ESG Impacts on Audit Engagements

October 2022

The purpose of this publication is to discuss the ways that sustainability, climate or environmental, social, and governance (collectively referred to as "ESG") matters may impact an audit engagement. This publication also provides auditors with guidance on how to respond to risks of material misstatement due to ESG matters.

Background

In recent years, expectations around ESG reporting have grown significantly as investors and other stakeholders call for enhanced disclosures related to ESG strategies. ESG reporting includes both qualitative disclosures and quantitative metrics used to measure an entity's performance against ESG risks, opportunities, and related strategies.

Currently, the International Sustainability Standards Board ("ISSB") has been formed by the IFRS Foundation to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs. In the interim, while ISSB develops the standards, many jurisdictions have issued their own guidance for ESG reporting. Refer to the table below to see examples of such guidance from several jurisdictions.

Jurisdiction	Guidance
Australia	Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/ISAB Practice Statement 2
Brazil	New regulation on social, environmental, and climate-related risk disclosures
Canada	Canadian securities regulators seek comment on climate-related disclosure requirements
European Union	Insights on Reporting the Business Model Sustainability Risks and Opportunities
New Zealand	Climate-related disclosures
United Kingdom	UK to enshrine mandatory climate disclosures for largest companies in law
United States	SEC Response to Climate and ESG Risks and Opportunities

Additionally, the Technical Readiness Working Group ("TRWG"), a group formed by the IFRS Foundation Trustees to undertake preparatory work for the ISSB, has released a climate-related disclosures prototype. The prototypes are the result of six months of joint work by representatives of the

- Climate Disclosure Standards Board ("CDSB")
- International Accounting Standards Board ("IASB")
- Financial Stability Board's Task Force on Climate-related Financial Disclosures ("TCFD")
- Value Reporting Foundation ("VRF")
- World Economic Forum ("Forum")

They are supported by the International Organization of Securities Commissions ("IOSCO") and its Technical Expert Group of securities regulators. The TRWG has consolidated key aspects of these organisations' content into an enhanced, unified set of recommendations for consideration by the ISSB.

Auditors' responsibilities in audit of financial statements

ESG matters may have a material impact on the financial statements for certain entities that are directly affected by such matters. Examples may include entities in the insurance, energy, and agriculture (food and beverage) industries. For other entities, the impact may not be material; however, depending on the jurisdiction, certain disclosures related to ESG matters may still be required or expected based on users' expectations.

The following provides guidance regarding the auditors' responsibilities related to ESG matters reported or disclosed in the financial statements.

Entity and its environment

While planning the engagement, the engagement team obtains an understanding of the entity and its environment, including its internal control. This understanding includes relevant information regarding the regulatory environment, legislation and regulation, and environmental requirements affecting the industry and the entity's business. Any of these items may be associated with ESG matters, which could impact the entity and result in a risk of material misstatement. Engagement teams may consider adding additional inquiries of management and those charged with governance to understand whether the entity is impacted by ESG matters.

Internal control

The engagement team is required to obtain an understanding of internal control relevant to the audit. While obtaining this understanding, the engagement team may consider how the entity's internal control handles the identification, recording, and reporting of transactions and disclosures related to ESG matters. The engagement team may consider:

- The existing business process for such transactions and whether management already established a process for identifying and recording transactions or disclosures related to ESG matters
- Whether management has developed new or specific processes and controls for ESG matters and how those processes and controls work within the system of internal control
- How the engagement team will remain professionally sceptical when understanding the new processes and to challenge management's assertions, when appropriate.

Risk factors

While obtaining the understanding of the entity and its environment including internal control, the engagement team may identify risk factors related to ESG matters, whether internal or external, that may alert the engagement team to an increased risk of material misstatement.

Refer to the table below for example situations and corresponding risk factors that may arise.

Situation due to ESG matters	Type of risk factor
Travel and tourism entity with hotel and boating properties in drought-stricken areas	Change in conditions or circumstances
ESG impact on impairment analysis for an agricultural entity located in a flood plain that has experienced more frequent flooding events	Complexities associated with classes of transactions or accounting requirements
Energy company that spilled oil due to faulty maintenance, which resulted in immeasurable damages	Complexities associated with classes of transactions or accounting requirements
New government regulations to reduce toxic waste, which require retooling of manufacturing machinery	Changes in conditions or circumstances
Key customers may demand commitments to certain ESG goals, which may include reporting the ESG goals performance	Change in conditions or circumstances; or Complexities associated with classes of transactions or accounting requirements
Requirements from lending or private equity owners to reduce carbon emissions	Changes in conditions or circumstances
Decrease in demand for existing products based on changes in consumer tastes to more sustainable alternatives	Potential problems that may hinder an entity from achieving its financial reporting objectives

Disclosures

While scoping the engagement, the engagement team considers ESG-related disclosures. Disclosures related to ESG are rapidly evolving based on changes to reporting frameworks and user expectations, and entities modifying their disclosures to provide high-quality financial reporting. The engagement team considers whether ESG-related disclosures are an elevated inherent risk and hence a scoped item.

Estimates

While obtaining an understanding of the entity's accounting estimates, the engagement team may identify certain assumptions that are directly impacted by ESG matters, such as restoration costs for contaminated sites. Whereas other assumptions may be indirectly impacted by ESG matters, such as the value of property, plant and equipment or mineral resources, which may need to include ESG-related inputs. Another example where ESG inputs may need to be considered includes the evaluation of the entity's ability to continue as a going concern.

Going concern

While obtaining an understanding of the entity and its environment, the engagement team may identify risk factors related to ESG matters that may impact the entity's ability to continue as a going concern. For example, entities may be directly impacted because they cannot operate as intended, as is the case of a ski resort in an area where snow is now infrequent. Entities may also be indirectly impacted, such as insurance entities facing increased liabilities due to increased insurance claims after many unpredicted extreme events. Even those entities with only indirectly impacted by ESG matters may face risks related to the entity's ability to continue as a going concern. An example of such a situation includes an entity that currently does not include ESG disclosures and needs to obtain new financing, and the lenders in the jurisdiction expect entities to include ESG disclosures.

Communications with those charged with governance

Due to the increasing pressure to disclose the impact of ESG matters – whether disclosure is currently required or not – engagement teams may consider whether it is appropriate to discuss the entity's approach to ESG matters with those charged with governance. Such discussions may also provide the engagement team with insights regarding the entity's preparedness for changes to the financial reporting framework. Those charged with governance have a responsibility to provide appropriate governance considering the impending requirements to financial reporting.

Auditors' responsibilities with respect to other information

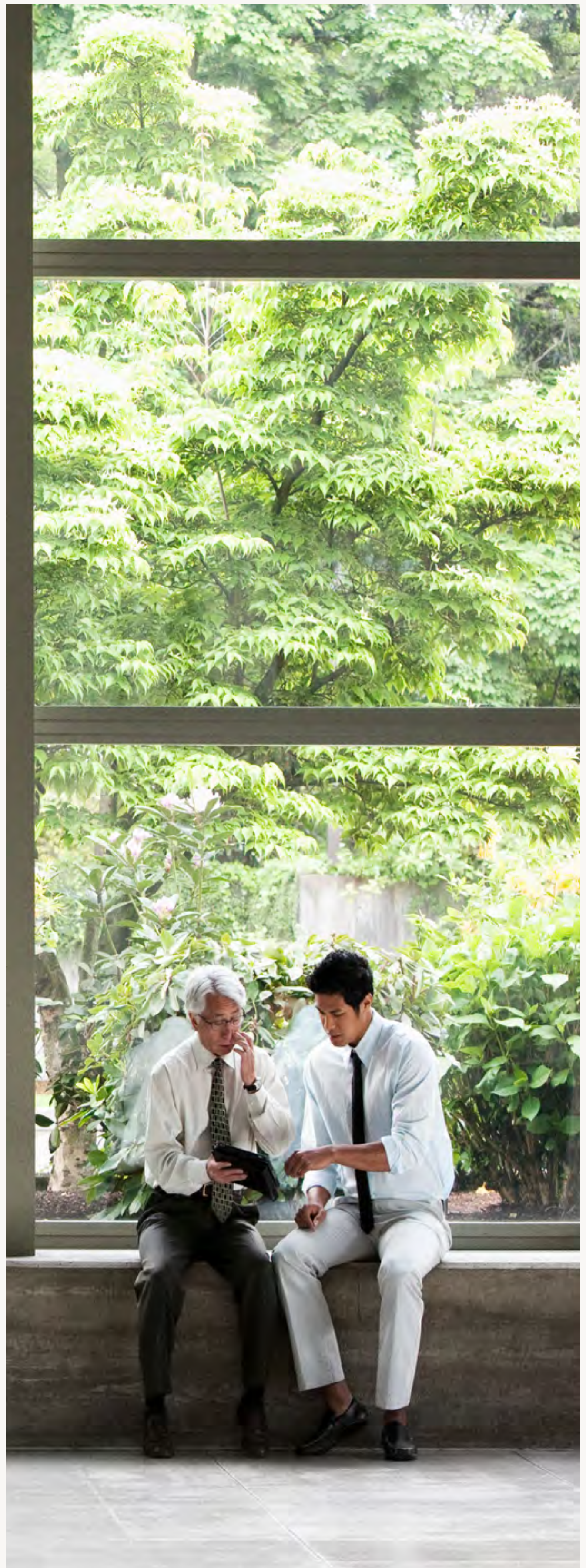
The expectations around ESG reporting have grown significantly in recent years due to investors and other stakeholders calling on entities to disclose more about their ESG strategies. Entities are including ESG matters within documents that form part the annual report, management report, management commentary (or operating and financial review) or similar reports. The information may include the entity's response to ESG matters and the impact on the entity's operations or the entity's financial results and financial position. For example, a university may include data regarding their diversity and inclusion initiatives in the governance, professor and faculty, and student populations within their annual report. This information will typically meet the definition of other information as defined in ISA 720 (Revised). ISA 720 (Revised) requires the engagement team to read the other information and, in doing so, consider whether there is a material inconsistency between the other information and

a) the financial statements; and

b) the engagement team's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit (referred to as read and consider procedures hereafter).

The dynamic nature of the current economy and increasing stakeholder expectations for information related to ESG matters may lead to possible changes in how the annual report is prepared and there may be a higher likelihood of inconsistencies between the other information and the financial statements or the engagement team's knowledge.

When performing the read and consider procedures, ISA 720 (Revised) requires the engagement team to remain alert for indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated. For example, the engagement team may note a difference in the entity's description of how it used funds received as part of a green energy grant program and how such funds were utilized as part of the knowledge obtained in the audit.



Audit firm risk management policies

Audit firms may consider developing risk management policies related to ESG matters, which may include any of the following:

- Requiring an engagement quality review when the entity is significantly impacted by ESG matters, which may be the case when an entity needs to materially adjust the financial statements for ESG matters.
- Requiring additional approvers as part of client acceptance and continuance for audit engagements that will not include required ESG reporting.
- Requiring consultation with member firm experts for engagements with risks of material misstatement related to ESG matters.

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