis is important to assess the resilience of a company's business model. Often there is only scant mention of what has been assessed, how this has been handled in the accounts, and what the impact has been.

Roles and responsibilities

There are clear and distinct responsibilities that apply to a company's board and its auditors. While these will differ somewhat by jurisdiction, these are summarised at a high level below:

- Companies are responsible for stating which components of their climate strategy, commitments and targets have been included in their financial statements, and how these have been dealt with. They should include a sensitivity analysis where there is a lack of certainty about the outcome.
- Auditors are responsible for confirming how they have assessed the company's approach to climate and for identifying any areas of concern or risk. They should specify any feedback given to the company on the improvements they have recommended.

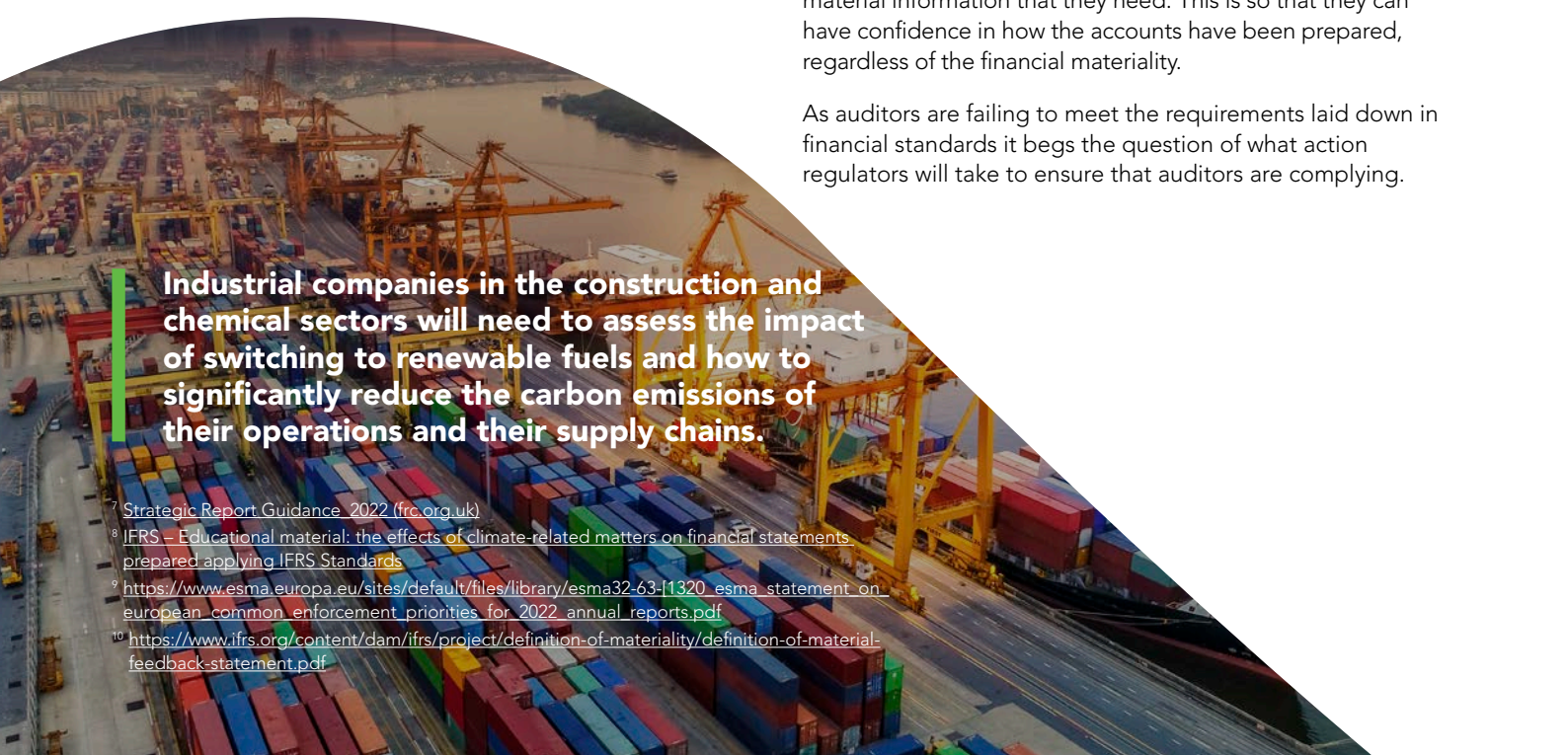
Materiality

The International Accounting Standards Board defines information as material if "omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."¹⁰

The role of auditors

Investors rely heavily on the independence of auditors and on regulators to ensure that company accounts reflect the assumptions that have been included, clearly and transparently. While regulators have provided clear guidance^{7,8,9} for when and how auditors should include information relating to climate impacts on company accounts, companies and auditors will often state that the climate commitments have not yet had a financially material impact. However, investors argue that understanding how climate change risks and opportunities are being dealt with at the world's biggest carbon emitters is material information that they need. This is so that they can have confidence in how the accounts have been prepared, regardless of the financial materiality.

As auditors are failing to meet the requirements laid down in financial standards it begs the question of what action regulators will take to ensure that auditors are complying.



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⁷ Strategic Report Guidance 2022 ([frc.org.uk](https://www.frc.org.uk))

⁸ IFRS – Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards

⁹ https://www.esma.europa.eu/sites/default/files/library/esma32-63-1320_esma_statement_on_european_common_enforcement_priorities_for_2022_annual_reports.pdf

¹⁰ <https://www.ifrs.org/content/dam/ifrs/project/definition-of-materiality/definition-of-materiality-feedback-statement.pdf>



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Auditor oversight of a company's approach to this issue is critical. While there can be differences by jurisdiction, in general, integrated statutory or regulated reporting requires the auditor to evaluate the statements made in the report and to confirm that in their view there is no misalignment. Some companies provide separate climate reports, which can offer additional and useful information for investors. However, if these are not included in auditors' assessment of the accounts, it can lead to uncertainty about the full alignment of a company's climate commitments.

EOS has worked with the Institutional Investors Group on Climate Change (IIGCC) to help build a coalition of support for a set of Investor Expectations for Paris-aligned Accounts.¹¹ Published in November 2020, these ask companies to:

- commit to supporting a 1.5°C Paris-aligned future, meeting net zero at least by 2050, and setting targets validated by the Science Based Targets initiative;
- ensure that lobbying and advocacy through a company's membership of associations and institutions support its own net-zero commitments; and
- ensure that these commitments are aligned with a company's financial statements and are the basis for the preparation of their accounts.

Within the CA100+ group of companies, we have seen good progress on commitments and targets, with 75% setting net-zero targets,¹² 92% with board oversight and 91% aligned with the Task Force for Climate-related Financial Disclosures. Although there is still more that needs to be done, companies have also started to provide better information on lobbying and advocacy, aligning how they represent their stated climate commitments in public and use their influence to

support actions to limit climate change. However, the majority of companies still score poorly against the Climate-Aligned Accounting benchmark.¹³ In the latest report, no company met the requirements in all areas and only nine out of 152 assessed had partial alignment, including BP, Glencore, and Rio Tinto.

Our engagement approach

Over the past year we have stepped up our engagements with companies to highlight this issue, outlining our concerns and challenging companies through the board chair and audit chair. We seek clarity on what the critical accounting assumptions are, how climate risks are factored in, and the sensitivity analysis used for a 1.5°C pathway. In the auditors' report, we want to see details about how climate risks were examined.

For example, we have been engaging with one of the world's biggest emitters, cement company CRH, challenging it to provide more transparency. While the management team has made good commitments to reduce the company's carbon impact, and CRH aspires to reach net zero by 2050, these commitments are not yet supported by details.

We need to see more granularity around the assumptions and estimates used, as currently it is not possible to confirm how the company concluded that there was no material effect from its climate commitments on its financial statements. Although the auditor mentioned climate as a key accounting matter in the 2020 annual accounts, this was absent in 2021, leaving investors confused about how the company and the auditor were treating the issue.

¹¹ <https://www.iigcc.org/download/investor-expectations-for-paris-aligned-accounts/?wpdmdl=4001&masterkey=5fab4d15595d>

¹² [CA-100-Progress-Update-2022-FINAL-2.pdf](https://www.climateaction100.org/CA-100-Progress-Update-2022-FINAL-2.pdf) (climateaction100.org)

¹³ [October-2022-Benchmark-interim-assessments_public-summary_Final_13Oct22.pdf](https://www.climateaction100.org/October-2022-Benchmark-interim-assessments_public-summary_Final_13Oct22.pdf) (climateaction100.org)



We also spoke to the new lead independent director of French food company Danone. We recognised the progress the company had made in achieving Science Based Targets initiative validation for its 1.5°C emissions reduction targets, and in setting a specific target for forest, land and agriculture.¹⁴ We said that Danone should ensure that these commitments were clearly reflected in its accounts, so that investors could see how they had been assessed.

As participants in CA100+, we led discussions with German car manufacturers BMW, Volkswagen and Mercedes in advance of the publication of their accounts, to reinforce the expectations made in writing by CA100+. We also wanted to help the companies understand where their previous accounts were not aligned with investor expectations.

Engagement with oil and gas companies such as Shell and BP on climate disclosures in financial statements has taken place over a longer period, resulting in market-leading levels of disclosure. However, we want to see further improvements, such as details of the quantitative carbon prices used in impairment testing, and disclosure of the estimated future accounting impacts of the costs associated with the use of negative emissions technologies, such as offsets, or carbon capture and storage.

Outlook

Looking ahead to the rest of 2023, we will focus our engagement on those companies that have already been contacted through CA100+, highlighting investor expectations on this topic. For the remaining CA100+ companies, we will confirm where we see material gaps, and what our expectations for improvement are for the coming year.

We will continue to challenge the main audit companies to meet the requirements of relevant financial regulators, as well as asking regulators to crack down on auditors that are failing to deliver against their obligations.

Our ultimate goal is to ensure that investors can have confidence that companies and their auditors are taking their climate commitments seriously. In our view, this is critical for long-term sustainable wealth creation.

With a few exceptions, we have similar questions for the majority of the CA100+ companies with which we engage. We have asked these companies to work with their auditors and to close the gaps in line with investor demands. Failure to do so could result in investors expressing their disapproval at annual shareholder meetings by voting against a company's audit committee chair, its auditor, the audit report, or all three.

In terms of our own voting recommendations, we make companies aware that continued failure to comply with financial regulations may result in us recommending a vote against the audit committee chair, or the other directors responsible for setting out how the accounts should be drawn up.^{15,16} Where auditors have not indicated how they have assessed the accounts from a climate point of view, this could result in a recommendation to vote against either the reappointment of the auditor or the approval of the financial accounts, if there is serious doubt about whether they truly reflect the financial outcome of the company's climate commitments.

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We have also highlighted to regulators and audit companies the seriousness of an inadequate treatment of material climate-related issues in company financial reporting, and the importance of their role in helping to ensure alignment. In November 2022 we supported the sending of letters to auditors, copied to the UK's Financial Reporting Council (FRC), outlining investors' growing concerns, and confirming their expectations of the auditor's role. We followed up with each auditor to understand their position, and participated in roundtable discussions with the FRC's chair, to ensure our concerns were properly understood.



¹⁴ <https://www.danone.com/impact/planet/climate-actions.html>

¹⁵ [fneos-corporate-global-voting-guidelines-2022.pdf](#) (hermes-investment.com)

¹⁶ [eos-europe-australia-public-vote-guidelines-2023.pdf](#) (hermes-investment.com)

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