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A&A Accounting Technical

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Clarity in financial reporting

Disclosure of climate-related risks

Talking points

- Climate change is generally accepted to be a present risk that companies in various industries across the world are already facing
- With growing pressure from investors, emerging focus from regulators, and continued social pressure in Australia, it is increasingly expected that companies will consider and provide meaningful and useful disclosure about climate-related risks that could impact the entity and how management are responding to these risks
- Currently there is no mandatory framework for reporting climate-related risks. However there is growing support, both globally and within Australia, for TCFD (Task Force on Climate-related Financial Disclosures) reporting, generally within or associated with the annual report
- The ASX Corporate Governance Principles and Recommendations revised in February 2019 encourages consideration of the TCFD's recommendations. ASIC has also recommended that listed companies consider their disclosure in this respect, again with reference to the TCFD recommendations
- The AASB and AUASB have issued a joint guidance statement on the relevance of climate-related risks for financial statement reporting. Application of this guidance is not mandatory but can be considered best practice
- There is a prominent Australian legal opinion, that of Noel Hutley and Sebastian Hartford Davison for the Centre for Policy Development, "*Climate Change and Director's Duties*", which found that in their opinion, directors who do not properly manage climate risk could be held liable for breaching their legal duty of due care and diligence. Investor expectations along with the industry in which the company operates could result in climate-related risks being material, thereby requiring disclosure in the financial statements, regardless of their numerical impact
- In this publication, we briefly discuss some of the guidance related to disclosure of climate-related risks that companies are expected to consider while preparing their financial statements.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

Introduction

What is climate change?

Climate change is a change in the pattern of weather, and related changes in oceans, land surfaces and ice sheets, occurring over time scales of decades or longer[1].

Why is it a current issue for businesses?

Climate change will drive some of the most profound changes to businesses. Frequent and severe climate-related events are already causing major impacts on products and services, supply chains, loss of asset values and market dislocation. These effects are now compounded by policy and regulatory change and investor demands. Companies are facing increasing pressure from investors to disclose more meaningful information related to climate change risks. International regulators are already responding to climate-related disclosures.

How are the stakeholders reacting?

The business community is increasingly experiencing pressure from stakeholders, including investors, regulators and activist groups, to consider the impact that climate-related risks will have on business and how management will respond to it.

Investor and social impact initiatives

In December 2017, a global initiative, **Climate Action 100+** was launched. This is an investor initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. There is increasing pressure from this investor group on companies to curb emissions, improve governance and strengthen climate-related financial disclosures.

In January 2013, an environmental campaign group **Market Forces** was launched in Australia. Their work aims at exposing the institutions that they consider are financing environmentally destructive projects and help Australians hold these institutions accountable. Market Forces may also sponsor shareholder resolutions to further its objectives.

Companies are facing an increasing number of such shareholder resolutions or being specifically questioned at annual general meetings (AGM) about how they are considering the impact of climate-related risk. These are leading to actual changes in how companies do business. For example, it appears now that it is increasingly difficult to find Australian insurers willing to underwrite new thermal coal mines and power stations.

In the legal community, the Noel Hutley and Sebastian Hartford Davison legal opinion for the Centre for Policy Development, "*Climate Change and Director's Duties*"[2], found that, in their opinion, directors who do not properly manage climate risk could be held liable for breaching their legal duty of due care and diligence.

Regulators' reactions

From the regulators in Australia, the following statements have been made:

Australian Securities and Investments Commission - ASIC

In September 2018 ASIC released high-level findings and recommendations for listed companies following an ASIC review of disclosure practices in the market, which are set out in **Report 593 Climate risk disclosure by Australia's listed companies** (REP 593). ASIC encourages listed companies and their directors and advisors to:

- adopt a probative and proactive approach to emerging risks, including climate risk
- develop and maintain strong and effective corporate governance which helps in identifying, assessing and managing risk
- consider how best to comply with the law where it requires disclosure of material risks, and
- disclose meaningful and useful climate risk related information to investors.

[1] Defined by the Australian Academy of Science

[2] References to the legal opinions – Memorandum of opinion (October 2016) and Supplementary Memorandum of opinion (March 2019)

On 12 August 2019, ASIC released updates to existing RG[3] (regulatory guidance) **Regulatory Guide 228 Prospectuses: Effective disclosure for retail investors** and **Regulatory Guide 247 Effective disclosure in an operating and financial review** to clarify its application to the climate change disclosures. The updates include:

- in RG 228, incorporating the types of climate change risk developed by TCFD into the list of examples of common risks that may need to be disclosed
- in RG 247, highlighting climate change as a systemic risk that could impact financial prospects of an entity in future years and that may need to be disclosed in the operating and financial review (OFR)
- in RG 247, reinforcing that disclosures made outside the OFR should not be inconsistent with disclosures made in the OFR
- in **INFO 203: Impairment of non-financial assets: Materials for directors** highlighting that climate change may be relevant in determining key assumptions related to impairment calculations.

With the release of this update, ASIC has indicated that climate change is an area they continue to focus on. ASIC strongly encourages listed companies with material exposure to climate change to consider voluntary reporting under the TCFD framework. ASIC has indicated that they will conduct surveillances of climate change related disclosures in selected listed companies in the following year.

Australian Securities Exchange - ASX

ASX's updated version of the **Corporate Governance Principles and Recommendations** states climate change is expected to be considered by the entity's risk management framework. Boards are encouraged to monitor the adequacy of their organisation's risk management strategy (for financial and non-financial risk). Companies are also encouraged to improve climate and other non-financial risk disclosure by focusing on material environmental and social risks, including by reference to the TCFD recommendations.

Australian Prudential Regulation Authority - APRA

APRA expects to observe a continuous improvement in the sophistication of entities' management of climate change risks and preparations for the transition to a low-carbon economy, including an increase in adoption of the recommendations of the TCFD. In January 2020, APRA released its policy and supervision priorities for 2020 and stated that it will be more closely assessing institutions' capability to deal with emerging and accelerating risks, such as cyber-security and climate change.

Therefore, it is becoming increasingly urgent that companies are appropriately considering the impact of climate-related risk on their business, how they will respond to those risks, and how they should disclose these considerations to shareholders.

Disclosures outside the financial statements

TCFD Report

Overview

In order to help companies develop voluntary climate-related financial risk disclosures, the Taskforce on Climate-related Financial Disclosures (TCFD) was set up by the Financial Stability Board (FSB) in 2015. In June 2017, TCFD released 11 disclosure recommendations across four pillars (Governance, Strategy, Risk Management and Metrics and Targets). These disclosures belong in the narrative management commentary or related documents outside the financial statements. For more details, refer the **TCFD report on recommendations on Financial Disclosures**.

TCFD reporting is not mandatory, however there is growing global support for the reporting framework from business, investors, regulators and governments, and therefore is it advised that where relevant, clients adopt the framework for reporting purposes. Deloitte globally has significant experience in assisting clients in adopting TCFD reporting. It should be noted that TCFD reporting is not a straight-forward implementation process, and it takes approximately three years for an entity to fully adopt the reporting requirements. Therefore, if a client is interested in adopting TCFD reporting, it is highly recommended they start earlier rather than later. Deloitte's Risk Advisory team has significant experience in assisting clients through the process of adopting the TCFD recommendations and offers various services through this implementation process.[4]

Risks in key sectors

The TCFD report identifies the following sectors as most likely to be affected by climate-related risks:

- Financial sector – banks, insurance groups, asset owners, asset managers
- Non-financial sector – energy, transportation, material and buildings and agriculture, foods and forest products

[3] Reference to the media release

[4] Refer last page of this publication for relevant contacts in the Risk Advisory team

The report also identifies the main climate-related risks that companies should consider:

1. Physical risks - These are risks associated with disruption to business activities arising from climate change. Physical risks are further categorised into acute risk and chronic risk.

2. Transition risks - These are the risks associated with a global commitment to move to a low carbon economy. Transition risks are further categorised into policy and legal risks, technology risks, market risks and reputation risks.

These risks can affect all companies directly or indirectly through their valuable supply chain. Impacts include, but are not limited to, reduced revenue, increased costs, higher cost of capital, and non-availability of insurance. These risks are further explained below:

Climate-related risk	Examples
1. Physical risk	
(a) Acute risk Acute risks include one off disruptions such as hurricanes, floods and fire.	Widespread flooding in Thailand in 2011 disrupted global supply chains with an impact on key manufacturing facilities. As a result, a major car manufacturer postponed the launch of a new model car and halted production in Malaysia for several months due to the disruption of component supplies in Thailand. Another car manufacturer was forced to cut output and halt supply in North America for a few months due to the impact of the floods on its supply chain.
(b) Chronic risk Chronic risks are more gradual changes such as changing rain patterns and rising sea levels.	With rising average daily temperatures, climate change is having a major effect on wineries. Warmer temperatures produce overripe grapes with high alcohol content and cooked flavors. These changes are expected to increase in the following years. Wine growers are exploring different varieties of grapes that would adapt to warmer climates and are considering moving vineyards to colder areas.
2. Transition risk	
(a) Policy and legal risks These are risks to the business as a result of governments responding to climate change through regulations by increasing efficiency standards, capping supply or use of resources, or the use of a carbon price.	In 2019, a court refused permission for a new open-pit coal mine in New South Wales, Australia on the grounds that negative impacts, including climate change, outweighed the economic and public benefits of the project.
(b) Technology risk Technology will allow existing products and services to be replaced with ones that are more energy efficient and deliver lower emissions. This will have increased research costs and impact demand for existing products.	As a part of the effort to reduce carbon emissions, countries around the world are encouraging more people to buy electric cars. Several countries including UK and France have announced a ban on petrol and diesel cars to come into effect between 2030 and 2040. These changes would result in phasing out of petrol and diesel cars in these geographies. Car companies will need to reconsider their revenue mix going forward and invest heavily in research and development in electric car technology to compete.
(c) Market risk There is a significant change in consumer behavior and expectations with consumers looking for low carbon goods and services. This could lead to risks of reduced demand for existing products (as green products become more attractive), uncertainty in the market, and increased cost of raw materials and production.	It is expected that global warming and consequent sea level rise will increase the cost of available resources. This will place an increased burden on the existing system of roads, pipelines, water supply, water treatment, power transmission lines, and other facilities that make up the infrastructure of countries. Governments will have to spend more to keep these systems running and this will result in an increased cost to use these resources.
(d) Reputation risk Stakeholders have higher expectations of how businesses respond to climate change issues. Risks in this area can lead to loss of revenue or market share if these expectations are not addressed.	The International Energy Agency (IEA) has noted that banks, insurance companies, hedge funds, utilities and other operators in advanced economies are exiting the coal business. Over the past few years, the market has seen investors reducing investment in coal and oil.

Disclosures within the financial statements

AASB-AUASB joint bulletin

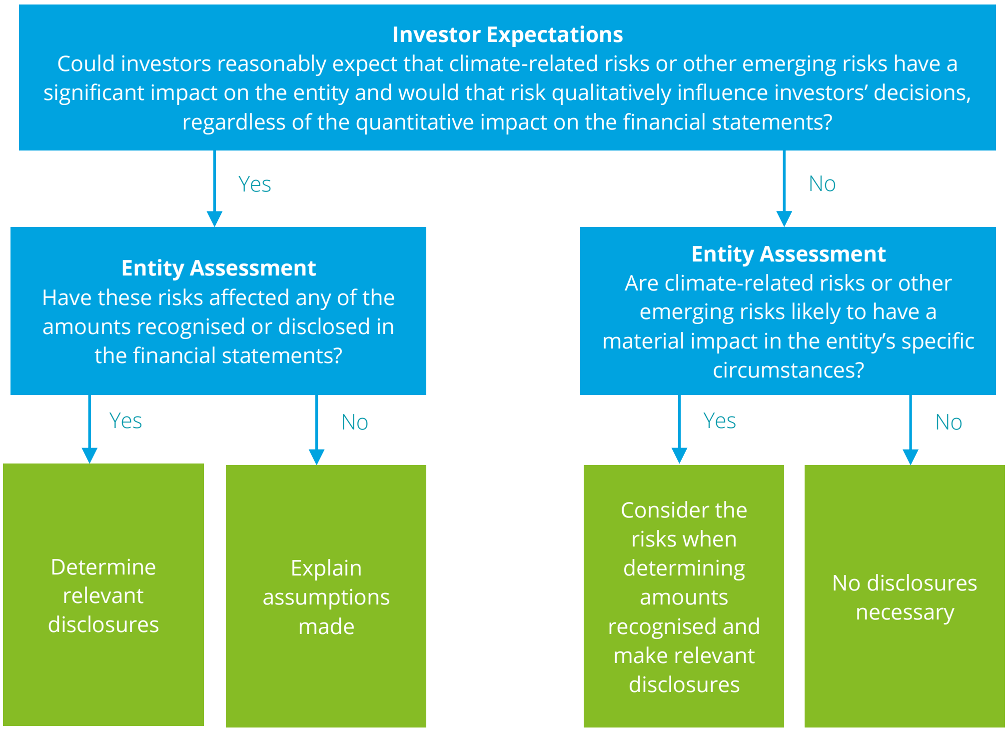
Overview

The Australian Accounting Standards Board (AASB) and the Auditing and Assurance Standards Board (AUASB) issued a joint bulletin in December 2018 (and updated in April 2019), **Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2**.

The bulletin states that climate-related risks and other emerging risks are currently predominantly discussed outside of the financial statements, if at all. Qualitative external factors, such as the industry in which the company operates and investor expectations, may make climate-related risks material and may require such risks to be disclosed in the financial statements as they pertain to specific financial statement line items. It notes that companies can no longer treat climate-related risks as merely a matter of corporate social responsibility as investors are making repeated statements on the importance of climate-related risks to their decision making. The AASB/AUASB's guidance is not mandatory. However, companies need to consider user needs and investors' expectations while preparing financial statements. If this information can affect investors' decision-making, then this information should be deemed as 'material' and should be disclosed.

Considerations in assessing materiality

The flowchart below is the guidance for companies to consider in assessing climate-related and other emerging risks in the preparation of their financial statements:



Source: AASB-AUASB joint bulletin - Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2

Financial reporting considerations

Climate-related risks could have implications on the financial statements, some of which are discussed below:

Impact on financial reporting	Relevant Accounting Standards	Thinking it through
1. Asset impairment	AASB 136 *Impairment of Assets*	Climate-related risks could be an indicator of impairment for an entity's asset/group of assets. Entities must consider the impact of these risks on impairment calculations, for example forecasts of future cash flows, and any relevant disclosure requirements under AASB 136, where this impact is significant.
2. Changes in the useful life of assets	AASB 116 *Property, Plant and Equipment* and AASB 138 *Intangible Assets*	Climate-related risks could reduce the expected useful lives of an entity's assets or create stranded assets, and as a result would affect the depreciation/amortisation expense recognized every year.
3. Changes in the fair-valuation of assets	AASB 13 *Fair Value Measurement*	The measurement of fair values of assets could be impacted by climate-related risks and this should be factored into the fair value calculations. This could, for example, impact the discount rate used or the forecast of future cash flows. Entities impacted by these risks, should disclose the assumptions around including these in the fair value calculations.
4. Recognition of provisions and contingent liabilities	AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*	Climate-related risks could lead to recognition of additional provisions and contingent liabilities, as outlined below: • Provision for onerous contracts driven by potential loss of revenues/increased costs • Provision for decommissioning a plant or rehabilitating environmental damage in extractive industries as a result of shortened project lives or regulatory changes • Contingent liabilities related to potential litigation and fines/penalties due to stricter regulations.
5. Changes in expected credit losses for loans and other financial assets.	AASB 9 *Financial Instruments* and AASB 7 *Financial Instruments Disclosures*	AASB 9 requires use of forward-looking information to recognise expected credit losses. The impact of climate-related risks on the borrower must be considered when determining whether credit risk of the financial assets has increased significantly since initial recognition.
6. Disclosure of climate-related risks	AASB 101 *Presentation of Financial Statements*	Information related to climate-related risks will be relevant to the understanding of the financial statements if investors could reasonably expect that these risks have a significant impact on the entity and this would influence their decisions. AASB 101 requires disclosure of such information in the notes to the financial statements.

The bulletin discusses each of the above in more detail explaining how climate-related risks could have these impacts and which accounting standards need to be considered. It is expected that companies, at a minimum, should consider the physical and transition risks as listed above in determining what risks could affect them and to what extent. As noted, this assessment should take into consideration not only the company's operations, but also the supply or value chain. As a result, climate risks could affect companies not just directly, but indirectly as well.

Resources

Deloitte-ICAEW website

Deloitte, in collaboration with the Institute of Chartered Accountants in England and Wales (ICAEW) has launched a **dedicated climate change website**. This joint initiative is designed to help businesses and finance professionals learn more about tackling climate change. We encourage teams to share this widely with clients to achieve the greatest impact. The website also lists links to additional resources.

Summary of other useful resources

- **Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement 2**- issued by the AASB and the AUASB in in December 2018 (and updated in April 2019).
- **Memorandum of opinion** issued in October 2016 and **Supplementary Memorandum of opinion** issued in March 2019 in relation to the Noel Hutley and Sebastian Hartford Davison legal opinion for the Centre for Policy Development, "Climate Change and Director's Duties".
- **Corporate Governance Principles and Recommendations** – released by ASX in February 2019 stating that climate change is expected to be considered by the entity's risk management framework.
- **Report 593 Climate risk disclosure by Australia's listed companies** (REP 593) – released by ASIC in September 2018 which sets out their findings on review of climate risk disclosures and high-level recommendations for listed companies on climate risk disclosure.
- **TCFD report on recommendations on Financial Disclosures** – released in June 2017 to help companies develop voluntary climate-related financial risk disclosures.

Conclusion

Climate change is a present risk to business and the time to act is now. Climate–related change can give rise to many uncertainties and it is management's responsibility to consider these uncertainties and how best to respond to them. Companies are increasingly expected to provide information to investors about how they have considered climate-related risk to the business and make relevant disclosures in the financial statements. Identifying these risks and assessing whether they are material or not requires judgement and must be done carefully.

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