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Governance *in brief*

FCA and FRC publish findings on climate change disclosure – improvements required

Headlines

- Over the summer, the FCA published the findings of its initial review of the first 171 companies to publish TCFD aligned disclosures under Listing Rule 9.8.6(8)R. It also commented on detailed findings from a more in-depth review of 31 of those companies.
- Areas highlighted for attention include:
  - Over 90% of companies self-reported that they had made disclosures consistent with the TCFD's Governance and Risk Management pillars, but this dropped to below 90% for the Strategy and Metrics & Targets pillars.
  - 81% of companies indicated that they had made disclosures consistent with all seven TCFD disclosures the FCA expected companies to comply with this year.
  - The most common reporting gaps were in respect of the more quantitative elements of the TCFD's recommendations e.g. scenario analysis and metrics & targets.
- In some cases the FCA identified that companies claimed they had made disclosures consistent with the recommended disclosures, but the disclosures themselves appeared to be very limited in content. The FCA is considering whether further action is appropriate in its capacity as regulator of the Listing Rules.
- The FRC also published a complementary review by the Corporate Reporting Review team (CRR) of 25 larger companies in industries that are more exposed to climate change and raised recommendations for better disclosure and good practice examples.
- The FRC's annual observations on areas of focus for 2022 annual reports and the CRR's Annual Review of Corporate Reporting are expected during October 2022.

The FCA's Review of TCFD-aligned disclosures by premium listed commercial companies

The FCA's review, published on 29 July 2022, provides observations based on its quantitative review of compliance and a detailed analysis by Task Force on Climate-related Financial Disclosures (TCFD) pillar and the associated disclosure expectations (the four pillars being Governance, Strategy, Risk management and Metrics & Targets). It also reiterates the FCA's expectations of premium listed companies and recommends companies should review the FRC's complementary analysis for observations to improve reporting and examples of better practice.

Observations based on quantitative review of compliance

- Statement: Over 90% of companies included a recognisable statement in their annual report indicating whether they had made climate-related financial disclosures consistent with the TCFD framework.
- Location of statement: 84% of the statements were made in the strategic report, with eight percent elsewhere in the annual report. Eight percent of statements were outside the annual report.
- Location of disclosures: 82% of TCFD disclosures were inside the annual report, in the strategic report or a self-contained TCFD report within the annual report. 18% of disclosures were outside the annual report.
- Length of statement and disclosures: nearly 80% of statements took up as little as half a page, with an average page count in the annual report dedicated to TCFD disclosures of five pages.
- Net zero statements: 80% of annual reports included net zero statements, typically described as an "ambition", "goal", "target" or "commitment". 2040 and 2050 were the most common target dates. The FCA encourages companies to consider the TCFD's Guidance on Metrics, Targets and Transition Plans when making net zero commitments in 2022 annual reports.
- Consistency with TCFD recommendations: on average, companies reported that 90% of their disclosures were consistent with TCFD recommendations. Self-reported consistency was lowest for Strategy and for Metrics & Targets.

The nature, extent and complexity of disclosures varied considerably. In some cases companies indicated they had made disclosures consistent with the recommendations, but content was very limited and, the FCA hints, insufficient.

The FCA's findings are consistent with Deloitte's findings in our publication earlier this year: The new FCA compliance statement on TCFD disclosures: Observations from first reporters.

Analysis by TCFD pillar

Companies in the FCA's focused sample of 31 had typically improved TCFD reporting in 2021. The most common gaps identified were mainly in respect of the more quantitative recommended disclosures: scenario analysis on the resilience of strategy; processes for managing risks; metrics used to assess climate-related risks and opportunities and metrics on climate-related targets. Most companies indicated that they intended to make these disclosures within the next year or two.

Governance

Almost all companies provided at least a high-level description of their governance of climate-related risks and opportunities.

Although 98% of companies self-reported consistency, the FCA considered that only half of the companies in the sample made disclosures that were mostly or partially consistent with the relevant recommended disclosure and all-sector guidance on management's role in assessing and managing climate-related risks and opportunities.

Observations on governance disclosures included:

- disclosures were not specific about the frequency of board engagement on climate-related issues, the provision of information to the board and the typical matters that the board considers
- companies often did not elaborate on how the board monitors and oversees progress against goals and targets for addressing climate-related issues
- with regard to management's role, companies included less detail on the processes by which management is kept informed about climate-related issues; these processes were often either not described or described less clearly.

The FCA refers to the FRC's thematic review for examples and expectations that companies should provide sufficient detail on how management assesses and manages climate-related issues, including communicating to the board or other governing body, and how climate policies relate to other procedures for financial management.

Strategy

Almost all companies provided at least an overview of their strategy on climate-related risks and opportunities.

However, a small number of companies did not disclose the climate-related risks and opportunities the organisation has identified over the short, medium, and long term and the impact of climate-related risks and opportunities, disclosures the FCA expects to be made by all companies.

Observations included:

- few companies described how they had taken into account the useful life of the organisation's assets or infrastructure when setting out their horizons
- few companies described the processes used to determine which risks and opportunities could have a material financial impact on the organisation
- companies often did not differentiate between risks and opportunities and where they did, disclosure related to opportunities was less detailed
- there was limited information on how identified climate-related issues had affected businesses, strategy, and financial planning (including the time period(s) used, and how risks and opportunities are prioritised)
- few companies described the impact of climate-related issues on their financial performance (e.g. revenues, costs) and financial position (e.g. assets, liabilities)

Around a third did not disclose the output of scenario analysis with regard to the resilience of strategy. Of those that did:

- companies typically conducted their scenario analysis consistent with at least a 2% or lower scenario
- some companies provided limited information on how they believe their business strategies might be affected by the scenarios or how those strategies might need to change
- information applying scenarios to forward-looking analysis was limited

Risk management	Metrics and targets
Disclosures on the identification of risks were typically more detailed: • some companies described scenario analysis under risk management, saying it is integral to their process for identifying climate-related risks • in some cases, process for assessing climate-related risks were described as part of overall risk management and difficult to relate specifically to climate risks • only a few companies were specific about the risk implications of existing and emerging regulatory requirements relating to climate change The FCA points to the FRC's thematic review for better practice examples of companies' providing more disclosure over the risk management processes and integration of climate-related risk management into the overall risk management process.	Many companies did not describe methodologies used for metrics or targets where the methodology was not apparent. Only a small number of companies provided information on methodologies used to make assumptions or estimates where data was not available: • the most common metrics in addition to GHG disclosures were related to energy, water and waste. Only a few companies disclosed more specific metrics relating to the nature of their business (for example, a media company disclosed metrics on paper) • internal carbon prices were not often disclosed • only a small number of companies described how metrics were incorporated into remuneration and performance policies Around two-thirds of companies disclosed their Scope 3 emissions, but most of those that did not do so did include plans to disclose Scope 3 emissions in the future. Companies are encouraged to provide better detail around methodologies, reliance on estimates or assumptions, and value-chain coverage. The FCA points to the FRC's thematic review for examples of disclosing Scope 3 emissions.

Expectations of listed companies

The FCA reminds companies that:

- Listing Principle 1 requires that a listed company – both premium and standard listed – must take reasonable steps to establish and maintain adequate procedures, systems and controls and that this extends to establishing and embedding climate reporting procedures, systems and controls.
- There is an expectation that listed companies retain records to support the annual report and the detailed assessment of the company's disclosures against the TCFD's recommendations and recommended disclosures.
- Listed companies are expected to comply with providing TCFD-aligned disclosures, considering in particular a detailed assessment of disclosures taking into account the Guidance for All Sectors, except where they face certain transitional challenges in obtaining relevant data or embedding relevant modelling or analytical capabilities.
- The FCA's 'comply or explain' compliance basis includes a requirement for companies to set out the steps they are taking, or will be taking, to make disclosures in future.
- Reference should be made to other relevant documents set out in guidance, in particular where companies are making net zero commitments considering the TCFD's Guidance on Metrics, Targets and Transition Plans and ensuring that disclosures are not misleading.

The FCA also encourages companies to:

- Deepen their familiarity with the TCFD's recommendations and further improve internal processes to be ready to disclose effectively when ISSB standards are finalised and adopted in the UK – noting in particular that Scope 3 disclosures will be required by proposed ISSB standards.

- Consider using the SASB metrics when making disclosures both for TCFD recommendations and wider sustainability-related financial disclosures.
- Refer to the examples of better practice included in the FRC's complementary thematic review report.
- Check the guidance on "getting ready for TCFD-aligned disclosures" (see boxed note below).

FCA recommended steps: Getting ready for TCFD-aligned disclosures

- review your governance arrangements
- refresh your corporate strategy to incorporate climate change
- know your compliance framework – existing and new rules
- assess your existing public narrative and financial reporting of climate matters
- identify physical and transition risks and opportunities and their impact
- adapt your corporate wide (ERM) risk management processes
- assess your company against various climate scenarios
- identify relevant metrics and targets
- set up compliance review and assurance processes
- focus on training and capabilities at all levels of your company
- engage with your investors to understand their disclosure expectations

Next steps

The FCA is considering whether to take action against those companies that did not appear to have made a recognisable statement in their annual report, as well as those that made statements with insufficient detail to be able to determine whether disclosures are in fact consistent with TCFD recommendations.

The FCA voices strong support for the ISSB standards and expects the Government to consult on adoption in due course; the FCA will consult separately on adapting the existing disclosure rules to reference the final IFRS Sustainability Disclosure Standards and moving away from the current 'comply or explain' basis to mandatory disclosure requirements.

CRR Thematic review of TCFD disclosures and climate in the financial statements

The FRC's report was published on 29 July 2022 and evaluated both the quality of TCFD disclosures and the extent of climate-related disclosures within the financial statements. It provides examples of better practice disclosures which it encourages companies to refer to when preparing or seeking to improve their own disclosures. The FRC's review covered 25 large listed companies, weighted towards sectors and industries that are perceived to face greater risks concerning climate change.

The FRC indicates that companies have improved their reporting both in terms of completeness and consistency with the TCFD framework (TCFD recommendations, recommended disclosures, all sector guidance and supplemental guidance for financial and non-financial companies). The FRC also reports a 'significant improvement' in making reference to climate-related risks in the financial statements (22 out of 25 companies).

Areas where the FRC notes that companies need to improve their TCFD disclosures and financial statement reporting in relation to climate change include:

- Granularity and specificity: more granular and specific information about the effect of climate change on different businesses, sectors and geographies.
- Balance: ensuring the discussion of climate-related risks and opportunities is balanced and linking climate-related opportunities to technological dependencies.
- Interlink with other narrative disclosures: linking climate-related disclosures to other elements of narrative reporting, for example information about the business model and strategy, or the risk management and governance processes.

- **Materiality:** how has the company decided which climate-related information should be disclosed? The FRC expects companies to articulate clearly how they have considered materiality in the context of their TCFD disclosures when preparing the TCFD 'statement of compliance' and how they have taken into account the TCFD all-sector guidance and, where appropriate, the supplemental guidance for the financial sector and for non-financial groups.
- **Connectivity between TCFD and financial statements disclosures:** better clarity regarding the relationship between climate-related risks and amounts in the financial statements. Companies should provide explanations, where necessary, to address whether:
  - the degree of emphasis placed on climate change risks and uncertainties in the narrative reporting, including TCFD disclosures, is consistent with the extent of disclosure about how those uncertainties have been reflected in judgements and estimates applied in the financial statements;
  - the relationships between assumptions and sensitivities considered in TCFD scenarios, including any Paris-aligned scenarios, and those applied in the financial statements, require further elaboration;
  - emissions reduction commitments and strategies described in the narrative have been appropriately reflected in the financial statements;
  - the scale of growth of businesses and extent of progress against climate-related opportunities referred to in the narrative reporting is appropriately reflected in the segmental disclosures;
  - discussion of matters which may have an adverse effect on asset values or useful lives in the narrative reporting is consistent with positions taken in the financial statements; and
  - the effects of different global warming scenarios, and the company's own net zero commitments, may affect the valuation of the company's assets and liabilities.

The FRC highlights specific disclosure expectations, including:

- The Listing Rule statement of consistency with TCFD recommended disclosures must be **included in the annual report and must be clear and unambiguous**. If companies describe the ongoing development of their disclosures, they should be clear whether the relevant disclosures are considered consistent in the current reporting period.
- Signposting to the detail of where the disclosures can be found should be granular and specific, including specific page references or hyperlinks. Any references to the TCFD disclosures elsewhere in the annual report should give **consistent messages** about the extent of compliance.
- If disclosures are found outside the annual report, **a reason for that should be provided**. Any referenced information presented outside of the annual report should cover the same time period and be available no later than the publication of the annual report.
- If disclosures are not provided, there should be **full, clear and meaningful explanations** that are specific to both the company and the individual disclosure requirement in question and avoid boilerplate references to 'transitional challenges'.
- The FRC may challenge companies that state disclosures are consistent with the TCFD Framework if it is not clear how **all relevant and material elements of the all-sector and relevant sector-specific guidance have been addressed**. The FRC may also challenge companies that have not made those disclosures the FCA has identified it would particularly expect to be provided without providing a credible explanation.
- TCFD disclosures should include **sufficient, company-specific information to support decision-making by investors.**
- Companies should clearly describe the **extent of any external assurance** over TCFD disclosures and what information was covered, avoiding terms that may imply a higher level of assurance than that obtained.

Deloitte view

- We welcome the publication of the FCA and FRC's findings in the area of TCFD reporting – the level of detail is helpful for management and for audit and sustainability committees as companies prepare for the second year of TCFD reporting.
- As companies face the requirement this year to provide more detail on net zero commitments, boards will want to review practical and fully-costed transition plans.
- The seriousness with which regulators are taking high-quality disclosure in this area is clear, with observations about the balance of the annual report, the focus areas for FRC reviews and on improving the decision-usefulness of disclosure for users.
- These reports add momentum to the UK's ambition to foster a robust climate reporting environment in line with TCFD and in due course with ISSB and to develop the reputation and strength of the London market as a centre for green finance.
- Overall, the message is that companies have made a good start in the first year, but expectations are higher for the second year of reporting, and regulators are threatening enforcement action for laggards.

For further information

FCA Review of TCFD-aligned disclosures by premium listed commercial companies
CRR Thematic review of TCFD disclosures and climate in the financial statements
TCFD's Guidance on Metrics, Targets and Transition Plans
Deloitte's The new FCA compliance statement on TCFD disclosures: Observations from first reporters
Deloitte ESG Assurance blog FRC's Thematic Review of TCFD and Climate Disclosures – Considerations for firms

Contacts - Environmental, Social and Governance (ESG) assurance

Our team works with organisations to provide gap analysis of current disclosures and corporate reporting, provide technical update training, including Board sessions, and to help organisations navigate the continuously evolving regulatory landscape concerning ESG reporting requirements and emerging best practice.

Stephen Farrell – 020 7303 7491 or stephenfarrell@deloitte.co.uk

Sarah Martin-Young – 020 7007 4539 or samartinyoung@deloitte.co.uk

James Self – 020 7303 8561 or jaself@deloitte.co.uk

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Contacts – Centre for Corporate Governance

Tracy Gordon – 020 7007 3812 or trgordon@deloitte.co.uk

Corinne Sheriff – 020 7007 8368 or csheriff@deloitte.co.uk

William Touche – 020 7007 3352 or wtouche@deloitte.co.uk