Impact of climate-related risks on financial statement audits

Background

Sustainability and climate change are becoming priority topics for investors and other stakeholders as the effects of climate change are increasingly felt around the world. Climate-related risks have the potential to impact reporting issuers of all sizes across every industry and could impact a reporting issuer's business model, processes, and ability to continue operating.

Since 2022, CPAB has been exploring how financial statement auditors are identifying and assessing the risk of material misstatement related to the impact of climate-related risks in their audits of Canadian reporting issuers.

CPAB performed climate-focused thematic reviews in 2022 and 2023 to understand:

i. How audit firms are preparing engagement teams to consider the impact of climate-related risks in financial statement audits of public companies, and

ii. The extent to which engagement teams are currently doing so.

This document summarizes CPAB's observations and is intended for financial statement audit practitioners who audit Canadian reporting issuers.

Financial statement impacts

Risk assessment

Canadian Auditing Standard 315, *Identifying and Assessing the Risk of Material Misstatement* (CAS 315), requires auditors to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. The auditor is required to perform risk assessment procedures to obtain an understanding of the entity subject to audit which includes the entity's risk assessment process relevant to the preparation of financial statements. This understanding includes identifying business risks relevant to financial reporting objectives, assessing the significance and likelihood their occurrence, and addressing those risks.

> While the words "climate change" are not explicitly mentioned in the standard, climate-related risks are business risks that should be evaluated by management as part of their own risk assessment process.[1] To the extent that climate or sustainability related events or conditions (both within and outside an entity's controls) may contribute to the susceptibility of the financial statements to misstatement, auditors should be considering their impact.

[1] The International Auditing and Assurance Standards Board (IAASB) has published a Staff Audit Practice Alert focused on The Consideration of Climate-Related Risks in an Audit of Financial Statement.

Financial statement impacts

There are a number of different ways that climate-related risks may materially impact financial statement balances. It is important that audit teams, as part of their understanding of the entity's activities, consider these potential risks. Below are some examples.

Inventory

- Estimates of net realizable value (NRV) could be materially affected by climate-related changes such as: (i) regulatory changes that render inventories obsolete, (ii) a significant weather event that causes physical damage to inventories, or (iii) changing customer behaviors and preferences that reduce demand.

Property, plant and equipment

- Climate-related factors could result in impairment indicators such as: (i) a material decline in demand for products or (ii) changes in regulation that could adversely affect an entity's operations.
- An entity might also have to acquire new Property, Plant, and Equipment (PPE) to support changes in its processes and/or market demand in risk to climate-related changes.
- Useful lives of PPE may need to be shortened.

Asset retirement obligations

- Climate-related factors may impact the recognition, measurement and disclosure of asset retirement obligations due to changes in legal obligations, regulatory requirements or timing of remediation work.

Financial instruments

- Loan contracts could include terms that link contractual cash flows to an entity's achievement of climate-related targets.
- Climate-related risks could also impact a lender's exposure to credit losses and assets could become inaccessible or uninsurable, impacting the value of collateral for lenders.

Thematic review observations

In 2023 CPAB inspected 130 files (2022: 132) and found that 41 (2022: 25) of those files had included consideration of climate-related risks as part of their risk assessment activities. All of the files that considered climate-related risks were from the largest four firms where the firm had introduced a required risk assessment template focused on climate-related risks.

While we observed more auditors identifying and assessing climate-related factors during their risk assessment activities in 2023 compared to 2022, the quality and depth of the risk assessment performed varied significantly between files and firms.

The introduction of required climate-related risk assessment templates at some firms did improve consistency of the assessments performed, however in some cases the assessments lacked rigour, were not clearly linked to management's risk assessment process, and did not sufficiently consider climate-related information disclosed by the entity outside of the financial statements.

We also observed that engagement teams are not consistently discussing climate-related risks with management or those charged with governance as part of their risk assessment activities, even when the reporting issuer operated in an industry that the firm's internal guidance had flagged as a priority industry.

Effective communications among the engagement team, management and those charged with governance are an important and informative input into an engagement team's risk assessment activities. We encourage firms to remind engagement teams of the requirement to understand management's risk assessment process. If the engagement team identifies risks of misstatement that management failed to identify, they are required to consider if it should have been identified by the entity's risk assessment process and, if so, obtain an understanding of why the entity's process failed to identify.

Good practices observed

We have summarized below some examples of good practices undertaken by firms to support auditors in identifying and assessing climate-related risks that were observed during our thematic reviews.

Training and resources

Developed and delivered targeted training and education.	• Allowed engagement teams to benefit from real life and industry specific examples, which better prepared them to understand how climate change could impact their client. • Enabled teams to have meaningful discussions with management and those charged with governance. • Provided example questions to help guide teams who may be discussing the topic for the first time with management or those charged with governance were particularly impactful in improving the quality of discussions.
Introduced mandatory climate-related risk assessment templates.	• Ensured that each engagement team considered climate-related risks. • Assisted teams in evidencing their assessment and identification of audit risks related to climate change.
Increased the number of climate specialists available to engagement teams.	• Allowed teams to access relevant expertise, enabling teams to perform higher-quality risks assessments.

Oversight

Conducted real time quality assurance reviews.	• Focused on how engagement teams identified and assessed climate-related risks of material misstatement. • Allowed teams to adjust their approach as needed before completing their audit work.
Identified higher risk reporting issuer audits.	• Allowed the firm to provide those audit teams with additional support to ensure they were able to sufficiently assess and understand potential climate-related risks that the entity may face.
Monitored use of climate-related specialists.	• Ensured that teams were sufficiently using the expertise of available specialists, particularly for reporting issuers more likely to be impacted by climate-related risks in the near-term.

Looking ahead

CPAB encourages audit firms to continue to prepare their teams to consider and address climate-related risks in their financial statement audits. CPAB will continue to monitor how auditors are identifying and assessing climate-related risks through our inspections and share our observations through various communications.

CPAB also continues to monitor, and, where appropriate, share perspectives on standard setting activities related to the development of sustainability reporting and assurance standards. For more information on CPAB's responses to ongoing sustainability standard setting consultations refer to our website.

Learn more

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