

## **Assurance on Disclosures of Carbon Emissions Information Summary of Discussion – Australian Roundtables**

Sydney

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The Institute of Chartered Accountants

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CPA Australia

This is an informal summary of the discussion at the two Australian Roundtables. It does not include all points raised, and points noted here do not necessarily represent a consensus view of those present. Nothing in this summary is intended to indicate a considered view of the IAASB, IFAC, CPA Australia, the ICAA or the Department of Climate Change.

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### **TERMINOLOGY**

The word “scope” can have several meanings in the context of emissions assurance:

- The GHG Protocol’s use of the word, i.e., scope of emissions included in a company’s inventory:
  - Scope 1: direct
  - Scope 2: indirect -- purchased electricity
  - Scope 3: other indirect

Where this meaning is intended below, capital “S” is used

- “scope of the engagement,” which itself can encompass 2 things:
  - Which elements of the entity’s emissions are being assured (even within a particular Scope); or
  - The nature of the procedures to be undertaken (particularly with respect to a limited assurance engagement).

Other terms:

- “External audit” is used in the NGER Act, but refers to the post lodgement compliance mechanism and is about the relationship between the regulator (GEDO) and the company. It could relate to an “audit” (reasonable assurance), limited assurance or agreed-upon procedures.
- “Verification” should be avoided, as it has connotations of 100% accuracy.
- “Materiality” – this can refer not only to the level of precision/numerical accuracy of given figures (misstatement), but also to whether a particular inventory includes all the elements that should be included (omission).

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### **STANDARD (ISAE) OR GUIDANCE (IPSAE)**

Particularly in the Australian situation with NGERS starting line in July, if guidance is quicker, that is an advantage.

Guidance may allow more flexibility to include matters that would not make the cut for a standard.

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## **CRITERIA**

Suitable criteria are critical. Comments received suggest that the ISAE/IPSAC should deal with how the auditor determines whether the criteria to be used by management are suitable.

### International differences

- What if there is a difference between domestic requirements (e.g., NERS), and:
  - The criteria a company uses for sustainability reporting (for example, if an international group uses the “equity share approach” for setting organizational boundaries under the GHG Protocol, but NERS requires the “control approach”) or
  - Other jurisdictions under which the company reports, e.g., EU ETS?
- Assurors should try to influence legislators/regulators to ensure no jurisdiction imposes rules that will be internationally inconsistent.
- Often better to have “loose” legislation on some things to ensure inconsistencies are not enshrined in statute. Regulations can fill in the gaps and are easier to change should inconsistencies arise.
- In the end if there is an inconsistency, or simply an elimination of a choice (as in equity versus control), which leads to different emission figures being reported in different places, then part of the assurance process may be to consider whether a reconciliation is disclosed.
- Comments received suggest that the ISAE/IPSAC should be jurisdiction-neutral and, therefore, capable of being applied in all countries.

### Judgement

- ISO 14064-1 and GHG Corporate Reporting Protocol don’t have the degree of granularity needed for consistent measurement.
- NERS Technical Guidelines are more detailed.
- Users are often only interested in THE number, so consistent measurement is vital.
- Question is then, how much judgement is enough/too much?
- GHG Protocol has a lot of “shalls” and many “shoulds,” but is still too loose.
- ISO 14064-1 does not cover all the issues that GHG Protocol does.

### Will we have a “true and fair override” built into the ISAE/IPSAC?

- We do for financial statement audits (ISA 700), so would expect so for this too.

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## **LEVEL OF ASSURANCE, AND PROCEDURES**

### Current situation:

- Risk of data being wrong is currently very high because systems for data capture and reporting are immature.
- Many preparers report on the basis of data collected in ad hoc spreadsheets without adequate controls.
- There will be errors – this needs to be recognised and preparers allowed to disclose, rather than hide, areas in need of development.
- Confidence in the accuracy of data is currently very low. A recent survey revealed that only 5 per cent of chief executive officers or chief financial officers have a high or even medium level

of confidence in their GHG emissions data; most either have no data or are unsure of the data they do have.<sup>1</sup>

Different purposes may allow for different levels of assurance:

- Because of the economic and environmental impact of an ETS, related disclosures should be subject to reasonable, not limited, assurance.
- The “Greenhouse Gas Reduction Scheme” in NSW requires reasonable assurance.
- Not all NGERs companies will be in the AETS, so limited assurance may be OK for them.
- Claims of carbon neutrality may be OK with limited assurance.
- If a company is ready for NGERs, then internal systems and controls may be better and, therefore, assurance easier; but a lack of systems and controls is not a reason for moving to limited assurance.
- If can’t do reasonable assurance, can’t do limited assurance.
- Cost is a consideration – the level of “data interrogation” for reasonable assurance may mean the cost is too high for SMEs.

Will limited assurance be understood by the users, especially if coupled with:

- Variations in assurance procedures from one engagement to the next (should we specify certain of the procedures to ensure consistency).
- Variations in Scope.
- Variations in which elements of entity’s emissions we are assuring.
- Variations in materiality levels.
- Variations in how the conclusion is expressed (some assurers are using positive form of expression when the description of procedures indicates they don’t have enough evidence to form an opinion!).

All of this leads to a lack of comparability and increased uncertainty and, therefore, increased difficulty in understanding what is being delivered. How can we avoid creating a new expectation gap (especially given that many financial statement users still don’t understand the difference between an audit and a review)?

ISAE/IPSAE should include guidance about what constitutes sufficient appropriate evidence. Considerations include:

- Reasonable assurance for emissions should be at the same level of confidence as reasonable assurance for financial statements.
- ISAE/IPSAE should cover such things as inadvertent reliance on spreadsheets, sampling and extrapolation (for example, when a limited number of sites are visited), tests of controls, analytical procedures etc.
- Procedures will vary markedly according to the type of emission being looked at, for example, procedures for non-combustion emissions are very different from procedures for fuel combustion emissions.
- When compiling an emissions inventory there is no self checking mechanism equivalent to double-entry bookkeeping for financial reporting. There is no trial balance.

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<sup>1</sup> Survey of 303 Australian companies with annual turnovers of at least A\$150 million, as reported in “Carbon Countdown -- A survey of executive opinion on climate change in the countdown to a carbon economy,” PwC, January 2008.

- Uncertainty – emissions data will always be an estimate. Unlike dollars, not every CO<sub>2e</sub> can be counted. There are, necessarily, a lot of extrapolations and estimations involved. It is more like valuing an intangible than reporting on transactions.
- Need guidance regarding assumptions and methods used. ISAs 540 (estimates); and 620 (experts) might be a start, but more specific guidance is needed. For example, factors for methane from an open cut mine can vary markedly depending on assumptions and methods.
- Need guidance on procedures for evaluating the suitability of criteria (which include assumptions and methods).
- The reporting entity for emissions information may be different from the reporting entity for financial statements purposes. Implications may include the need to rely on other auditors (ISA 600 “Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)”).

### **Procedures:**

- Comments received suggest that the ISAE/IPSAC should include minimum procedures to promote consistency in work effort, and in the case of limited assurance engagements, to ensure a meaningful level of assurance is established.
- Minimum procedures for limited assurance engagement need not include tests of controls. They should be analogous to a half-year review of financials statements, and include:
  - Obtaining an understanding of the entity, including the control environment and controls over the preparation of the emissions information (i.e., the assessor should have the same level of knowledge as if doing a reasonable assurance engagement).
  - A risk assessment to ensure the nature, timing and extent of procedures are determined according to risk and materiality.
  - Some substantive procedures (because there is no self checking mechanism).
  - Inquiry and analytical procedures.

### **Agreed-upon procedures:**

- Not suitable for public reporting because many users will have had no role in determining the procedures, and are unlikely to understand that there is no assurance.
- Comments received suggest that the ISAE/IPSAC should not address agreed-upon procedures, except to note that the more input management has in determining the procedures (for example, which sites will be visited), the more likely it is that the engagement should be treated as an agreed-upon procedures engagement rather than a limited assurance engagement.

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## **USERS AND SCOPE**

Users include employees, as well as NGO, regulators and investors.

To whom should the report be addressed?

Different uses of information will have different implications, e.g.:

- Consumer decisions based on carbon intensity of competing products:
  - This needs Scope 3 to be included.
  - Australian Competition and Consumer Commission has said that disclosures re product intensity need to have a rigorous life cycle analysis (LCA) underlying them.
- Assigning liability for emissions under an ETS:

- Scopes 1 and 2 only are needed (except maybe fuel distributors).

Many users are looking more broadly than just the data in the inventory, in particular, they want to know whether management has addressed the risks and opportunities that carbon presents. This is an important facet of disclosure.

Only a small number of companies will be part of AETS and therefore required to report on Scopes 1 and 2. For the others:

- Main financial impact will be in the price of electricity (and petrol if it is included at point of distribution).
- Many are concerned about reputation risk if they are not seen as behaving responsibly, and may therefore choose to report Scopes 1, 2 and 3.

Cherry picking:

- Within a broader sustainability report, but also within a particular Scope, the company may want assurance on some items but not on others.
- This could undermine the credibility of the profession. Dangers include:
  - Being associated with the entirety, even if clearly say in assurance report that only did X, Y and Z.
  - Management choosing to have assured only those items they know are right(ish), and excluding those they know are not supportable with evidence.
- For similar reasons, the assurator should not move from reasonable assurance to limited assurance without proper cause.
- Comments received suggest that wording modelled on ISA 800 “Special Considerations—Audits of Special Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement” may be appropriate.

Effect on reported emissions if outsource 20% of supply of raw material:

- If reporting on trend in emissions over time, need to adjust the baseline scenario.
- If reporting on Level 1 and 2 only, for example, under NGERs, this is simply a reduction in emissions as long as the company does not retain control over the outsourced supplier:
  - Should be accompanied by an explanation of the reasons.
  - What then is the assurator’s responsibility with respect to the reasons given? Is it similar to a financial statement auditor’s responsibility with respect to “other information” published with the financial statements, i.e. read the other information and take action if aware of a material inconsistency or material misstatement of fact (ISA 720 “Other Information in Documents Containing Audited Financial Statements”)?
- If reporting Levels 1, 2 and 3; this is a shift from Level 1 to Level 3.
- If reporting Levels 1, 2 and 3, what is the quality of data needed before can “sign off” on information included in Level 3.

Scope 3 disclosures:

- There are significant opportunities and risks regarding Scope 3 emissions, e.g., the majority of emissions from Cascade Green beer proved, unexpectedly, to be in the glass used to bottle it. Companies can realise benefits by changing their behaviour to control Scope 3 emissions.
- The level of uncertainty is inherently higher than with Scope 1 and 2. Issues include:
  - Determining which of a company’s emissions that should be included:

- Can only ever expect to report major Scope 3 emissions; so Scope 3 will never be fully “complete.”
- Does determination of completeness (and materiality) change when reporting emissions in the context of a company’s overall sustainability report, as opposed to a stand-alone statement of carbon inventory?
- Availability of data and reasonableness of assumptions:
  - Internal systems rarely track, e.g., flight miles; therefore need to rely on airline data and/or internal assumptions and averages.
  - May need an ISAE 3402/SAS 70-type audit sign-off from suppliers’ assurers.
  - If a specific LCA has not been done for a particular supplier, there are published Australian Bureau of Statistics factors for over 600 goods and services that can be used as default.
- Alternative views:
  - Should never assure Scope 3 without a full LCA.
  - Assurers should be able to give an opinion on whatever Scope 3 emissions the company identifies.
    - The inventory would at least need to identify that it is incomplete.
    - What work, if any, would the assessor need to do to ensure the main Scope 3 sources are included?

Should the ISAE/IPSAS attempt to deal with offsets, as well as emissions?

- If an assertion re carbon neutrality is to be credible, offsets as well as emissions must be assured. (Need to also ensure reported reductions have not been sold as offsets).
- In Australia, both the “Greenhouse Friendly” and the “Greenhouse Gas Reduction Scheme” have rules for calculation and verification of offsets (as does, e.g., the Clean Development Mechanism internationally).
- Practices in the voluntary offset market could certainly benefit from scrutiny by an assessor.<sup>2</sup> Issues include additionality and double-selling.
- Various criteria exist, but they are not all generally accepted, and one can expect changes over coming years.
- Offsets are only about 22% of traded value, so maybe best for IAASB to focus on the other 78% (reported emissions) first.
- The assessor of a company claiming carbon neutrality will usually not have access to the data supporting offsets, therefore offsets usually need to be assured at source, i.e., the offset provider will need to arrange for assurance. How does an assessor of the company purchasing an offset deal with this when assuring the company’s inventory:
  - Include the veracity of offset in scope of engagement, and rely on ISAE 3402/SAS 70-type audit sign-off from provider’s auditor.
  - Include the internal accounting for purchased offsets, but exclude the veracity of the offsets from scope of engagement. In this case the assessor would still have an ISA 710-type responsibility.

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<sup>2</sup> See “Making Sense of the Voluntary Carbon Market A Comparison of Carbon Offset Standards,” WWF, March 2008, <http://tinyurl.com/5wg5j7>

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## **MATERIALITY**

- The GHG Protocol on “Corporate Accounting” differs in its treatment of materiality from the Protocol for “Project Accounting”.

Preparer v auditor materiality:

- To work out if something is material, does it need to be quantified (the implication being that having quantified it, it may as well be accounted for, thus the benefit of invoking materiality is lost).
- For an auditor, is materiality equal to “tolerable error?” – is an analogy to financial statement audit appropriate?

Comments received suggest that the ISAE/IPSAC needs to address qualitative aspects of materiality, e.g., where appropriate, the process for identifying significant emissions in Scope 3, as well as quantitative aspects.

How is materiality affected by aggregation/disaggregation of data? Is the financial statements audit analogy re materiality at the subsidiary and the parent entity applicable?

NGERS Policy Paper is not clear on the issue of materiality.

Comments received suggest that the ISAE/IPSAC should include discussion of the distinction between:

- The role of materiality.
- The nature of emissions data and the inherent uncertainty associated with the measurement of emissions (an explanation of which should be included in the assurance report).
- A deliberate limitation on procedures performed in a limited assurance engagement.
- A qualified assurance conclusion, in either a limited assurance or reasonable assurance engagement (it may be appropriate to include standard wording for commonly encountered situations, in particular, when the data gathering and reporting system is deficient).

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## **EXPERTS**

Comments received suggest that the considerations in ISA 620 are a good starting point as they will generally be translatable to emissions assurance engagements.

- The auditor uses the work of an expert as an input to judgements about the fair presentation of the inventory, i.e., the assurance work is at a higher level than the fundamental data verification that experts are often involved with (an analogy may be the difference between bookkeeping and financial reporting).
- The ISAE/IPSAC needs to include guidance on the extent to which the auditor is entitled to “rely” on the work of experts, and the extent to which the auditor should be challenging an expert’s competence and capabilities, findings and methods.

Dual sign-off, i.e. both the assessor and the expert sign the assurance report:

- Would raise legal and regulatory issues that can be avoided if one party retains overall responsibility.
- Not sure what users want, but they may find dual responsibility confusing.

- Potential to create gaps in responsibility if have 2 parties.

If the assessor is not a Registered Company Auditor, how can regulators and other users know if the assessor has proper assurance expertise, is a fit and proper person etc?

- Regulators can introduce registration process.
- ASIC already does this – is it worth replicating?
- It is incumbent upon assessors who are not financial statement auditors to have appropriate audit expertise.

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## **INDEPENDENCE**

Self-review is the biggest threat. Areas that may require interpretation include: can the auditor advise on general environmental issues but not specifically on emissions; how far can the auditor go in helping to correct auditor-identified calculation errors or unsuitable assumptions; and can the auditor provide internal audit services to an assurance client.

Section 291 of the IFAC Code (re broader assurance engagements) applies, not Section 290 re financial statement audit.

Particularly in Australia, where the standard/guidance is intended to be used by both accountants and non-accountants, comments received suggest that issues such as independence and other ethical considerations, quality control, and assurance expertise, will need to be built into the standard because the Code, ISQC 1, Education Standards etc do not apply to non-accountants.

Publication of recommendations and advice to management in the assurance report poses a threat to independence:

- Including recommendations may be justified for overall sustainability reports because the assessor can comment on strategies etc, but not so for a GHG inventory.
- It may be that long form reports including, e.g., details of procedures and findings, an explanation of the inherent limitations of the emissions data, and other commentary, rather than recommendations, are appropriate.
- It is essential that any additional information included in the assurance report does not contradict the opinion/conclusion.

Where AA1000-type stakeholder engagement is undertaken, it should be done by the company, not the assessor. It may, however, be appropriate for the assessor to observe.

Independence concepts are highly developed and well understood by financial statement auditing firms; but perhaps less so by other assessors.

The Greenhouse Challenge Plus program has split verification from advice. The Climate Registry and ISO 14064-3/14065 have useful information on conflicts of interest.

With approximately 900 Australian companies needing to report under NGERs by 2010, there may be a capacity issue if assessors can't provide advice.

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## **LINK WITH SUSTAINABILITY REPORTING GENERALLY**

- Emissions reporting is the first sustainability reporting topic to become mainstream – others will likely follow.
- Are financial statement audit methodologies being massaged to fit this new subject matter, when a different approach may be appropriate?



- “Inclusivity” – AA 1000 and stakeholder engagement can be useful for identifying the broader sustainability issues.
- Assurors need to be careful not to impede evolution by stopping preparers exploring new ways of reporting
- Potential for broader disclosures associated with emissions, for example, impact of alternative energy sources on biodiversity.
- Some areas are very specialised and require environmental scientists, social scientists etc.
- Increasingly, the accounting profession and other professions will need to converge, particularly as better techniques are found for quantifying social and environmental impacts.
- Limited assurance on completeness may be cost effective, whereas reasonable assurance may not be.
- The GRI “G3” Guidelines probably need company-specific supplementation to be “suitable” as criteria for a sustainability report.

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## **DIRECT REPORTING VERSUS ASSERTION-BASED ENGAGEMENTS**

While there may be some potential for “direct reporting engagements,” the ISAE/IPSAE should encourage assertion-based engagements. Management’s assertion should include identification of:

- The criteria, including any company-specific assumptions and methods used. Company-specific assumptions and methods are part of the criteria and need to be available to users (e.g., if they are in company manuals, then those manuals should be available on the internet).
- The inherent limitations of emissions information due to measurement uncertainty.
  - Users need to be made aware of this (as do those in reporting companies who are taking ultimate responsibility for the “accuracy” of the information).
- Any limitations on the elements included in the inventory
- Any limitations in the processes used to develop the information

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## **OTHER**

Impact on SMEs. Should the same rules apply regarding, e.g.:

- Determination of materiality.
- Nature, timing and extent of procedures.
- Level of assurance.

Timing for an Australian pronouncement:

- Reporting framework from DCC won’t be issued till late 2008.
- Standard/guidance for Australian market should be expedited.
- AUASB would prefer to wait for IAASB, but may not be able to.
- AUASB has budgeted for this as a priority area, and hopes to have something out by year-end.
- This is an opportunity for Australia to lead international developments.

Discussion with the company up front about: the meaning of assurance (and different levels etc), what is included in the scope and what isn’t, and the data quality that is expected, can avoid many complications and misunderstandings later on.

Is it possible to explicitly account for uncertainty when calculating or disclosing emissions information – perhaps, for example, by:

- Showing a range rather than a point estimate.
- Mathematically building in an uncertainty variable.
- Showing a reconciliation of reported data with what it would have been reported had standard factors, assumptions and methods been used.
- Rating emissions information (A, B, C etc according to its level of uncertainty).