IoD Guernsey Breakfast - Friday 12th November 2021

Effective climate governance and best practice in climate risk reporting

With you today

Amy Pickering
Assurance Senior Manager, ESG and Net Zero
PwC Channel Islands (Guernsey)
amy.pickering@pwc.com
07781 125874

Ali Cambray
Advisory Director, ESG and Net Zero
PwC Channel Islands (Jersey)
alison.cambray@pwc.com
07700 838337

What we'll cover this morning

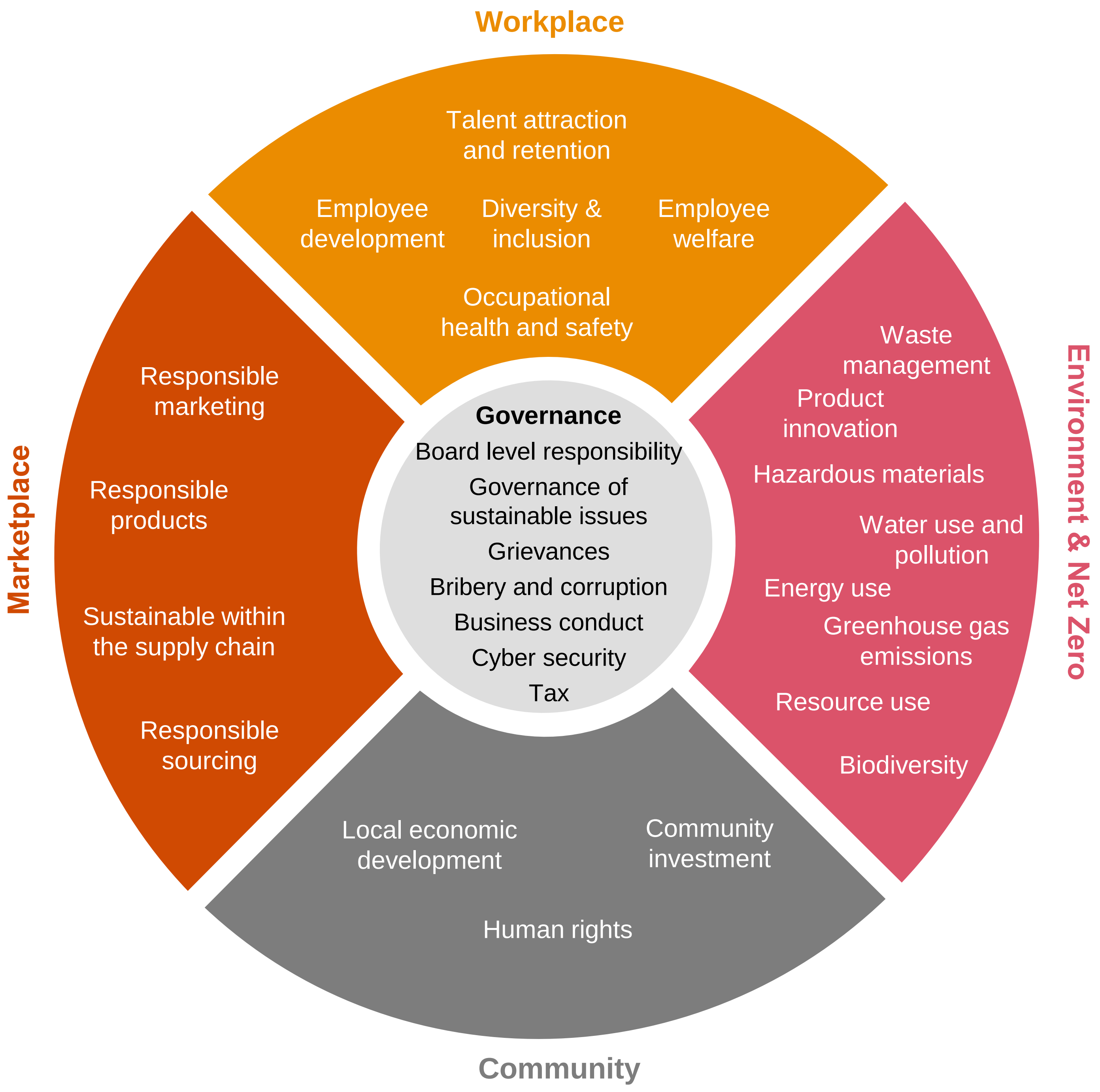
1. **The rise of ESG**
2. **What are "net zero" and "climate risk"?**
3. **What is the TCFD?** How is it driving best practice in climate governance and climate risk reporting?
4. **What does good practice look like?** For:
   - Climate governance
   - Strategy
   - Risk management
   - Metrics and targets
5. **What are the implications for financial statements, and for financial audits?**
6. **Key takeaways**
7. **Q&A**

1

The rise of ESG

What is 'ESG'?

- Broad scope of environmental, social and governance issues.
- Considered alongside "traditional" financial performance from a:
  - **risk** perspective
  - **value** perspective.
- Focus on material issues; some well advanced, others emerging.



Why now? What is driving the pace of change? The science… and…

Regulation

Investor action

Finance

Customer demand (B2B & B2C)

Enabling technologies

How does ESG impact business in practice?

The three dimensions of the ESG revolution

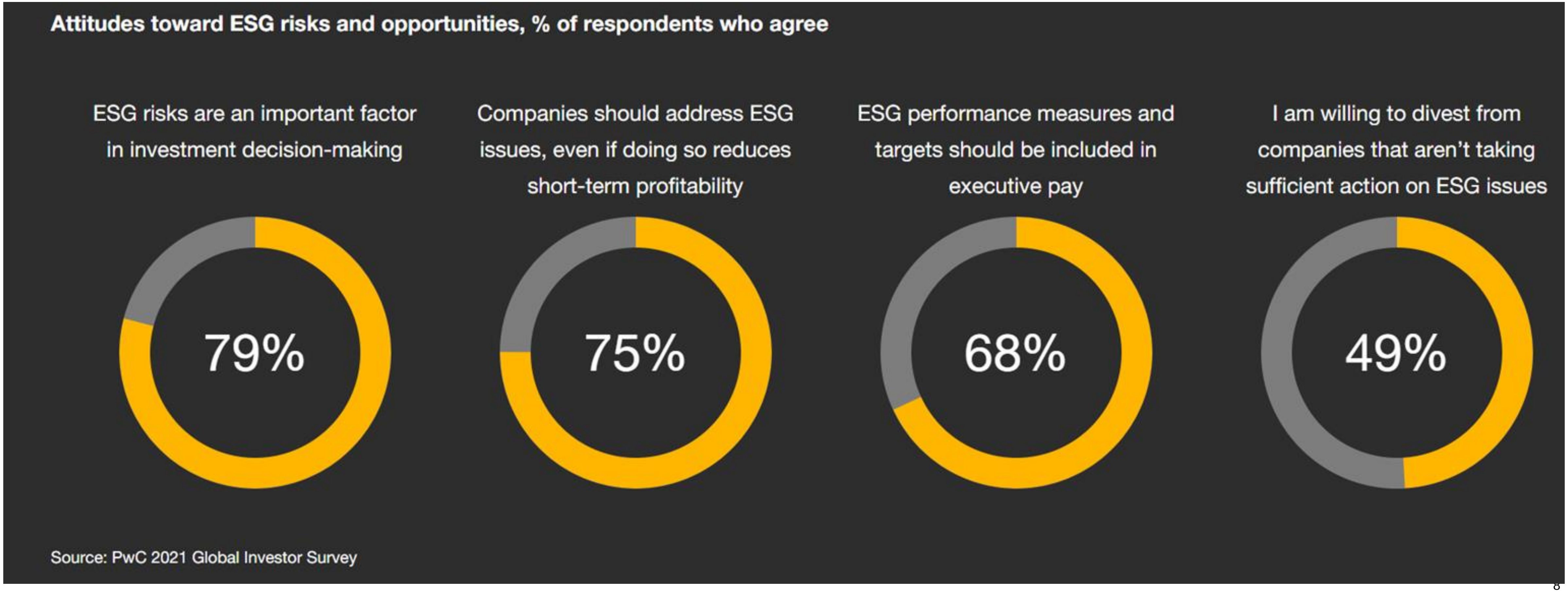
Translates ESG aspirations - What must we do? What should we do? What could we do? - into a blueprint for where and how to compete

Enables the measurement and reporting of ESG factors such as carbon emissions, workforce diversity, and supply chain sustainability

Drives ESG strategy and reporting into the heart of the business, often informing and extending ongoing digital transformation

The economic realities of ESG

- For investors, what started out as a way to measure the ESG performance of a company for the purposes of gauging risk, is now a major force driving investment strategy.
- Investors are increasingly calling for clarity about the ESG initiatives companies are undertaking, and demanding more holistic, comparable and reliable decision-useful ESG reporting.



SASB materiality map for your sector: Good practice

Dimension	General Issue Category	Real Estate
Environment	GHG Emissions	
	Air Quality	
	Energy Management	
	Water & Wastewater Management	
	Waste & Hazardous Materials Management	
	Ecological Impacts	
Social Capital	Human Rights & Community Relations	
	Customer Privacy	
	Data Security	
	Access & Affordability	
	Product Quality & Safety	
	Customer Welfare	
	Selling Practices & Product Labeling	
Human Capital	Labor Practices	
	Employee Health & Safety	
	Employee Engagement, Diversity & Inclusion	
Business Model & Innovation	Product Design & Lifecycle Management	
	Business Model Resilience	
	Supply Chain Management	
	Materials Sourcing & Efficiency	
	Physical Impacts of Climate Change	
Leadership & Governance	Business Ethics	
	Competitive Behavior	
	Management of the Legal & Regulatory Environment	
	Critical Incident Risk Management	
	Systemic Risk Management	

- A helpful sense check for wider sustainability issues
- Highlights those most likely to have a material impact on financial or operational performance
- Suggested metrics / indicators are provided under each issue
- Good practice is to disclose metrics for the material issues… what gets measured gets managed

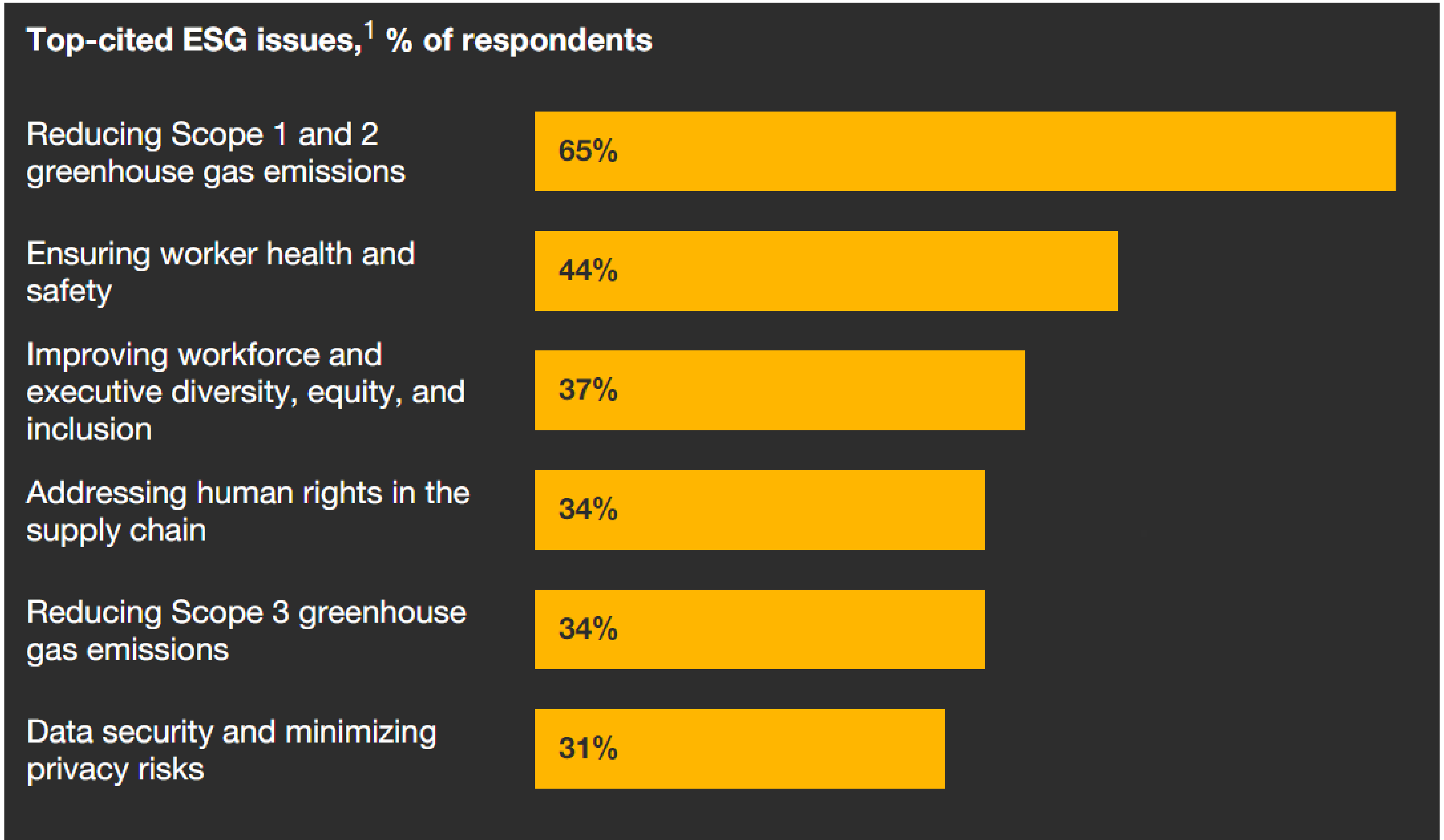
https://materiality.sasb.org/materiality.html

Industry Level Map

○ Not likely a material issue for companies in the industry

■ Likely a material issue for companies in the industry

Reducing Scope 1 and 2 GHG emissions is investors' priority



[1] Respondents were asked to select up to 5 issues from a list of 14 for companies in the main industry the respondent covers.

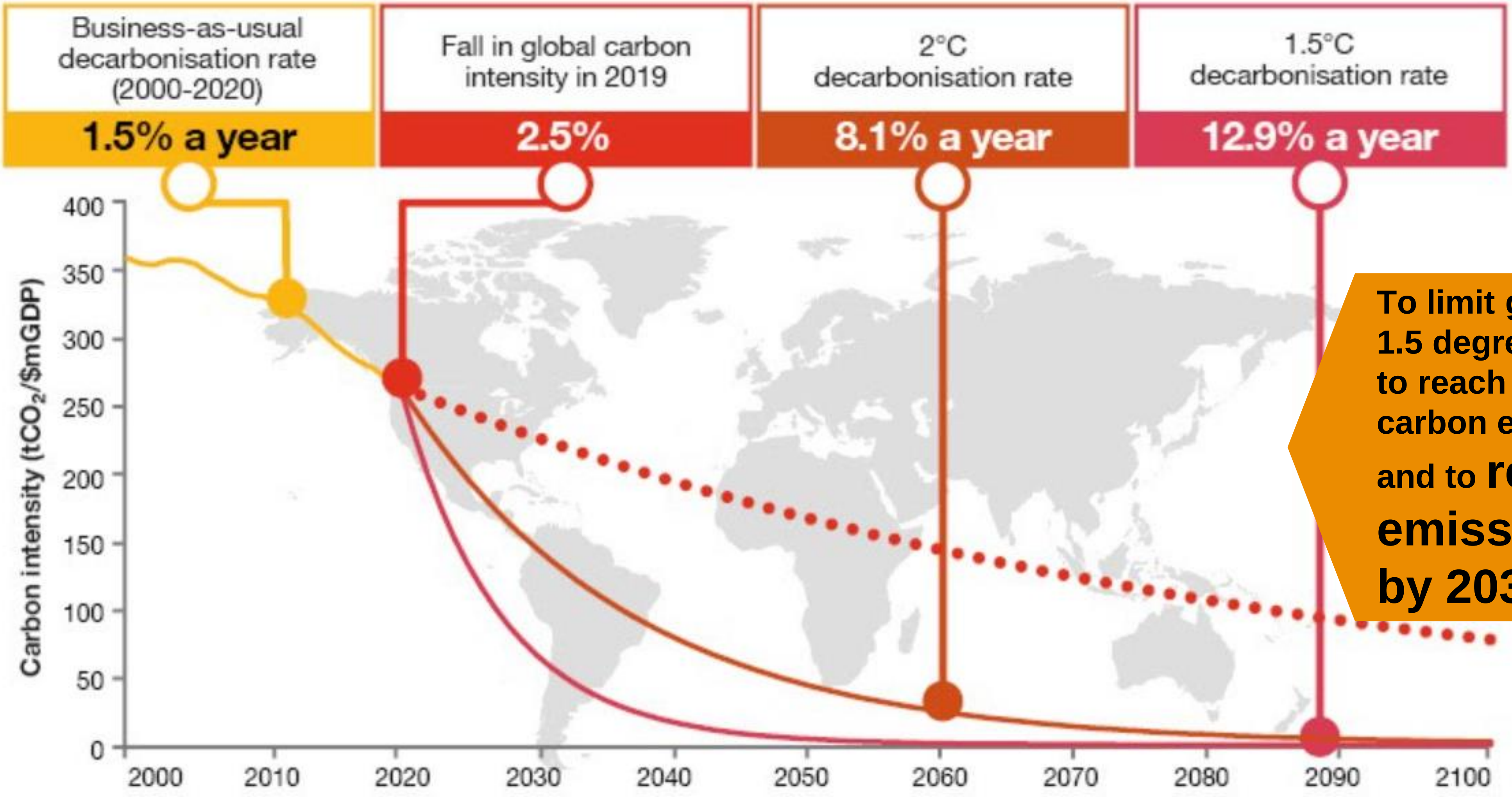
Source: PwC 2021 Global Investor Survey

https://www.pwc.com/economic-realities-of-ESG

2

What are “net zero” and “climate risk”?

The 2020s are the pivotal decade for climate action



To limit global warming to 1.5 degrees the world needs to reach net-zero global carbon emissions by 2050, and to reduce emissions by 50% by 2030

Source: PwC's [Net Zero Economy Index 2021]

What's the difference between carbon neutral and net zero?

Increasing level of ambition (at business, country or global economy level)

Carbon neutral

Achieve GHG neutrality by ***purchasing the equivalent GHG offsets***

- No GHG reduction target required
- Scope 1 and 2 focus, Scope 3 encouraged but not required
- Unregulated offsetting purchase scheme (sinks or credits)
- No imposed scope or timeline

Science-based target (SBT)

Reduction targets in line with climate science. **Does not use offsets to meet reduction targets.**

- Largely operational emissions and some material value chain emissions (where Scope 3 > 40% of emissions)
- Duration of targets is **5 - 15 years**
- Set r**eductions year on year** in line with 1.5C
- Targets are validated by an **independent body**

Net zero

SBT reduction (inc. value chain) + offsets to bring date forward

- Setting of an SBT
- Commitment to reducing impact throughout value chain
- More comprehensive and mandatory annual disclosure
- Carbon removals(drawdown tech / particular offsets) used to reach Net Zero before 2050
- Advocacy on climate action

Climate related risks

"Inside-out"

Risk of negative impact and/or a positive opportunity on the climate by the company e.g. energy usage and greenhouse gas emissions (SECR), policies, Net Zero etc.

COMPANY (or AUM / investment portfolio)

CLIMATE

Risk of negative impact and/or a positive opportunity on the company by climate e.g. climate related risks/ opportunities impacting future operations / business model, etc. (TCFD reporting).

PHYSICAL RISKS

TRANSITION RISKS

"Outside-in"

Climate related risks – 6 types of physical and transition risks

<2C

Climate change

>4C

Physical risks

… are associated with the **physical effects of climate change**. They can be:

- **Event-driven (acute)**, such as cyclones, hurricanes, wildfires, heatwaves, plagues, drought or floods; or
- **Longer term (chronic)** shifts in climate patterns, such as: sustained higher temperatures with melting of glaciers and ice sheets causing sea level rise; permafrost melt; chronic heat waves and desertification; extreme variability in precipitation; land degradation; and changes in air quality.

Transition risks

… arise as **economies transition towards less polluting, greener solutions**. These include externally imposed risks such as:

- **Policy, legal and regulatory**
- **Market risk**
- **Technology risk**
- **Reputation risk**

and the consequent business decisions taken to respond to such changes.

Transition risks have the potential to crystalise suddenly, for example as a result of policy change.

Opportunities

The opportunities are also significant:

- Resource efficiency
- Energy sources
- Products and services
- Markets
- Resilience

3

What is the TCFD framework?

How is it driving good practice in climate governance and climate risk reporting?

The Task Force on Climate-related Financial Disclosures

- **Established by the Financial Stability Board in response to a request from the G20 and Central Bank**
- **Made up of 32 private sector members drawn from a range of industries and countries**
- **Final recommendations published in June 2017**
- **4th Status update published in 2021**

2020 Status Report
Published November 2020
See the report here

2021 Status Report
Published October 2021
See the report here

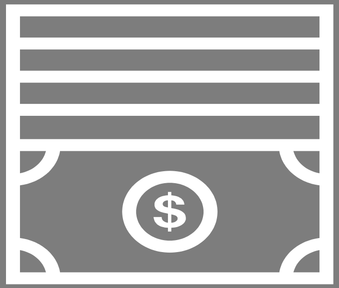
2,600
Companies and organisations support the TCFD

$194tn
Value of financial assets of financial institutions signed up to TCFD

89
Number of countries represented

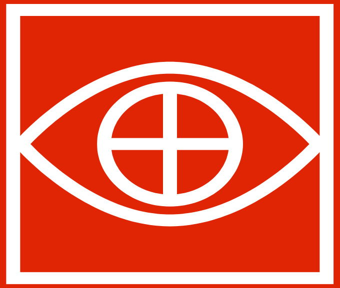
1,069
Number of financial firms

What makes the TCFD different?



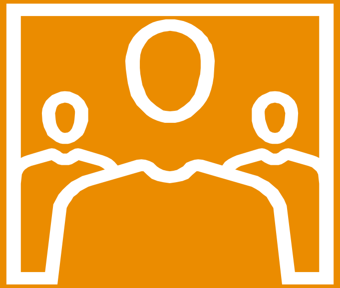
#1

It shifts the emphasis from sustainability metrics to *financial disclosures* in financial reports



#2

The use of *scenario analysis* in assessing the potential impacts of climate change to a *company's financials*



#3

It is a *private sector-led* initiative of leaders and forward-thinkers with a balance across industries and roles

UK regulatory landscape and mandatory TCFD disclosures

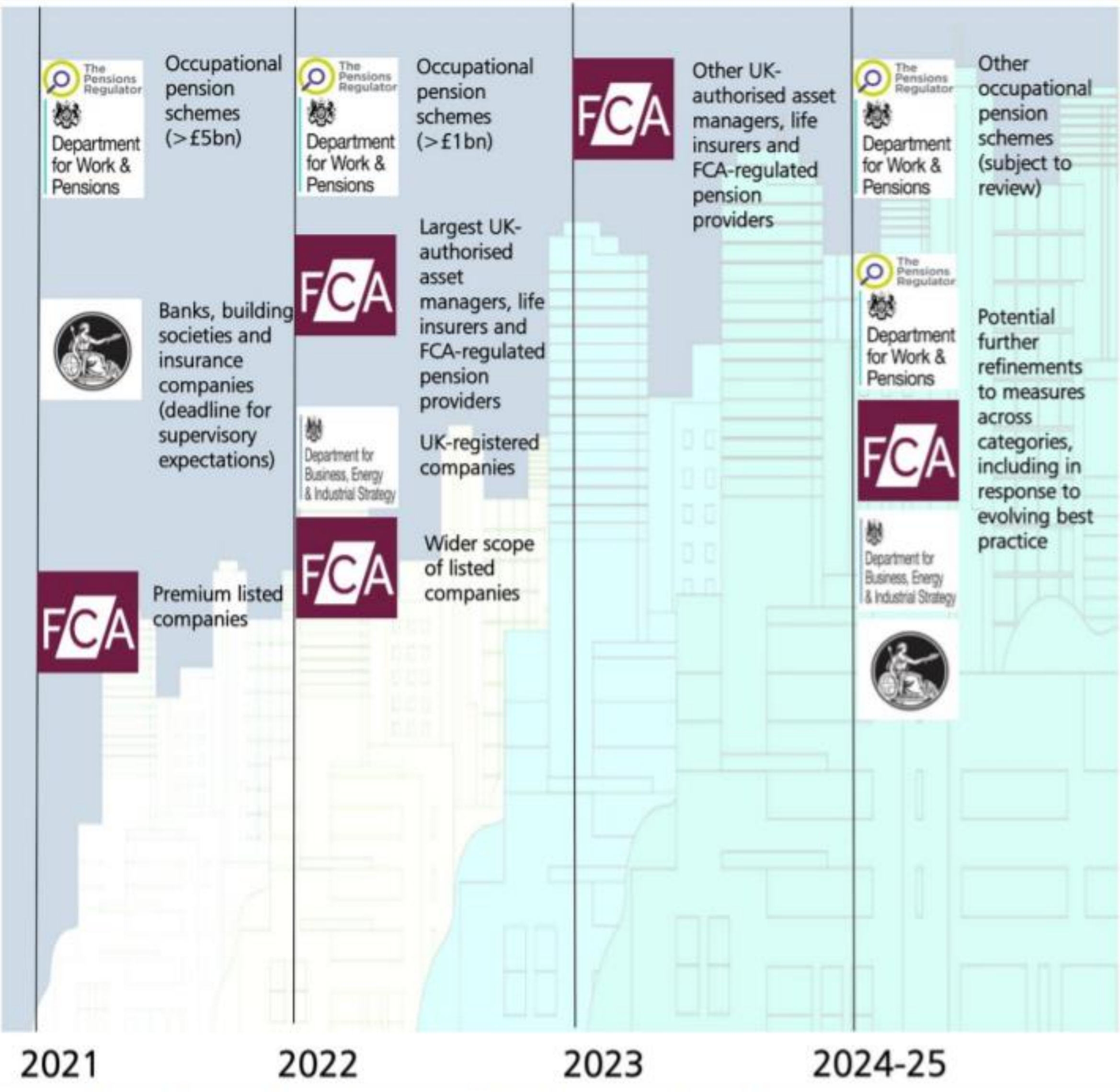


Figure 2: Timeline of planned or potential regulatory actions or legislative measures
Source: A Roadmap towards mandatory climate-related disclosures

Guernsey regulatory requirements on climate risk

GFSC Finance Sector Code of Corporate Governance

- Applies to all companies that hold a licence from the GFSC under the regulatory laws or which are registered / authorised as CIS under The PoI Law
- Amended in June 2021 with regards to climate change:

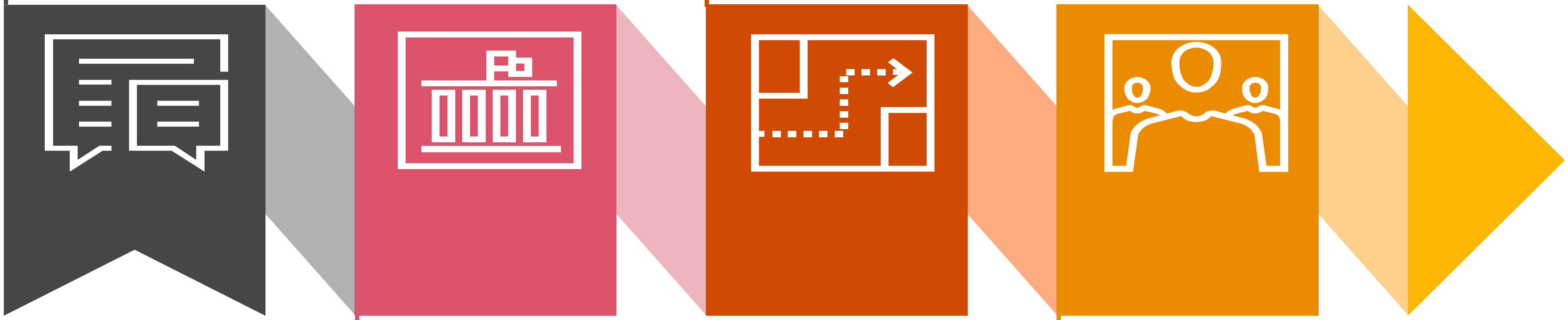
> ***"The Board should consider the impact of climate change on the firm's business strategy and risk profile and, where appropriate in the judgement of the board, make timely climate change related disclosures."***

- Effective for financial years starting on / after **1 October 2021.**
- Companies which report against the UKCGC or the AIC Code are deemed to meet this Code.

The benefits of implementing TCFD recommendations

Stakeholder & investor views
Increase investors' confidence that the company's climate-related risks are appropriately assessed and managed

Risks & strategy Understanding climate-related risks and opportunities within the company improves risk management and strategic planning



Regulatory Momentum
Effectively meet existing requirements and stay ahead of incoming regulation

Peer movement
Keep pace with competitors who are making moves to enhance their climate-related disclosures

What are the TCFD recommendations?

The TCFD disclosure recommendations are for all industries, as set out at a high-level below. There are also specific implementation guidance for insurers outlining expected actions for the industry.

A

Governance
Disclose the extent of board and management's oversight of climate-related risks and opportunities.

B

Strategy
Disclose the actual & potential impacts of climate-related risks & opportunities on the organisation's businesses, strategy, and financial planning where such information is material.

C

Risk Management
Disclose how the organisation identifies, assesses, and manages climate-related risks.

D

Metrics & Targets
Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

The Task Force has produced additional guidance that underpins these four broad recommendations. This can be found on the TCFD website. Refer to the Annex titled Implementing the Recommendations of the TCFD and a Technical Supplement titled The Use of Scenario Analysis.

Figure 4

Recommendations and Supporting Recommended Disclosures

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.
Recommended Disclosures	**Recommended Disclosures**	**Recommended Disclosures**	**Recommended Disclosures**
a) Describe the board's oversight of climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.	a) Describe the organization's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.	b) Describe the organization's processes for managing climate-related risks.	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
	c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

Source: Final Report - Recommendations of the Task Force on Climate-related Financial Disclosures

TCFD Status Report overview

Energy companies led the way on disclosure until 2021, when materials and buildings took the lead

Alignment with the TCFD recommendations increased from 2017 to 2021 for every recommended disclosure

% of companies disclosing against the TCFD recommendations can vary significantly across industries

All sectors struggle with scenario analysis

Recommendation	Recommended Disclosure	Banking (282)	Insurance (132)	Energy (267)	Materials & Buildings (404)	Trans-portation (158)	Ag., Food & Forest (142)	Technology & Media (106)	Consumer Goods (160)
Governance	a) Board Oversight	22%	35%	34%	27%	23%	17%	6%	20%
	b) Management's Role	17%	23%	20%	23%	15%	13%	8%	16%
Strategy	a) Risks and Opportunities	45%	52%	67%	61%	49%	50%	25%	41%
	b) Impact on Organization	35%	36%	47%	49%	36%	31%	28%	26%
	c) Resilience of Strategy	15%	18%	18%	14%	6%	11%	7%	8%
Risk Management	a) Risk ID and Assessment Processes	33%	37%	30%	33%	25%	28%	12%	23%
	b) Risk Management Processes	32%	47%	32%	31%	22%	25%	8%	21%
	c) Integration into Overall Risk Management	29%	39%	31%	29%	18%	23%	11%	18%
Metrics and Targets	a) Climate-Related Metrics	35%	32%	44%	58%	41%	48%	26%	42%
	b) Scope 1, 2, 3 GHG Emissions	27%	30%	36%	52%	28%	39%	24%	37%
	c) Climate-Related Targets	22%	27%	41%	43%	28%	41%	25%	35%

Legend: Low to high percentage of disclosure

Source: TCFD Status Report 2021

4

What does good practice look like?

A: Governance

Figure 4

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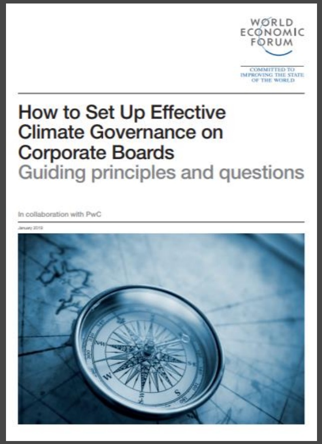
Source: Final Report - Recommendations of the Task Force on Climate-related Financial Disclosures

WEF Climate Governance Initiative

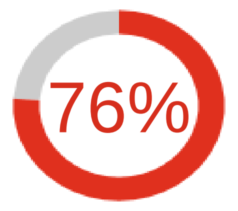
“How to Set Up Effective Climate Governance on Corporate Boards: Guiding principles and questions”



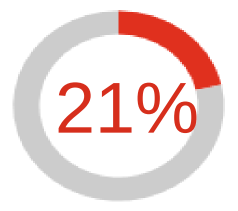
- A set of practical guiding principles and questions to guide the development of good climate governance.
- Designed to help board members practically assess and debate their organization’s approach to climate governance and frame their thinking about how to improve their approach.
- Builds on existing corporate governance frameworks as well as other climate risk and resilience guidelines.
- Drafting process involved extensive consultation with over 50 executive and non-executive board directors, among others.

Governance reporting good practice

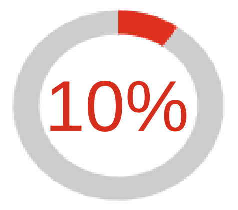
Stats from PwC's Climate change award 2020 which scored FTSE 350 companies on their climate change reporting



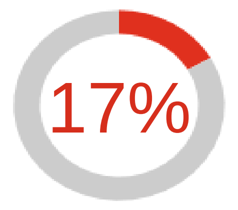
Over three quarters mentioned a Board level committee with climate change oversight.



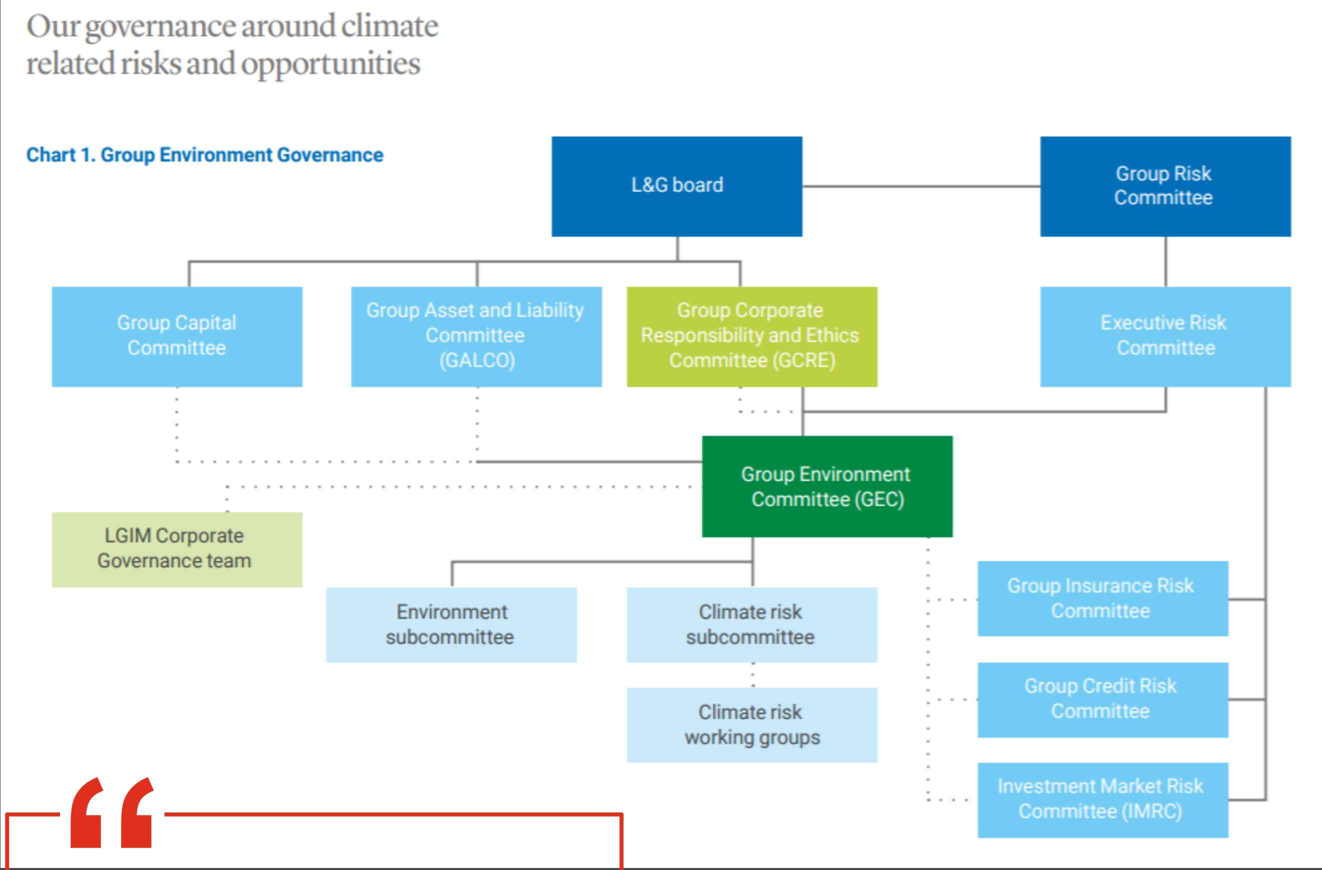
Less than one quarter mentioned executive remuneration linked to climate-related objectives



1 in 10 described the competencies of one or more board members in relation to climate change



Less than 20% outlined a plan for training of board members or have already carried out training



"We like how Legal & General show both how climate risk has board oversight and also how it feeds into the Executive/Group Risk Committees.

B: Strategy

Figure 4

Recommendations and Supporting Recommended Disclosures

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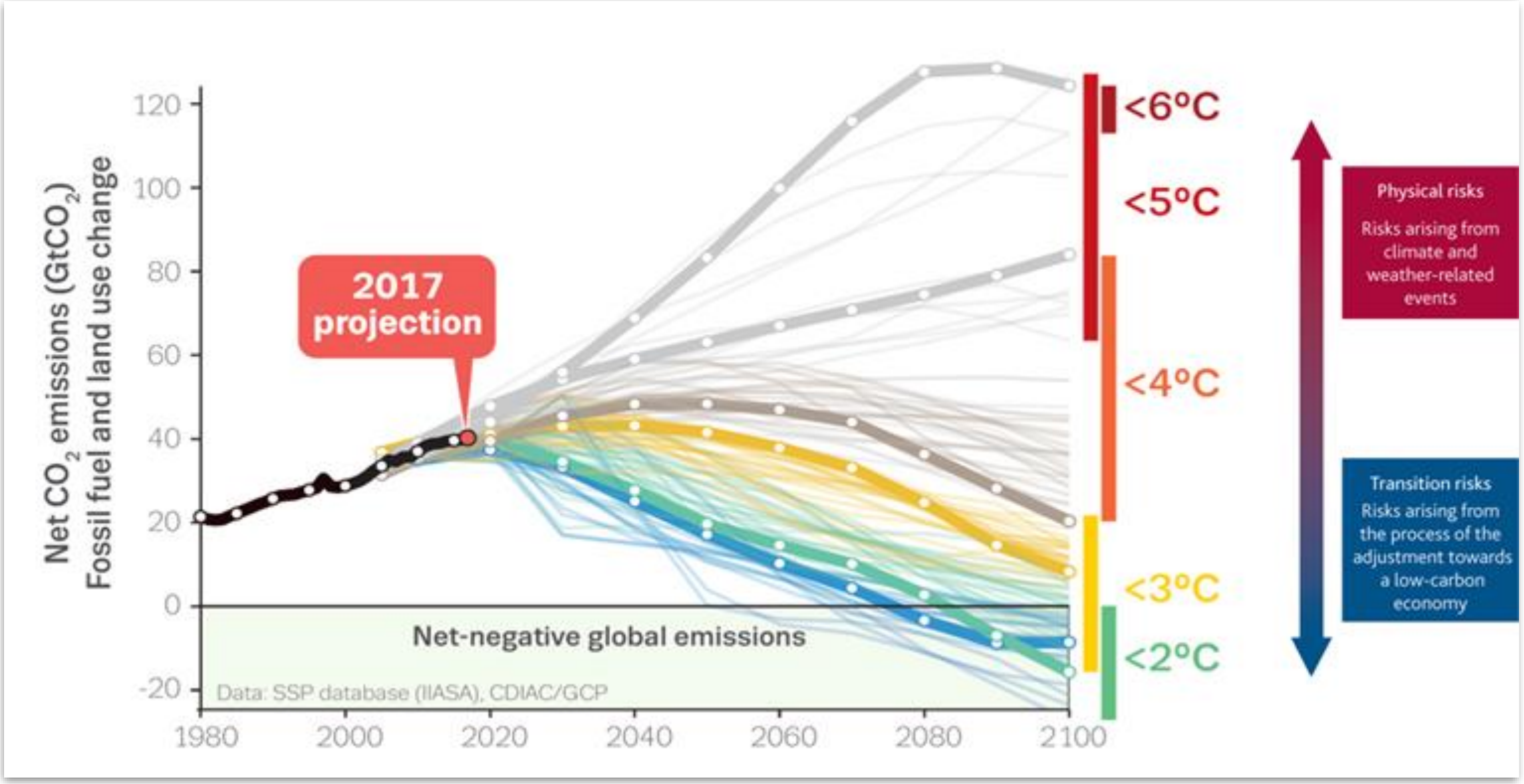
Source: Final Report - Recommendations of the Task Force on Climate-related Financial Disclosures

B: Strategy. Use scenario analysis to assess business implications and inform stakeholders of the business' position



Global Carbon Project (2017); Bank of England graphic

4ºC temperature increase:
No change in climate policy

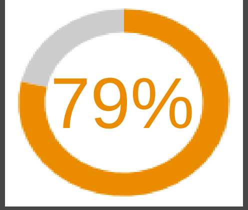
3ºC temperature increase
Governments enact policies to meet stated ambition but these are not sufficient to achieve goals of Paris Agreement

2ºC temperature increase:
Governments increase policy ambition to limit climate change

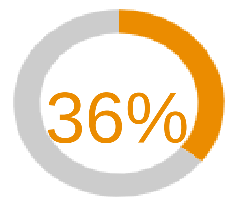
1.5ºC temperature increase:
Governments rapidly increase policy ambition to avoid climate change

Strategy reporting good practice

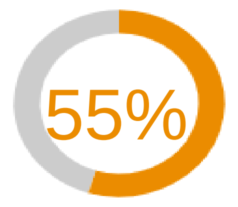
Stats from PwC's Climate change award 2020 which scored FTSE 350 companies on their climate change reporting



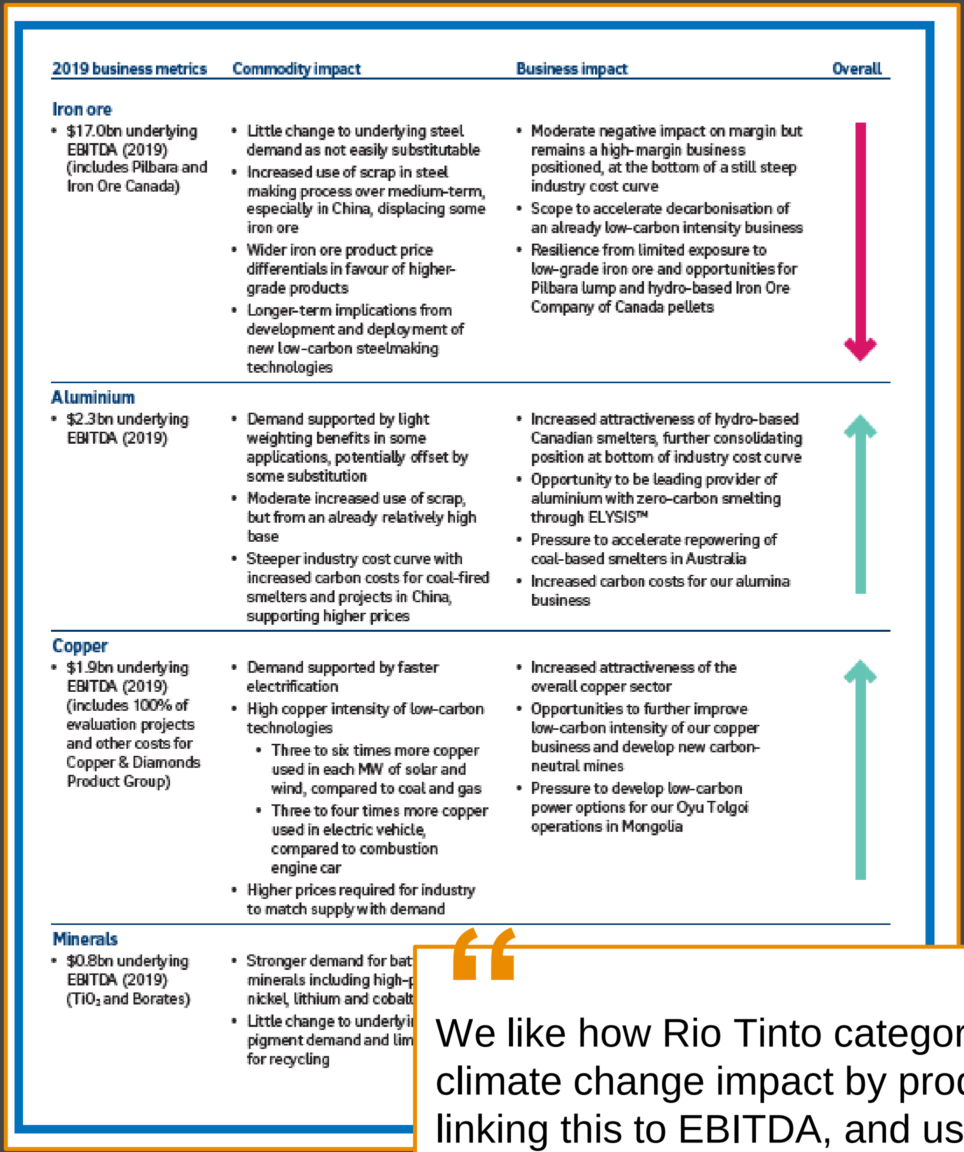
Nearly 80% of companies identified the impacts of climate change, however only 40% of companies link climate impacts to financial performance in some way



Over a third have performed scenario analysis and described the resilience of strategy in each scenario.



Over half have made net zero commitments.



2019 business metrics	Commodity impact	Business impact	Overall
Iron ore • $17.0bn underlying EBITDA (2019) (includes Pilbara and Iron Ore Canada)	• Little change to underlying steel demand as not easily substitutable • Increased use of scrap in steel making process over medium-term, especially in China, displacing some iron ore • Wider iron ore product price differentials in favour of higher-grade products • Longer-term implications from development and deployment of new low-carbon steelmaking technologies	• Moderate negative impact on margin but remains a high-margin business positioned, at the bottom of a still steep industry cost curve • Scope to accelerate decarbonisation of an already low-carbon intensity business • Resilience from limited exposure to low-grade iron ore and opportunities for Pilbara lump and hydro-based Iron Ore Company of Canada pellets	
Aluminium • $2.3bn underlying EBITDA (2019)	• Demand supported by light weighting benefits in some applications, potentially offset by some substitution • Moderate increased use of scrap, but from an already relatively high base • Steeper industry cost curve with increased carbon costs for coal-fired smelters and projects in China, supporting higher prices	• Increased attractiveness of hydro-based Canadian smelters, further consolidating position at bottom of industry cost curve • Opportunity to be leading provider of aluminium with zero-carbon smelting through ELYSIS™ • Pressure to accelerate repowering of coal-based smelters in Australia • Increased carbon costs for our alumina business	
Copper • $1.9bn underlying EBITDA (2019) (includes 100% of evaluation projects and other costs for Copper & Diamonds Product Group)	• Demand supported by faster electrification • High copper intensity of low-carbon technologies • Three to six times more copper used in each MW of solar and wind, compared to coal and gas • Three to four times more copper used in electric vehicle, compared to combustion engine car • Higher prices required for industry to match supply with demand	• Increased attractiveness of the overall copper sector • Opportunities to further improve low-carbon intensity of our copper business and develop new carbon-neutral mines • Pressure to develop low-carbon power options for our Oyu Tolgoi operations in Mongolia	
Minerals • $0.8bn underlying EBITDA (2019) (TiO_2 and Borates)	• Stronger demand for bat[illegible] minerals including high-[illegible] nickel, lithium and cobalt • Little change to underlyi[illegible] pigment demand and lim[illegible] for recycling		

“

We like how Rio Tinto categorises the climate change impact by product, linking this to EBITDA, and using a specific scenario (IA SDS), which is linked to the IPCC scenarios.

C: Risk management

Figure 4

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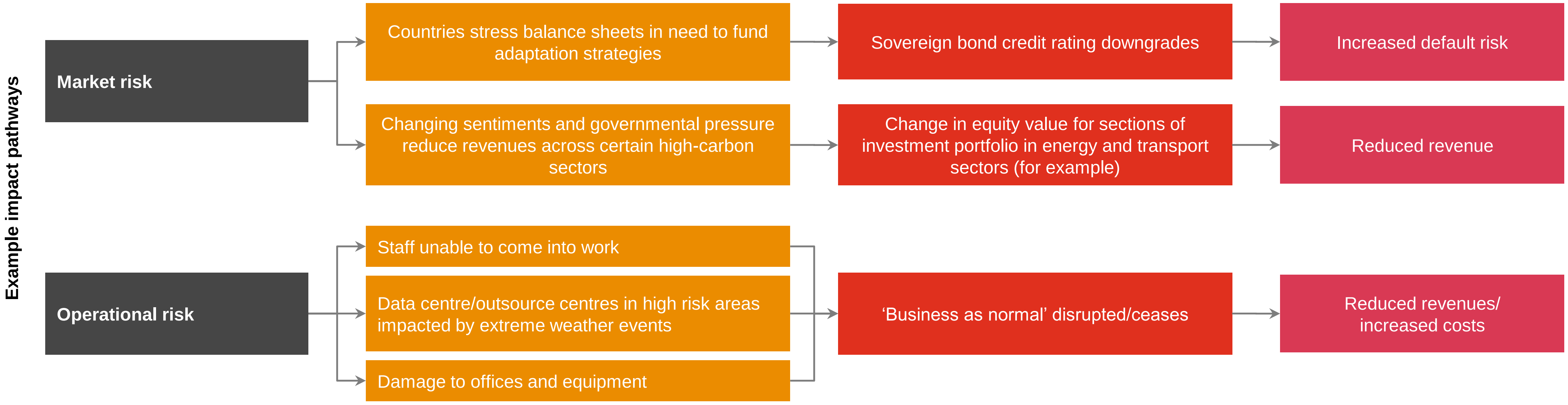
Source: Final Report - Recommendations of the Task Force on Climate-related Financial Disclosures

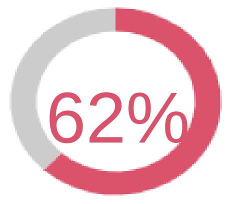
C: Risk management: linking climate risks to financial impacts

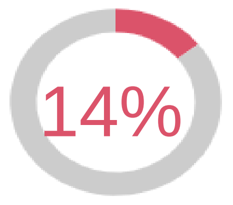
	Credit risk	Market risk	Operational risk
Example climate risk factor	Companies' business models are not aligned to a 1.5C or 2C transition.	Tightening of climate-related policy has economic impacts.	Severe weather impacts could impact business continuity.
Key considerations	Increased risk that financial counterparties might default on obligations.	Market risks impacts could be felt through company or securities valuations; asset impairment; and credit rating implications. The PRA has identified executing brokers as key in helping clients manage market risks.	Operational risk profile could be impacted through extreme weather events in London e.g. transport system flooded. Any key outsourced functions or processes in high-risk locations should be given particular consideration.



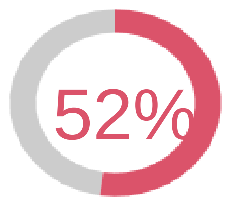
Risk management reporting good practice

Stats from PwC's Climate change award 2020 which scored FTSE 350 companies on their climate change reporting

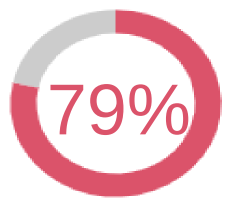




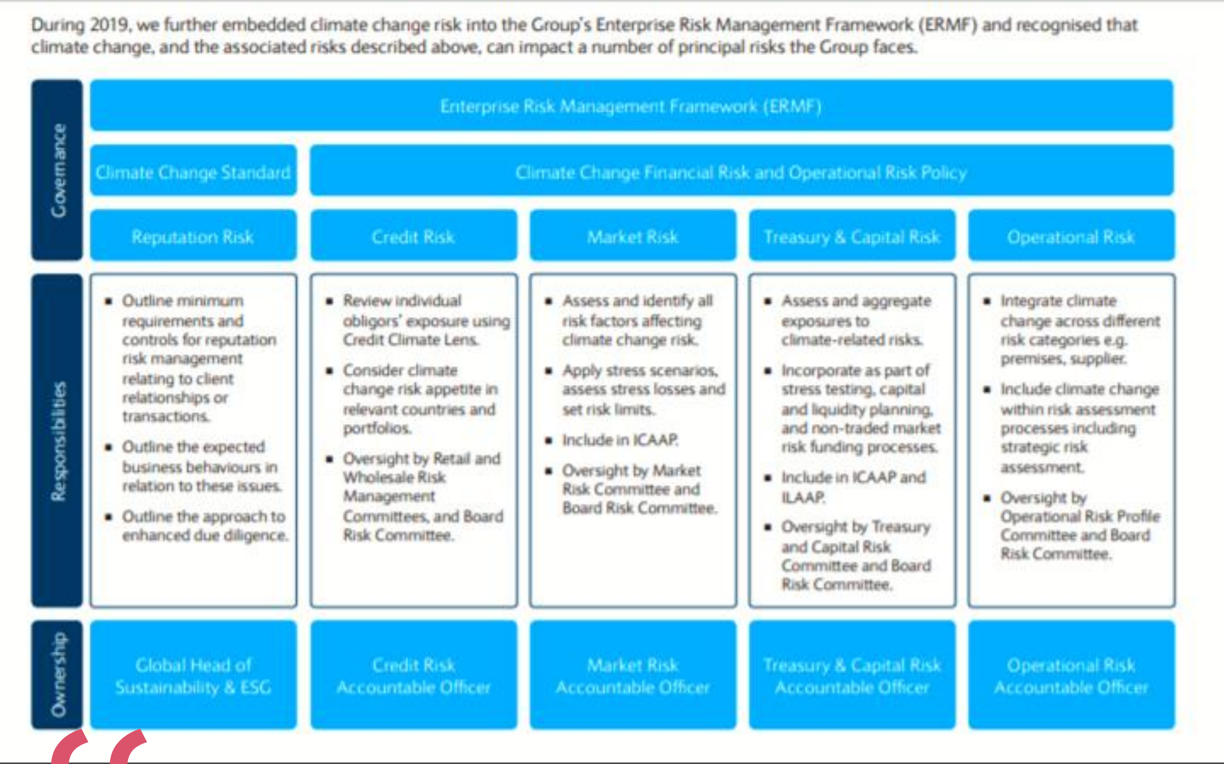
Almost 2/3rd described some sort of mitigation of climate-related risks, however there was very low disclosure on management of the financial implications of climate risk.



Over half described engagement with multiple stakeholders (including suppliers, customers, industry or policy makers)



Most disclose some level of integration of risks into their risk management process.



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We like how Barclays clearly shows how climate risk is integrated into the Enterprise Risk Management Framework, with oversight across multiple parts of the bank, led by Risk Officers who have responsibility beyond climate risk.

D: Metrics and targets

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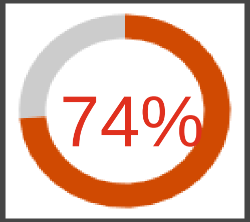
	A) Disclose the metrics used to assess climate related risks and opportunities	B) Disclose Scope 1 & 2 and if appropriate Scope 3 GHG emissions, and related risks	C) Describe the targets used to manage climate-related risks and opportunities and performance against targets opportunities
Asset owners / Asset managers	• Describe metrics used to assess climate-related risks and opportunities in each fund or investment strategy • Describe metrics used in investment decisions and monitoring	• Disclose the weighted average carbon intensity, where data is available or can be reasonably estimated, for each fund or investment strategy * • Disclose any other metrics believed to be useful for decision making + description of the methodology	• This often includes emissions reduction targets. Increasingly, investors are looking for alignment of emissions reduction initiatives with Net Zero

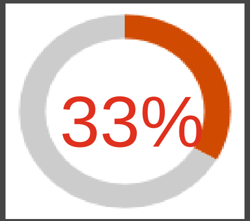
* TCFD has issued latest guidance on financial sector metrics – see their website

Metrics and targets reporting good practice

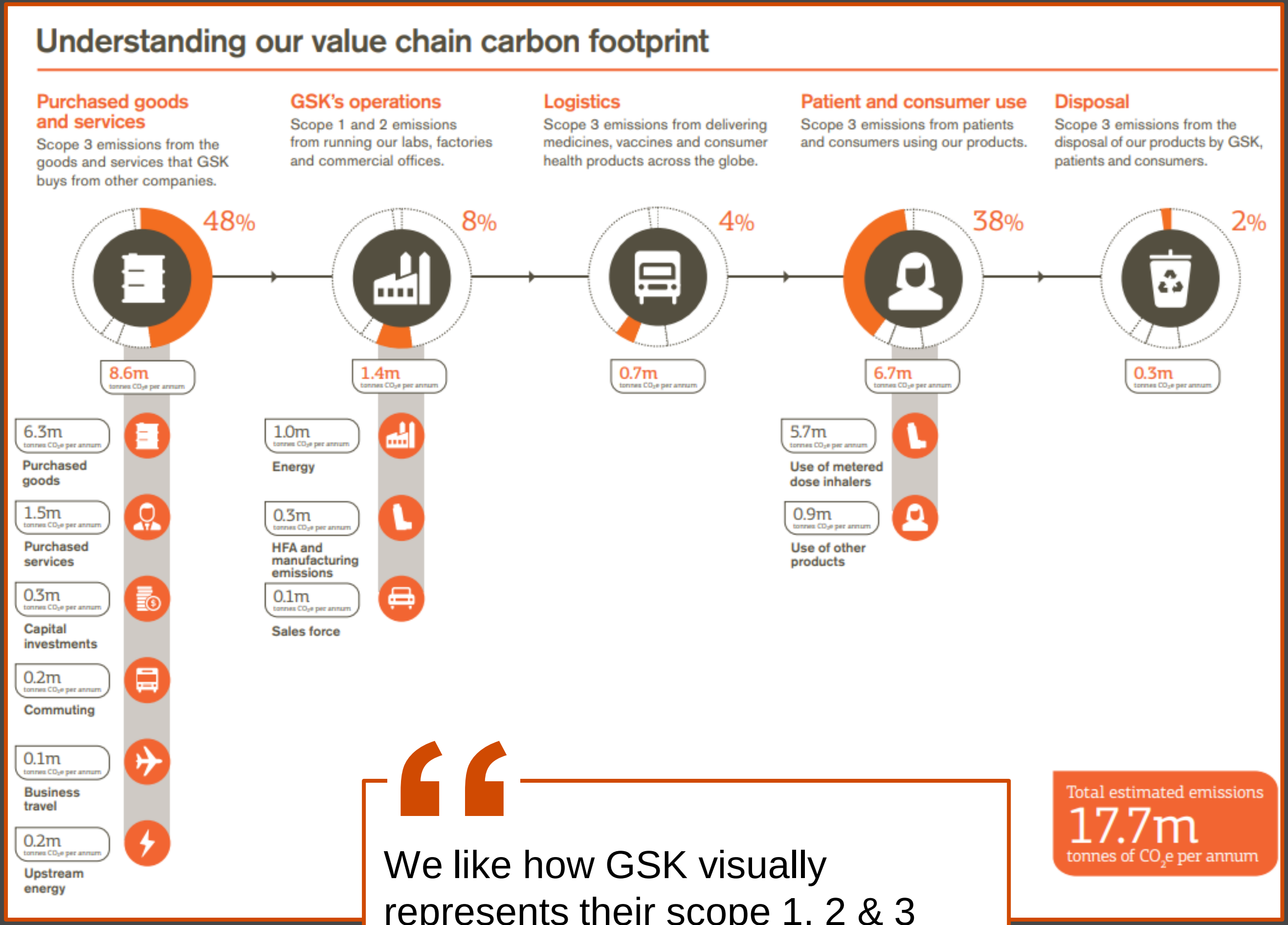
Stats from PwC's Climate change award 2020 which scored FTSE 350 companies on their climate change reporting



Three quarters reported Scope 1,2 and 3 emissions



One third disclosed targets linked to broader strategic targets such as Net Zero or the company's strategy.



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We like how GSK visually represents their scope 1, 2 & 3 emissions across the value chain.

5

Implications for reporting and assurance

How can Climate and ESG impact the financial statements?

Potential impacts to other information (the 'front half') prior to new climate reporting requirements:

- Strategic report - including strategically relevant information on:
  - environmental reporting via the non financial information statement
- AIC Code of Corporate Governance requirements, including:
  - Governance focused on the long term success of companies
  - Principal / emerging risks
  - Viability statements
- Section 172 of UK Companies Act

Incoming regulations now specifically requiring climate reporting:

- TCFD reporting / climate reporting as deemed appropriate by the Board in order to meet the requirements of the GFSC Finance Sector Code

Potential impacts to the financial statements (the 'back half'):

- Value measurement of investments
  - how sustainable is the portfolio?
- Accounting judgements and estimates
  - Are sustainability factors likely to influence useful life / and recoverable amount estimates?
- Financial instrument disclosures
  - IFRS 7 requires disclosure of risks on financial instruments held, and how these risks are managed
- Provisions, contingent liabilities and contingent assets

Climate risk - regulatory focus

The defining issue of our time

There is an unprecedented level of attention by Government, regulators and investors on effective reporting and auditing in this area.

Management needs to appropriately consider and respond to the impact of climate-related risks and opportunities in the annual report, and are responsible for performing a robust assessment of risks and opportunities that climate change has on the business and determining what impact these may have on the financial statements and report accordingly.

Impact on financial audits

Audit teams will challenge management’s assessment of how climate-change related risks and opportunities impact the financial statements and how this has been disclosed, particularly focussing on how those risks and opportunities have been considered and factored into broader narrative reporting including assumptions and estimates.

Audit procedures can be expected to include:

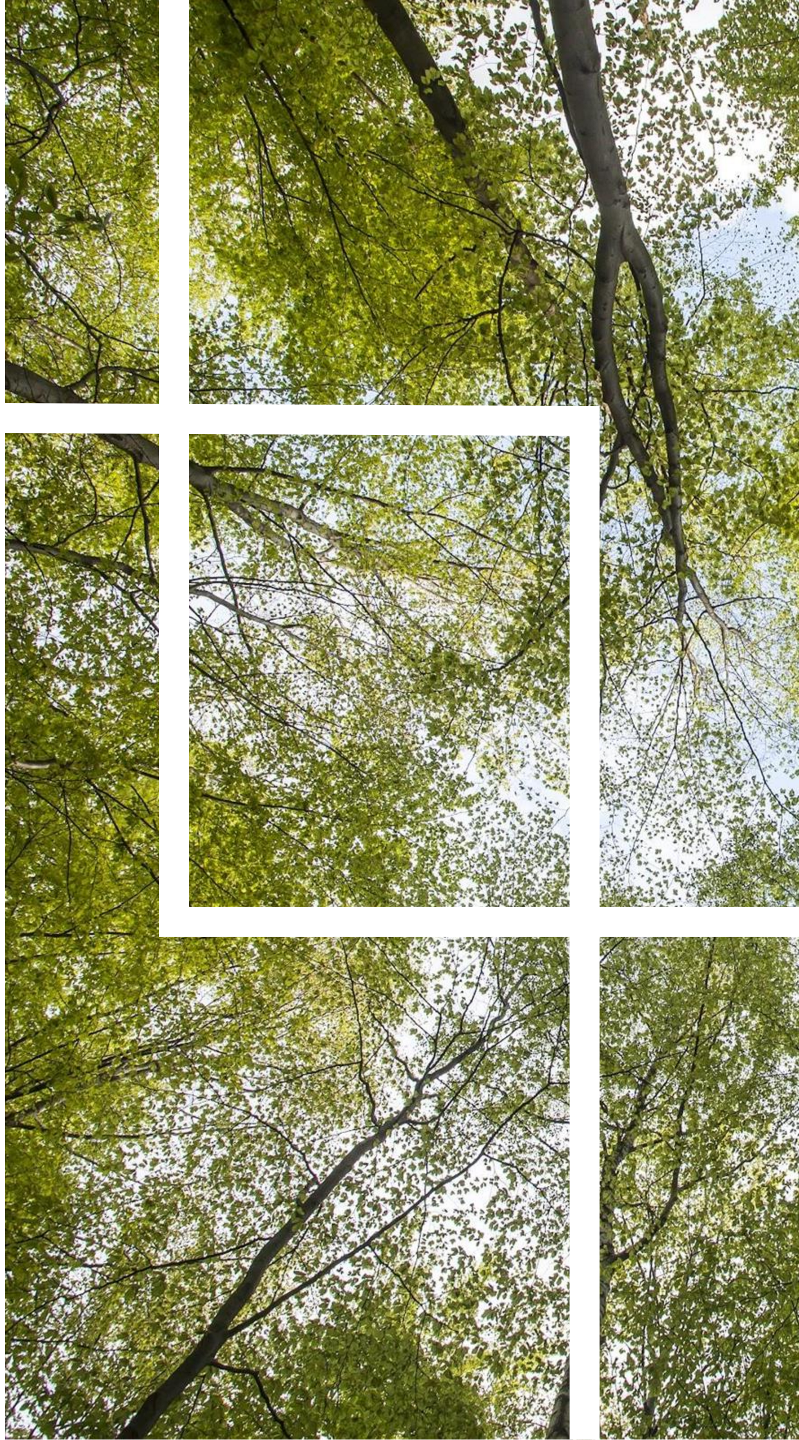
- Understand management’s process for identifying climate-related risks and opportunities;
- Understand the governance process over this;
- Understand what the climate -related risks (and opportunities) are, and what the assessed impact is;
- Understand whether any climate rated commitments have been made or are being considered;
- Review reporting of climate-related risks and opportunities within the financial statements; and
- Consider, and challenge management where appropriate, if the impact of climate-related risks have not been sufficiently considered or disclosed.

6

Key takeaways

Conclusions and takeaways

- Expectations around climate governance and reporting are rising
- Investors, clients (and regulators) want better quality, insightful disclosures
- The TCFD framework has emerged as the global standard
- It is not a tick-box exercise, but a process of continuous improvement, based around financial implications
- Don’t wait for perfect information and data to start your journey
- Good governance is the key



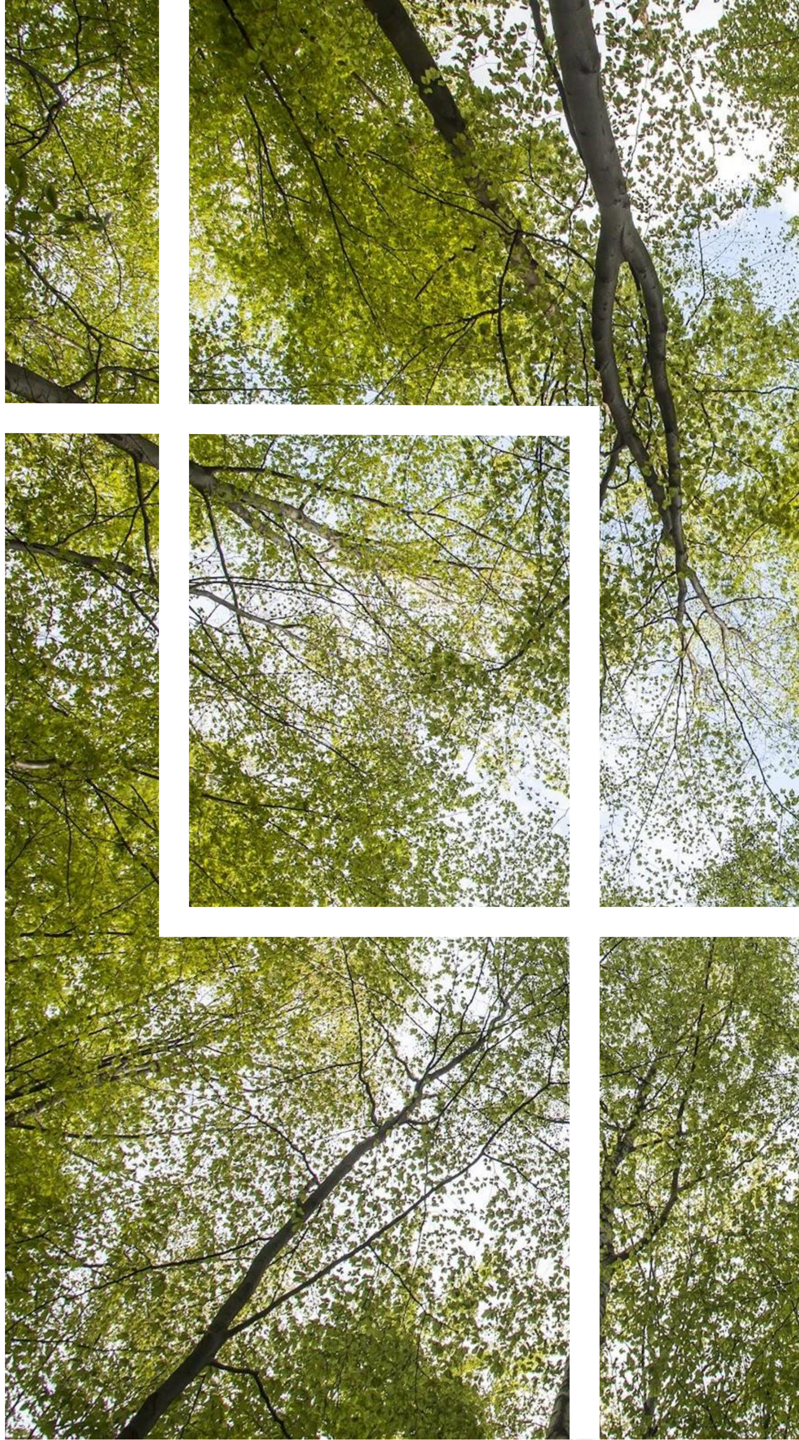
Further links to good practice and helpful supporting materials

- PwC: Excellence in sustainability and climate change reporting - a review of leading UK companies: https://www.pwc.co.uk/services/sustainability-climate-change/insights/sustainability-and-climate-change-reporting-tips.html

- PwC: Where to start / TCFD guidance and good practice reporting examples: https://www.pwc.co.uk/services/audit/insights/tcfd-guide.html

- WEF: Climate Governance guiding principles: https://www3.weforum.org/docs/WEF_Creating_effective_climate_governance_on_corporate_boards.pdf

- FRC: guidance on TCFD reporting and good practice reporting examples, including scenario analysis guidance: https://www.frc.org.uk/news/october-2021/preparing-for-mandatory-tcfd-reporting,-including



Q&A

Amy Pickering
amy.pickering@pwc.com
07781 125874

Ali Cambray
alison.cambray@pwc.com
07700 838337

Thank you

Thank you

If you would like to chat with us further, please get in touch:

PwC Channel Islands LLP

alison.cambray@pwc.com
amy.pickering@pwc.com

pwc.com