FINANCIAL MARKETS AUTHORITY
TE MANA TĀTAI HOKOHOKO

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Climate risks and the impact on financial statement audits

This document provides clarity for auditors about the expectations of the Financial Markets Authority – Te Mana Tātai Hokohoko for information about climate risks in audit files. It will also be useful for preparers of financial statements and anyone else involved in climate risk and reporting for businesses with financial reporting obligations.

Businesses with financial reporting obligations have two reasons to consider the impact that climate risks and opportunities have on their financial statements:

1. About 200 reporting entities must comply with a mandatory framework for climate-related disclosure (CRD), to provide investors and other stakeholders with better insights into the climate risks and opportunities impacting those entities; and
2. All entities – whether or not they are captured by the CRD regime or other mandatory framework – have existing requirements, under current Australian and New Zealand Accounting Standards, to assess what impact, if any, climate change has on their financial statements.

The mandatory framework was introduced in 2022 and applies to all reporting periods commencing January 2023. The FMA intends to take a constructive, supportive approach to supervising and enforcing compliance, given the relative newness of the requirement.

The existing requirements are of course more established so, while for the 200 entities captured by the mandatory framework, the framework and some of its specific reporting requirements are new, the overall responsibility to consider the impact of climate change is not. Accordingly, the FMA sees useful overlap in the requirements which should help entities to consider, prepare for, and comply with both (to the extent that is required).

In that context, this document assists auditors to assess the impact of climate-related matters in financial statements arising from both sets of both requirements. We also note as relevant resources:

1. the IFRS Foundation's guidance document from 2020

- International Sustainability Standards Board (ISSB) exposure drafts on the possible development of a single sustainability framework.

Why is it important?

Climate change is receiving increased attention from governments, investors, and other stakeholders as its effects become more visible. These effects include physical risks[1] and transitional risks[2] which can impact the operations of entities of all types and sizes, including those with high carbon emissions.

There may also be uncertainty as to how entities will be affected by other, related factors, such as government policies, impacts on suppliers, changing customer preferences, and the availability of debt and equity funding.

Our expectations

Directors and management

Directors and management of an entity are responsible for ensuring that financial statements comply with Accounting Standards. Climate-related risks can impact the key assumptions and estimates that underpin accounting treatments and financial statement disclosures.

We therefore strongly recommend that management and directors consider climate risks throughout their risk assessment process and look at how this impacts the preparation of financial statements (and for CRD reporting entities, climate statements).

While accounting standards do not refer explicitly to climate-related matters, entities must consider these matters when they are material in the context of the financial statements as a whole. Information is material if omitting, misstating, or obscuring it could reasonably be expected to influence decisions made by primary users of financial statements and climate statements.

Entities should focus on providing information in a clear, concise, and effective way, so material information isn't lost in lengthy explanations of circumstances and financial impacts. This includes disclosing any sources of estimation uncertainty and key assumptions that underlie asset values, impairment and relevant provisions that may be materially impacted by climate risks.

When documenting and supporting climate risk disclosures in financial statements, we expect entities to focus on the following:

- Preparation of high-quality technical papers for all material areas impacted by climate risk. This includes materiality assessments and accounting considerations of decisions made to support financial statement disclosures.
- Adequate documentation in minutes of board and audit committee meetings that includes discussions, analysis and conclusions for accounting areas impacted by climate change.

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[1] Physical risks are the risks related to the physical impacts of climate change, such as extreme weather events, chronic heat waves, sea-level rise, erosion, and biodiversity loss for entities.
[2] Transition risks are the risks that follow societal and economic shifts toward a low-carbon and more climate-friendly future for entities.

Due to the challenges and inherent uncertainty in key assumptions, these documents will be critical for the entity to maintain proper accounting records to support the material disclosures in the financial statements.

Where decisions are made that items are deemed immaterial, these decisions should also be included in the documentation. Materiality is not universal, and how entities are impacted by climate risk may be dependent on their particular industry, and not all entities will be affected in a similar way.

Entities should also consider how their information and communications related to climate change comply with laws and regulations, and if their messages align across their various communications including the messages in the financial statements. Auditors will be looking at areas of non-compliance with laws and regulations, including assessing matters referred to in other information accompanying financial statements.

Auditors

The auditor's objective is to obtain reasonable assurance about whether the financial statements are free from material misstatement, and to report on whether the financial statements are prepared, in all material respects, in accordance with the financial reporting framework.

If climate change impacts the entity, the auditor needs to consider whether the financial statements appropriately reflect this.

As part of an audit, the auditor should consider the potential risk of material misstatement of the financial statements due to climate change. An example is where an entity has decided, or is required, to reduce the carbon footprint of its manufacturing plant - this may impact the entity's impairment calculations if machinery or property becomes obsolete due to planned "greener" alternatives.

Where auditors identify risks, they must determine an appropriate audit response to assess if they have a material impact on the financial statements.

In October 2020, the IAASB issued *Consideration of Climate-Related Risks in an Audit of Financial Statement*, which sets out some of the more significant areas that may need to be considered in relation to risk assessment and responses to assessed risks, audit evidence, communication with those charged with governance and auditor reporting.

Below we set out what climate-related risks we expect auditors to consider, focus on and document in the audit file – particularly for entities that are large emitters or have significant exposures to large emitters.

ISA Standard	How the auditor should consider and respond to climate change risk
Consideration of laws and regulations	The auditor should understand the applicable climate change-related laws and regulations in the jurisdictions the entity operates in. Given the fast-moving nature of regulations in this area, we expect auditors to discuss with management and directors how laws may impact the entity's operations and how compliance is managed.

	Auditors should also consider other laws and regulations such as environmental regulations, regulations about fair dealing when making statements about climate change and net zero emissions targets, and general requirements to not make misleading statements. A breach of such regulations may have a material effect on the financial statements, e.g. a breach may result in a contingent liability for potential litigation, and fines or penalties. The auditor should further use this understanding to assess the impact on the entity's risk of material misstatement.
Identifying and assessing the risks of material misstatement	Climate-related risks may give rise to risks of material misstatement in respect of one or more relevant assertions, for example, accuracy, valuation and allocation, rights and obligations, and presentation for a class of transaction, account balance or disclosures. We expect the auditor to consider potential climate change impacts when performing their risk assessment, including: • Obtaining the entity's assessment of how climate change may impact their business. If the entity has not made its own assessment the auditor should independently assess the impact. • Understanding how the entity's business model may be impacted by climate change, including any subsidiaries that operate in other jurisdictions. We also expect auditors to challenge business models, e.g. industry practices that may require changes to remain competitive. • Considering how climate-related laws and regulations could affect taxation, or otherwise affect the way the entity can conduct business, and the impact on financial statements. This may include requirements to become carbon neutral, which may mean a business needs to invest in cleaner production methods, with existing equipment becoming obsolete. • Assessing whether other external factors may impact the entity, such as bank lending restrictions or consumer preferences for greener products.
Materiality	Auditors should assess whether identified climate-related risks could affect audit materiality. When considering materiality, the auditor should not only consider quantitative disclosures such as the impact of climate change on the impairment of assets, but also disclosures that could reasonably be expected to influence the economic decisions of users, based on the financial statements as a whole. Many investors have identified climate-related issues as an important part of their decision making, and the auditor should take this into account when determining materiality.
Response to assessed risks	Where the auditor has identified that climate change risk could have a material impact on financial statements, we expect the auditor to design audit procedures to respond to these risks and obtain sufficient audit evidence to address them.

Accounting estimates	Climate risks could increase estimation uncertainties and impact the assumptions used in accounting estimates. Accounting estimates that may be impacted include: • Impairment of property, plant and equipment, intangible assets and goodwill • Fair value of financial assets (investments and receivables) • Fair value of financial liabilities • Certain provisions and contingent liabilities • Mineral resources and reserves, and restoration provisions. We expect there to be a clear link between material climate risks and the impact on assumptions and methods used in assessing accounting estimates. When considering the impact of climate change on accounting estimates, we expect the auditor to assess: • the impact on estimation models, and conclude whether these models are still fit for purpose or new models need to be developed to capture climate change effects • whether the data provided is relevant and reliable for use in the determining estimate. The auditor should take into account that forecasts and discount rates can be highly subjective, as they: • include long forecast periods or terminal values with a significant impact on the overall outcomes • are based on data that is currently unobservable. When considering material climate-related inputs in accounting estimates, we expect the auditor to clearly document the evidence obtained to challenge the assumptions used in management's estimates. We also expect that relevant disclosures are made to respond to increasing investor interest in climate-related data and related uncertainties.
Auditors' experts	Climate-related risk may often be complex or technical, therefore auditors should determine if the engagement team may require specialised skills or knowledge to appropriately identify and assess the risks of material misstatement or to respond to assessed risks. We expect auditors to clearly document and assess if specialist skills are required and how they determined that the audit team or auditor's expert has the appropriate skills. Auditors should also ensure that experts are provided with the appropriate information or have taken into account climate risks when performing their work.
Misstatements	Where errors and/or omissions are identified during the audit, the auditor is required to determine whether these are material, individually or in aggregate. We expect auditors to follow their usual processes when evaluating misstatements. When it comes to climate-related risks, additional attention should be paid to: • Errors and omissions in judgemental areas that are important to users' understanding of the financial position, financial performance, or the entity

	cashflows. These errors and omissions may arise from using inadequate assumptions or failing to disclose key considerations when assessing estimates. • It is inappropriate to make, or leave uncorrected, departures from NZ IFRS to achieve a particular presentation of an entity's financial position, financial performance or cashflows. For this reason, auditors should remain alert to all misstatements.
Going concern	There may be instances where climate-related risks give rise to an event or condition that casts significant doubt on the entity's ability to continue as a going concern. It is important that the auditor evaluates management's going concern assessment and ensures that it contains all relevant information in relation to climate-related risk. We expect the auditor to document their assessment of the significant climate risks and how they have been considered in the entity's assessment of going concern. Examples of areas that should be considered include: • significant litigation claims that may impact the entity's ability to continue its operations for the foreseeable future • any changes in regulations that may prohibit the entity from continuing its current business. There should also be a clear link between assumptions used for impairment assessment and the budgets used for going concern assessments.
Audit report	In performing the audit, the auditor is required to assess if the entity has complied in all material respects with the applicable financial reporting framework. We expect the auditor to give additional consideration to the impact of climate risks in assessing the appropriateness and adequacy of disclosures. Where the entity may not have appropriately disclosed the effect of climate-related risks in the financial statements, we expect a robust assessment of the impact this has on the audit opinion. In instances where the auditor concludes that the financial statements as a whole are not free from material misstatement, they are required to modify the opinion in the auditor's report.
Key audit matters	The degree to which climate-related risks require auditor attention affects whether to include this area as a key audit matter. Climate risk may not always require a separate key audit matter, but elements of climate change may be incorporated in other key audit matters, such those relating to impairment or going concern. The auditor should disclose why the matter was one of most significance in the audit and how it was addressed.
Other information	The auditor is required to read and consider the financial and non-financial information accompanying the financial statements within an entity's annual report. In Australia, entities may voluntarily report in accordance with the TCFD framework. The directors' reports for all entities are also required to comment on compliance with environmental

	regulation. In New Zealand, CREs will be required to prepare and file a Climate Statement based on standards issued by the External Reporting Board. We expect auditors to assess whether there are misstatements of fact or material inconsistencies between the financial statements and any climate-related information contained in other information. When climate-related information is presented in a document outside the annual report, it may be necessary to determine whether the document nevertheless forms part of the annual report as defined for the purposes of ISA (NZ) 720. For example, a sustainability report is sometimes published separately to the annual report.
Communication with those charged with governance	When entities are materially affected by climate risks, the auditor should draw attention to the effects of climate-related risks in their communication to those charged with governance and explain how they addressed this risk in the audit. Specific attention should be given to the appropriateness of the accounting policies and whether the disclosures provide sufficient information. The auditor may make a statement about their assessment of climate risks even if they believe the entity is not materially impacted.

FMA response

Climate risks can have a significant impact on an entity, and on its financial outlook and financial statements. As the agency that monitors audited financial statements – and climate statements under the mandatory framework – we will be increasing our focus on how entities and auditors have addressed these risks when preparing and auditing financial statements.

Climate change impacts will increasingly play a larger part of our financial reporting and audit monitoring activities, so market participants can expect more questions and enquiries in this area.

To improve the evolving understanding of climate risks, we will be engaging with stakeholders, including:

- Market participants, to better understand the challenges entities face when it comes to climate change.
- International regulators, through IOSCO (International Organization of Securities Commissions) and IFIAR (International Forum of Independent Audit Regulators), to understand their own regulatory responses, and to share knowledge and collaborate on best practice.
- Other local financial regulators, to share knowledge and avoid duplication.

Our aim is to continue to inform preparers, auditors, investors and other stakeholders of financial statements on the topic of climate change.