

CLIMATE CHANGE AND PROFESSIONAL LIABILITY RISK FOR AUDITORS: A COMPARATIVE UNITED KINGDOM/ AUSTRALIA ANALYSIS

PAPER 2 **AUDITORS' LEGAL DUTIES: CLIMATE RISK IN OTHER INFORMATION**

BE HEARD.
BE RECOGNISED.



CLIMATE CHANGE AND PROFESSIONAL LIABILITY RISK FOR AUDITORS

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Introduction

It is in this particular facet of corporate disclosure that there can be observed a significant gap, likely to become even further pronounced, between UK and Australian statutory requirements. This has brought about corresponding divergence in each jurisdiction's adaptation into local application IAASB's ISA 720 *The Auditor's Responsibilities Relating to Other Information*. I deal first briefly with the growing divergence in 'other information' or narrative disclosure, then the interaction with respective external audit requirements.

In the UK context, statutory other information includes the directors' report, the directors' remuneration report, the strategic report and the corporate governance statement¹. In contrast, the primary Australian statutory 'other information' requirement is confined to the annual directors' report, there of course being elements of common subject matter, say in relation to remuneration of key management personnel. The Australian corporate governance statement requirement comes from ASX Listing Rule 4.10.3, with Listing Rule 19.12, in turn, defining the basis of presentation being disclosure on an 'if not, why not' basis, the extent to which there has been followed the ASX *Corporate Governance Council's* recommendations.²

The relatively perfunctory narrative disclosure requirement for listed companies under the *Corporations Act 2001* is as follows:

¹ It is briefly noted that the UK corporate governance statement requirements are embodied in Section 7.2 of the Disclosure and Transparency Rules (DTR) of the Financial Conduct Authority. The extent and manner in which the DTR are sourced from the *EU Accounting Directive* is not addressed in this *Comparative analysis*. What is relevant though is the related operation of UK Companies Act 2006 s 497A requiring auditor's report on the separate corporate governance statement. The relevant Australian treatment remains within Auditing Standard ASA 720 *The Auditor's Responsibility Relating to Other Information* where, given the inclusion within a listed entity's annual report, the corporate governance statement is "Other information" (ASA 72 para. 12(c)) subject to a requirement that the auditor read this information and consider the presence of material inconsistency between this 'other information' and the financial report and in the light of knowledge obtain during the course of the audit (ASA 72 para. 14(a)&(b)). The potential liability implications of this divergence in the basis and formality of audit in relation to other information is considered in more depth in this *Comparative analysis* in the context of management commentary disclosures.

² The 3rd edition of the Corporate Governance Principles and Recommendations released in 2014 are currently under review and a 4th edition is anticipated for public consultation in the second-half of 2018.

CORPORATIONS ACT 2001 - SECT 299A

Annual directors' report--additional general requirements for listed entities

(1) The [directors'](#) report for a financial year for a company, registered scheme or disclosing entity that is listed must also contain information that members of the listed entity would reasonably require to make an informed assessment of:

- (a) the operations of the entity reported on; and
- (b) the financial position of the entity reported on; and
- (c) the business strategies, and prospects for future financial years, of the entity reported on.

This section replicates, in part, the more broadly applicable requirements of s 299, but is addressed specifically to enable informed assessments by members. Sections 299 and 299A are complemented by guidance issues by either the ASX or ASIC. *Risky business* under both the general outline of other information requirements (pp. 10 – 11) and the associated auditors' legal duties (pp. 16 – 17) addresses four legal duties of disclosure based within the UK Companies Act s 414C strategic report content requirements.³ I deal with each of these in turn. There are common themes in the UK and Australia and thus there might arise comparable expectation of narrative disclosure around climate change risk. Notwithstanding this similarity in broad subject matter, the pointers of corporate and director liability risk are, as would be expected, intertwined with each jurisdiction's statutory source, detail and context.

A fair view of the company's business (UK CA s 414C(2)(a))

Corporations Act 2001 s 299(1)(a) is expressed in more neutral language requiring the directors' report to contain a review of operations. That the expectation is active and analytic in nature is emphasised in the opening wording of ASX Guidance Note 10⁴:

The Review provides a framework for the directors of a company to discuss and analyse its performance and opportunities and risks underlying its results and financial conditions to ensure communication by the company on a consistent basis.

³ Section 414C is reproduced in full as an appendix to this paper.

⁴ ASX GN 10 is applicable to Listing Rule 4.10.17 and some readers might think its content somewhat prescient given the current version was issued back in March 2003. Listing rule 4.10.17 requiring a review of operations and activities for the reporting period contains the following Note: "*Listing rule 4.10.17 is based on section 299 of the Corporations Act. ASX does not require the review of operations and activities to follow any particular format. Nor does ASX specify its content. However, ASX supports the Group of 100 Incorporated publication Guide to the Review of Operations and Financial Conditions. This publication is reproduced in ASX's Guidance Note on review of operations and activities.*"

In turn, Table 1 of ASX Guidance Note 10 lists amongst a number of requirements that the Review should “make clear how any financial and non-financial performance indicators - - -, ratios or other information related to financial statements”, and further, should “deal with the broader dimensions of the company’s performance, such as sustainability reporting, where that is relevant to users.”

Similarly, ASIC’s Regulatory Guide 247 applying specifically to application of s 299A, and applicable also generally to s 299, states in its opening discussion of Operations that:

An OFR should describe and provide a review of the operations that the entity undertakes, including the results of these operations, and give any significant changes during the reporting period.⁵

The non-passive character of the expected narrative is emphasised in subsequent paragraphs dealing with providing an informed understanding of both the entity’s business model⁶ and the underlying drivers of performance.⁷

Considered then from the perspective of the positively expressed expectation in *Risky business* relating to CA s 414C that directors “should consider whether climate risk is an issue [relevant to] a fair review of the company’s business”, avenues at least exist within the Australian regulatory setting for directors to engage in a similar discourse.

A description of the principal risks and uncertainties facing the company (UK CA s 414C(2)(b))

Neither ss 299 or 299A of the Corporations Act use the words ‘risk’ or ‘uncertainties’. Aside from a commonsense inference from wording such as “the directors’ report - - - must - - - refer to likely developments in the entity’s operation in future financial years”⁸, any doubt as to a positive obligation to address the likelihood and implications of relevant material risks is dispelled with reference, for instance, to para. 61 of RG 247:

It is likely to be misleading to discuss prospects for future years without referring to material business risks that could adversely affect achievement of the financial prospects described for those years.

Likewise, that the expectation might embrace nascent climate change risk can be readily discerned from various content within ASX Guidance Note 10. Table 3 listing matters relevant to a discussion of the dynamics of the business includes “capacity and utilisation of resources”, “environmental”, “occupational health and safety”, “legislative change and changes in public policy”, and even ventures into the possible domains of trust and social license referring to “changes in company

⁵ RG 247.41

⁶ RG 247.42

⁷ RG 247.43

⁸ Section 299(1)(e)

philosophy”. Table 7 dealing specifically with risk profile, management and mitigation of risk distinct from treasury policies, gives specific reference to legal and regulatory compliance, and environmental issues. This offers ample latitude for the meeting of heightened expectations for companies and directors to engage with stakeholders through annual reports in a discourse around both transitional and physical climate change risk.

Trends and factors likely to affect the future development, performance and position of the company’s business (UK CA s 414C(7)(a))

Although wording is of course different, similar broad intent can be deduced in the framing of s 299A(1)(c) of the Corporations Act, in particular, as to the narrative content explaining business strategies and performance.⁹ The elaboration given in RG 247 again shows both a present basis for greater accommodation of more detailed levels of climate risk disclosure, and indeed, also the potential to complement the forms of risk management disclosure contemplated under Recommendations within Part C of the FSB TCFD’s Final Report.¹⁰ Particularly germane within RG 247 is para. 63:

An OFR should include a discussion of environmental and other sustainability risks where those risks could affect the entity’s achievement of its *financial* performance or outcomes disclosed, taking into account the nature and business of the entity and its business strategy.

Although, at face value, a statement that might reasonably be expected to encourage and accommodate over time shifting knowledge and expectation around climate risk that ought to be disclosed, aspects of broader statutory context point to markedly different approaches that would suggest in relation to Australia a lesser sense of compulsion to initiate more detailed disclosure of climate risk analysis.

As to whether the UK strategic report and Australian OFR requirements address divergent contexts is perhaps most apparent in the wording of the first and introductory subsection of UK Companies Act 2006 s 414C: “The purpose of the strategic report is to inform members of the company and

⁹ RG 247.60 under the heading *Prospects for future financial years* commences by stating: “An OFR should contain a discussion of the entity’s prospects for future financial years. This is a narrative explaining the financial performance and outcomes the entity expects to achieve overall, taking into account its disclosed business strategies and other relevant factors.” The language of this authoritative guidance from the corporate regulator gives primary emphasis to seeking explanation of outcomes and prospects in predominantly financial performance terms, and is arguably narrower than the intent contained in the wording of UK s 414C(7)(a) and what might be deduced as accommodatable within the wording CA s 299A(1)(c).

¹⁰ The nature and scope of this *Comparative analysis* precludes speculation as to how existing disclosure frameworks, both in the UK and Australia, might be adjusted in response to the Strategy and, Metrics and Targets components of the Final Report, though I mention in passing that the recently announced IASB review of its Management Commentary Practice Statement might address some of these matters under the identified impinging development around the challenges in reporting pre-financial indicators.

help them assess how the directors have performed their duty under section 172 (Duty to promote the success of the company).” Space here does not permit discussion of the controversy around development of a broader best interests duty, it merely appropriate to highlight specific reference in s 172 that the director in the discharge of the good faith obligation have regard to, amongst other matters, “the impact of the company’s operation on the community and the environment”.¹¹ Debate about the substantial shift in the law of directors’ duties brought about by the introduction into English law of s 172 aside¹², its presence nevertheless sets critical context for the strategic report - matters of relationship and impact which can only, at best, be inferentially read into the Australian law of directors’ duties, and specifically relevant to matters addressed in *Risky business* and this *Comparative analysis*, the scope and character of external audit.

Specifically then, with reference to UK Companies Act 2006 s 496 requirements for an auditor’s report on strategic report and on directors’ report, whilst subsections (1)(a)(i) and (1)(b), dealing respectively with consistency with accounts and knowledge and understanding gained in the conduct of the audit, are broadly statutory expression of ISA 720 requirements, the scope of expectation is specifically and emphatically bolstered with the inclusion of s 496(1)(a)(ii): “[auditor must - - - state whether] any such strategic report and directors’ report have been prepared in accordance with applicable legal requirements”. As to whether this highlighted additional audit requirement might operate beyond the confines of the relationship between sections 172 and 414C to embrace consideration of, for example environmental or OH&S laws, is not considered here. What is emphasised though is the clear drawing of audit practices, formation of opinions and reporting of opinions within the ambit of what were, and remains under Australian rules and practice, areas of judgment that are the primary domain of directors.

Environmental matters, including the impact on the company’s business on the environment (UK CA s 414C(7)(b)(i))

As noted in *Risky business*, the obligation created by this component of the UK strategic report statutory rule requires information that would directly assist any reasonably sought assessment by report users. In relation to the broad spectrum of subjects including not only the environmental

¹¹ Section 172(1)(d), and relevant also at a broader level is (e): “the desirability of the company to maintain a reputation for high standards of business conduct”.

¹² A worthwhile analysis is provided by Professor Andrew Keay “The duty to promote the success of the company: Is it fit for purpose?”, *University of Leeds School of Law Working Paper*, Posted 22 August 2010. Noteworthy also is a Post-Scriptum (22 September 2017) at the Oxford Law Faculty website by A/Professor Georgina Tsagas “Section 172 of the UK Companies Act 2006: Desperate Times Call for Soft Law Measures” discussing the UK Government’s August 2017 Corporate Governance Green Paper reviewing, amongst other matters, the utility of section 172. In comparison, no similar government analysis of the breadth and utility of the law of directors’ duties, and disclosure obligations therein, can be anticipated in Australia. The Senate Economic Reference Committee in its April 2017 report *Carbon Risk: a burning issue* did recommend that “the government review the *Corporations Act 2001* to consider whether the obligations for financial disclosure should require holistic considerations of a company’s prospects, including the viability of its business model.” This recommendation will not however be advanced with Government noting its view as to the sufficiency of the current principles-based nature of financial disclosure requirements (March 2018).

matters but also employee, social community and human rights issues, both information on policies and directors' assessment of effectiveness must be given. No such breadth of subject matter nor description of management's 'self-assessment' of effectiveness is compelled under Australian corporate reporting statutory rules. Nevertheless, at somewhat of an anomaly to the broad principles-based thrust of the Australian financial disclosure regime, s 299(1)(f) does enter into specifics of obligations external to the Act, and performance thereon:

The directors report for a financial year must - - - if the entity's operations are subject to any particular and significant environmental regulation under a law of the Commonwealth or a State or Territory – details of the entity's performance in relation to environmental regulation.¹³

The reference to narrow matters of legal obligation is confirmed in ASIC's periodically updated RG 68 *New financial reporting and procedural requirements*:

Prima facie, the requirements would normally apply where an entity is licensed or otherwise subject to conditions for the purposes of environmental legislation or regulation.¹⁴

Addressed then from an audit perspective, the prevailing Australian circumstance would at least compel inquiring of evidence of laws and regulations to which an entity's operations are subject. Noteworthy also in RG 68 is statement that accounting concepts of materiality are not applicable and that disclosure cannot be reduced or eliminated by mere reference to a statutory-based disclosure to an environmental regulator. The substantially broader context of environmental performance reporting under UK s 414C, coupled with the reforms to Chapter 4A audit reporting requirements described above, herald a period of significant uncertainty, whereas well established disciplines of audit practice would in Australia negate to a large degree litigation risk in relation to this very narrow and specific form of environmental reporting.

Climate risk disclosures in other information – criminal liability implications

I conclude this section of the *Comparative analysis* by returning briefly to director criminal liability and prohibitions and penalties stemming from false or misleading statements, some of the Australian developments around which were introduced above at 3.2.2. In *Risky business*, the following is stated:

If directors approve a strategic report that does not comply with these [CA, ss 414A-B Strategic report] requirements, they may be criminally liable. Directors may also be personally liable to compensate the company for any loss suffered by the company as a

¹³ The requirement is applicable to directors' reports of companies, registered schemes and disclosing entities for financial years ending on or after 1 July 1998, and thus, of course, bears no relationship to international developments around the UNFCCC which date back to the initial round of the COP in 1995 (Berlin).

¹⁴ Regulatory Guide 68 para. 74(a).

result of a false or misleading statement included in the strategic report, or any relevant omission.¹⁵

Under RG 247 liability and misleading information is addressed in the following terms:

Care needs to be taken in preparing an OFR that the information included is not ‘false or misleading’. The general liability provisions concerning such conduct (e.g. s 1308) will apply to the information included in an OFR.

Bearing in mind that the given example section falls within the Corporations Act criminal offence provisions (Part 9.4), as opposed to civil penalty provisions as would apply to contravention of financial reporting requirements¹⁶, the most applicable provision would likely be subsection 4 which can be paraphrased to say:

A person who makes, or authorises, a materially misleading statement in a document required by the Corporation Act, or omits information from the document which makes it materially misleading, without having taken reasonable steps to ensure that the statement was not false or misleading, or to ensure that the document did not omit any matter without which it would be misleading in a material respect, is guilty of an offence.

That the OFR is a significant ‘document of the company’ is further emphasised in such statements in RG 247 that s 299A cannot be satisfied by referenced to other documents or reliance on the fact that potentially relevant information may have previously been disclosed to the market.¹⁷ Thus both ‘best practice’ in disclosure and the overarching context of potential liability, should compel development and presentation of an OFR which is both coherent and thorough. Elsewhere in RG 247 there is further specific reference to presentation of an OFR:

Despite the similarity in wording used in parts of s299A and the prospectus disclosure requirements, we do not expect an OFR to contain the same level of disclosure as a prospectus.¹⁸

Without suggesting a conclusive position, it may be that choices around climate risk related disclosures creates a friction between the value of brevity potentially encouraged by RG 247 and a desire to include more detailed information to avoid accusations of being misleading.

Again, as a final point of speculation in relation to climate-related liability risk associated with ‘other information’ narrative disclosure, it is worth pointing briefly to Corporation Act s 1309. It is here that an offence is created where, in brief and amongst other relationships, an officer or employee makes available false or misleading information, or omits material information, to an auditor that

¹⁵ Page 10, footnotes omitted.

¹⁶ Refer Corporations Act subsection 344(1) and Item 5 of s 1317H.

¹⁷ RG 247.15

¹⁸ RG 247.13 with para. 14 elaborating the reasons as reasonable expectation of shareholders’ existing familiarity with the entity, the OFR’s presentation in conjunction with the financial statements, the possibility that there has already been reporting under continuous disclosure obligations and the available reference point of an observable securities market price.

relates to the affairs of the corporation. The authors of *Ford's* elaborate, in particular, on subsection 4 of s 1309 addressing liability arising out of information furnished by way of answer to questions occurring in the context of the officer or employee's dealings with, amongst other relationships, an auditor.¹⁹ Conceivable then, the operation of s 1309 might focus the minds of both directors and auditors as to the degree to which statutory narrative disclosures might be prone to becoming misleading through a failure to fairly address climate risk disclosure in a proactive and timely manner.

¹⁹ [11.030] p. 781.

APPENDIX

414C Contents of strategic report

(1) The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).

(2) The strategic report must contain—

(a) a fair review of the company's business, and

(b) a description of the principal risks and uncertainties facing the company.

(3) The review required is a balanced and comprehensive analysis of—

(a) the development and performance of the company's business during the financial year, and

(b) the position of the company's business at the end of that year,

consistent with the size and complexity of the business.

(4) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) analysis using financial key performance indicators, and

(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

(5) In subsection (4), "key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.

(6) Where a company qualifies as medium-sized in relation to a financial year (see sections 465 to 467), the review for the year need not comply with the requirements of subsection (4) so far as they relate to non-financial information.

(7) In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) the main trends and factors likely to affect the future development, performance and position of the company's business, and

(b) information about—

(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

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(iii) social, community and human rights issues,

including information about any policies of the company in relation to those matters and the effectiveness of those policies.

If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.

(8) In the case of a quoted company the strategic report must include—

(a) a description of the company's strategy,

(b) a description of the company's business model,

(c) a breakdown showing at the end of the financial year—

(i) the number of persons of each sex who were directors of the company;

(ii) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)); and

(iii) the number of persons of each sex who were employees of the company.

(9) In subsection (8), "senior manager" means a person who—

(a) has responsibility for planning, directing or controlling the activities of the company, or a strategically significant part of the company, and

(b) is an employee of the company.

(10) In relation to a group strategic report—

(a) the reference to the company in subsection (8)(c)(i) is to the parent company; and

(b) the breakdown required by subsection (8)(c)(ii) must include the number of persons of each sex who were the directors of the undertakings included in the consolidation.

(11) The strategic report may also contain such of the matters otherwise required by regulations made under section 416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.

(12) The report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

(13) Subject to paragraph (10), in relation to a group strategic report this section has effect as if the references to the company were references to the undertakings included in the consolidation.

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(14) Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.