

# CLIMATE CHANGE AND PROFESSIONAL LIABILITY RISK FOR AUDITORS

## A COMPARATIVE UNITED KINGDOM/ AUSTRALIA ANALYSIS

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BE HEARD.  
BE RECOGNISED.



# CLIMATE CHANGE AND PROFESSIONAL LIABILITY RISK FOR AUDITORS

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September 2018

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## Background and objective

The objective of this analysis is to outline the comparative legal obligations and potential sources of professional liability for Australian auditors based on ClientEarth's December 2017 publications "Risky business – Climate change and professional liability risk for auditors" (*Risky business*). At its core, that publication examines the various standards and rules applicable to UK auditors' duties relating to annual financial accounts, focusing in particular on where those corporate disclosures might reasonably be expected to contain climate risk-related information. *Risky business* is available at the ClientEarth website:

<https://www.documents.clientearth.org/library/download-info/risky-business-climate-change-and-professional-liability-risks-for-auditors/>

## Why the attention on climate change?

The World Economic Forum (WEF) has for the last twelve years produced what is probably the most authoritative, forward-looking assessment of global risks. The WEF defines "global risk" as an "uncertain event or condition that, if it occurred, can cause significant negative impact for several countries or industries within the next 10 years." Twenty-nine risks are identified and grouped into five customary categories: economic, environmental, geopolitical, societal and technological. More recently, assessment of the interconnection amongst risks has been sought. The 2017 Global Risks Report released earlier this year concludes:

Over the course of the past decade, a cluster of environment-related risks – notably extreme weather events and failure of climate change mitigation and adaptation as well as water crises – has emerged as a consistently central feature of the GRPS [Global Risks Perspectives Survey] risk landscape, strongly interconnected with many other risks, such as conflict and migration. This year, environmental concerns are more prominent than ever, with all five risks in this category assessed as being above average for both impact and likelihood.

The market and business reality of climate change is perhaps most effectively amplified by the work of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) whose final report<sup>1</sup> was released in June 2017. Michael Bloomberg, the chair of the Task Force, in his introductory letter to the Final Report noted:

The risk climate change poses to businesses and financial markets is real and already present. It is more important than ever that businesses lead in understanding and responding to these risks – and seizing the opportunities – to build a stronger, more resilient, and sustainable, global economy.

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<sup>1</sup> <https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf>

If there were any doubt that climate change is a ‘hear and now’ issue for Australian business, and as such gaining regulatory attention, this is amply dispelled by the very direct reference given this year to the TCFD and its recommendations in both the Australian Government’s response to the Senate Economics Reference Committee inquiry *Carbon risk: a burning issue*<sup>2</sup> and the ASX Corporate Governance Council consultation on a proposed fourth edition of the Corporate Governance Principles and Recommendations<sup>3</sup>.

Further, that developments encroach directly upon directors’ duties, and by inference as CPA Australia sees it, also with regards the relationship between general duties and specific duties as to financial reports and directors’ reports, and thus in turn the role of external auditors, is abundantly clear from a now widely acknowledged memorandum of opinion prepared by Noel Hutley QC and Sebastian Hartford-Davis:

It is likely to be only a matter of time before we see litigation against a director who has failed to perceive, disclose or take steps in relation to a foreseeable climate-related risk that can be demonstrated to have cause harm to a company (including, perhaps, reputational harm).<sup>4</sup>

## The comparative Australian analysis

With the above as background, *Risky business* provides a concise and highly valuable entree to examine in Australia the nature of climate change risk and the evolving understanding of corporate and company director responsibility, particularly around disclosure. It extends our understanding through identify the various touchpoints with audit practice, and thus, sources of potential liability for auditors. This Australian analysis (referred hereafter as *Comparative analysis*) is necessarily narrow, addressing three areas of potential similarity and difference that might emerge in relation to expectations around the conduct, and resulting risk of liability, of external audits of annual disclosures by companies which have an underlying climate change-related risk. The three areas of consideration are:

Auditors’ legal duties: climate risk in annual accounts (*Risky business* pp. 14 -15, Table 3) – *Comparative analysis* Paper 1

Auditors’ legal duties: climate risk in other information (*Risky business* pp. 16 – 17, Table 4) – *Comparative analysis* Paper 2

Annual accounts: climate risk implication – unlawful or improper dividends (*Risky business* p. 8) – *Comparative analysis* Paper 3

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<sup>2</sup>

[https://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Economics/Carbonriskdisclosure45/Government\\_Response](https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Carbonriskdisclosure45/Government_Response). Refer specifically Recommendation 4 and generally, Recommendations 1 and 2.

<sup>3</sup> <https://www.asx.com.au/documents/asx-compliance/consultation-paper-cgc-4th-edition.pdf>. Refer in particular proposed amendments to Recommendation 7.4 (sustainability disclosures).

<sup>4</sup> Centre for Policy Development and Future Business Council, 7 October 2016, para. 51.

By way of comparison, auditor obligations and potential liability in relation to non-audit services, particularly that around opinions given as part of corporate fundraising are discussed in Paper 1 of this *Comparative analysis*. The context for this broader Australian analysis is the enduring position of 'true and fair view' and assertions made that its meaning can be garnered from a negligence law-based perspective of misleading and deceptive conduct.

Finally, we do not address the broader public policy implications and market risks (or benefits) of attaching to audit firms a further potential source of litigation risk in an environment which is already highly litigious.

## Key conclusions and impressions

- Climate change and its impact on economic and business activities is creating friction and uncertainty within corporate disclosure regimes which were designed under markedly different circumstances. Similarly, it can fairly be asserted that scientific understanding increasingly outpaces public policy as it applies to the regulation and development of corporate disclosure regimes. Predicting corporate liability and professional liability of directors, let alone auditor professional liability, is, to say the least, challenging.
- The above said, the law developed over many decades which gives some degree of certainty to the circumstance and relationship-based dichotomy in liability between companies, directors and auditors, may inform the scope of future risk for auditors in relation to corporate disclosure or non-disclosure of climate change impacts. Nevertheless, regulatory uncertainty and opportunistic litigation may contribute to a blurring of what loose certainty there is in the boundaries of respective parties' exposure to liability risk.
- Given that both the UK and Australia adopt International Financial Reporting Standards (IFRS) and International Auditing Standards (ISAs) promulgated by the International Auditing & Assurance Standards Board (IAASB), similar technical relationships would initially provide context for determining climate change professional liability risk. (Refer accompanying Paper 1 section 2)
- The foundation of much of Australian corporate law in English common law should be applied with caution in predicting corporate liability, and in turn, professional liability for Australian auditors. Respective streams of statutory development may emerge as specific areas of climate change related legal controversy – perhaps most notably in the UK with mandated 'other information' corporate disclosure, and though with less certainty in Australia, with fundraising disclosures. (Refer accompanying Paper 1 section 3.3 and Paper 2)
- The true and fair view concept which is the basis of the auditor's opinion is an enduring feature in both UK and Australian corporate law and disclosure practices, yet defying narrow and concise definition. (Refer accompanying Paper 1 section 3.1)
- In contrast, financial reporting's fundamental purposes which may be used to inform understanding of 'true and fair view' are well articulated in authoritative statements. The capacity of those pronouncements to reflect shifting market and investor information expectations of financial statements, may, at some future time, feature in regulator and

litigation-based assessments of directors', and in turn auditors, judgments of truth and fairness. (Refer accompanying Paper 1 section 3.2)

- Development of a wider scope and purpose of accounting and auditing standards based on 'overarching' objects wording within the Australian Securities and Investments Act 2001 would only become a source for guiding disclosure practices if the Government were to take positive action in this direction. This, presently, is unlikely. (Refer accompanying Paper 1 section 3.2)
- Legal principles around misleading and deceptive conduct by company directors would, at a prima facie level, appear more applicable to fundraising disclosures, whereas within annual reports the more likely focus will be on professional judgment as to response via applicable accounting standards (Refer accompanying Paper 1 section 3.3).
- The very precise referencing in Australian statute to prohibitions on misleading and deceptive conduct indicate that further meaning of 'true and fair view' is unlikely to be drawn from this source. Similarly, the limited recent case law on 'true and fair view' would not support expectation of judicial development in this direction. (Refer accompanying Paper 1 sections 3.3 and 3.5)
- Understanding true and fair will continue to be aligned to relationships with financial accounting, thus emphasising the critical role of professional judgment as to the application of technical accounting rules and qualitative attributes in the context of corporate disclosure's adjusting for climate change risk. (Refer accompanying Paper 1 section 3.5)
- Misleading and deceptive conduct principles may nevertheless, in time, give a sharper understanding of the scope of reasonably expected analytic and narrative disclosures within Australian operating and financial review disclosure requirements. (Refer generally, accompanying Papers 1 and 2)
- Further, in the context of narrative "other information", it may be that given contrasting lines of legal development around directors' duties and associated disclosure requirements, liability risk associated with alleged deficiencies in climate change related disclosure for companies, and in turn auditors, may stem in the UK more from regulatory oversight and associated actions. Whereas in Australia, a less certain set of conditions will persist with a level of certainty perhaps only coming subject to effective legal argument that current disclosure practices under existing rules and frameworks ought to have evolved in response to what should be self-evident imperatives within the business and economic environment. (Refer accompanying Paper 2)
- It is tentatively speculated that auditors in Australia are at a heightened liability risk compared to their UK counterparts in relation to improper payment of dividends given Australia's adopting a balance sheet test for enabling distributions and authoritative statements as to the effect of auditor negligent mistakes. Any such likelihood further compounded by statutory reference to accounting standards as the basis for calculating assets and liabilities. (Refer accompanying Paper 3)
- None of the foregoing presents definitive answers about the avenues and magnitude of climate change related professional liability risk for auditors. Nevertheless, there is scope for developments in these directions sufficient to warrant deeper exploration and awareness raising across the financial reporting supply chain. As to the time horizon in



which regulator and shareholder activism in Australia extends to these matters, I would predict that this is some way off. A further observation should be made that any decoupling of the director/ auditor and director/ company relationship that would see the professional judgment of directors substituted with that of auditors should be avoided as derogating from the well understood primary responsibility of directors as recognised in both statute and the common law.