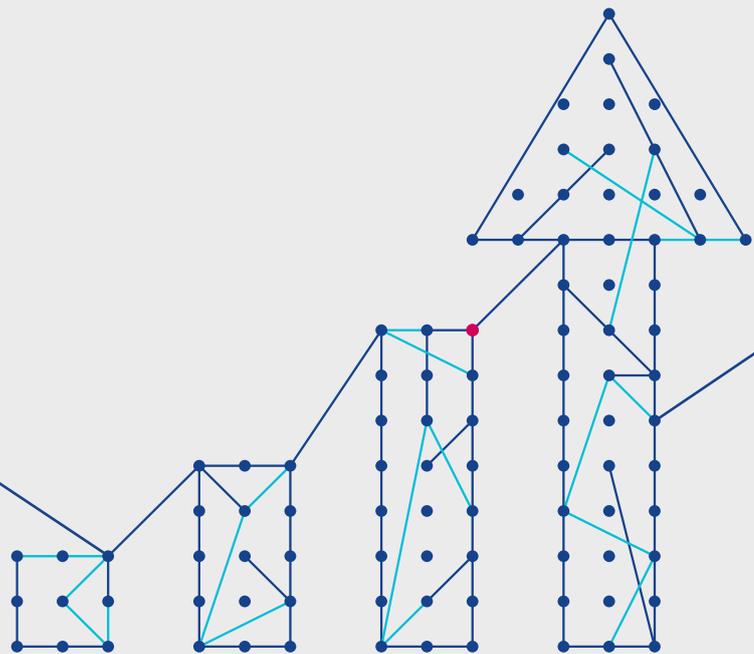


Accounting for climate

Integrating climate-related matters
into financial reporting



CDSB is an international consortium of business and environmental NGOs. We are committed to advancing and aligning the global mainstream corporate reporting model to equate natural capital with financial capital.

We do this by offering companies a framework for reporting environmental information with the same rigour as financial information. In turn, this helps them to provide investors with decision-useful environmental information via the mainstream corporate report, enhancing the efficient allocation of capital. Regulators also benefit from compliance-ready materials.

Recognising that information about natural capital and financial capital is equally essential for an understanding of corporate performance, our work builds the trust and transparency needed to foster resilient capital markets. Collectively, we aim to contribute to more sustainable economic, social and environmental systems.

For more information, visit cdsb.net or follow Climate Disclosure Standards Board on [LinkedIn](#) and Twitter [@CDSBGlobal](#).

We welcome your input and discussions. If you would like to comment on this document, please contact us at info@cdsb.net.

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1. Introduction

The 2020 edition of the World Economic Forum (WEF) annual Global Risks Report found “failure of climate-change mitigation and adaption” as its top risk in terms of impact. Additionally, for the first time the top five risks in terms of likelihood were all related to climate change and related environmental issues.¹ Climate change clearly poses a significant risk to the world economy. Ultimately, if not addressed climate-related risks will impact the financial position, performance and prospects of all businesses. Article 2.1(c) of the Paris agreement commits to “[m]aking finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development”.² An estimated US\$6.9 trillion a year is required to achieve the Paris Agreement goals by 2030.³ In response, investors, as the primary users of mainstream annual reports, are asking for greater clarity and transparency on the impacts of climate-related matters on businesses.

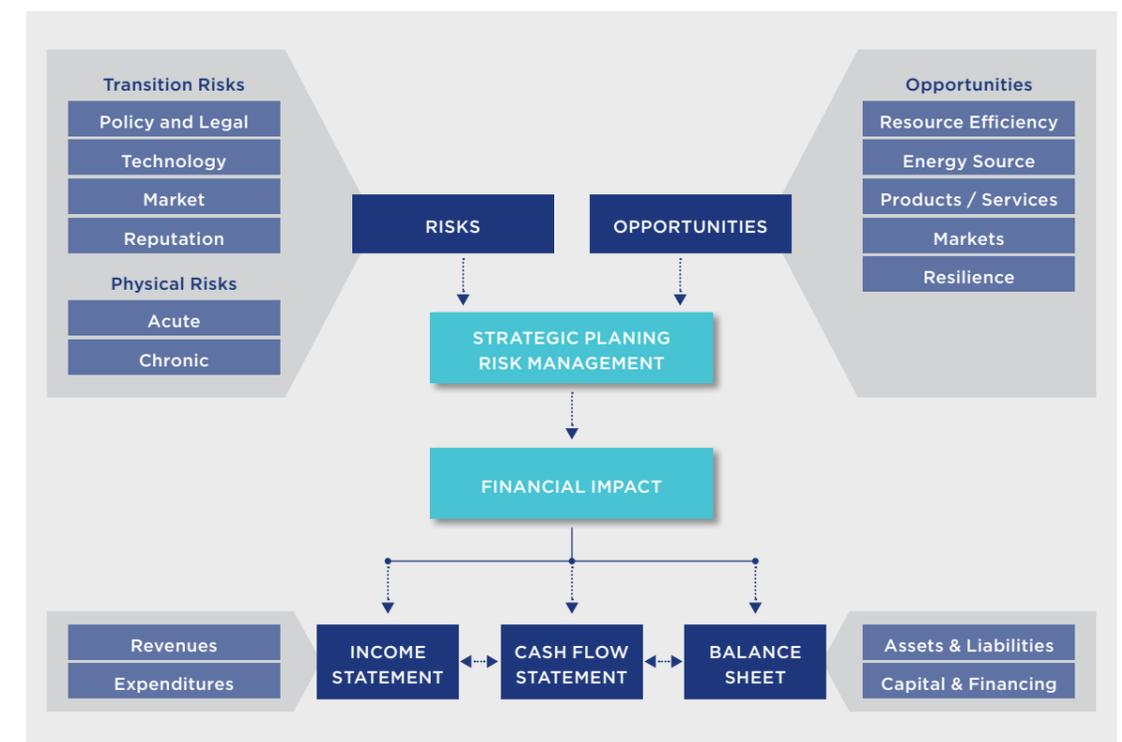


Figure 1 Climate-Related Risks, Opportunities, and Financial Impact. 2017 TCFD Final Report

The Taskforce on Climate-related Financial Disclosure (TCFD) recommendations have been a key driver for the inclusion of material climate-related information and potential effects on companies' future operations in mainstream narrative reporting (the so called 'front-half' of annual reports) in recent years. Although, disclosure of climate-related financial information by companies has increased per the most recent TCFD Status Report, continuing progress is needed, particularly quantifying the potential financial impacts of climate change on their businesses and strategies.⁴ Figure 1 of the 2017 TCFD Final Report summarises how climate-related risks and opportunities may have a financial impact on a company.⁵

Investors also require disclosure of the current financial effects of material climate-related issues on a company's financial statements. Disclosure of the financial effects of climate-related matters provides these users with better quality information and thus allows for more efficient and effective engagement, valuation, voting and capital allocation decisions. Disclosure of climate-related matters also enables markets to more effectively price the potential future financial impacts of climate change, which in turn supports the reallocation of capital resources necessary to transition to a low carbon economy.

However, the inclusion of material climate-related information within financial reporting (the 'back-half') could also be improved, particularly in comparison to the narrative disclosures in the front half of annual reports. For example:

- Research by Deloitte in 2020 on 100 companies listed on the London stock exchange found that while 90% of companies referred to climate change within their annual report, with 64% referring to TCFD, only two companies explicitly referred to climate change impacts in their financial statements⁶.
- Similarly, a 2020 CDSB review of the non-financial reporting of 50 of the largest companies in Europe found that 100% of

companies provided some narrative disclosure on climate-related matters. Of these companies, 68% referenced the TCFD recommendations, while 42% of companies referred to any environmental matter in their financial reporting, although this was very limited in nature.⁷ Further analysis found that only 10% of companies made any reference to climate-related matters in their financial reporting.

- The UK Financial Reporting Council (FRC) published its Climate Thematic in November 2020, which found that only six of the 24 companiesⁱ that were reviewed made any specific reference to climate change in their financial statements, in contrast to 22 companies providing narrative disclosure on climate change. In particular the FRC found it was generally unclear "*how forward-looking assumptions and judgements applied in preparation of the financial statements were consistent with narrative discussion of climate change*".⁸

Accordingly, CDSB has identified a need to support preparers in integrating climate-related matters into the financial statements. This guidance does not seek to create new accounting standards in relation to climate-related matters, but builds on International Accounting Standards Board's (IASB) position on how climate-related matters should be integrated into financial reporting based on current International Financial Reporting Standards (IFRS) Standards.ⁱⁱ

This guidance will seek to address three main questions:

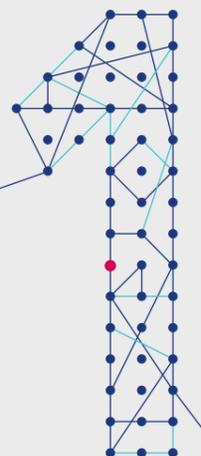
- Are climate-related matters relevant to financial reporting?
- How should climate-related matters be factored into a company's financial reporting and what this might look like?
- What steps can companies take to integrate material climate-related matters into financial reporting?

ⁱ Note the sample was heavily weighted towards those companies and sectors that the FRC expected to be most affected by climate change.

ⁱⁱ IASB is the independent body established to develop a single set of globally accepted accounting standards - IFRS Standards. IFRS Standards have been developed to enhance the international comparability and quality of financial information, in order to enable the primary users of financial reports to make informed economic decisions by providing them with the information to identify opportunities and risks, and make capital allocation decisions. Currently IFRS Standards are required in more than 140 jurisdictions and permitted in many more.

Chapter 1

Are climate-related matters relevant to financial reporting?



The first chapter of this guidance outlines how climate change is relevant to financial reporting and why preparers of financial statements need to pay attention to this. A number of the key climate-related considerations are outlined to support preparers in making the case internally to both senior management and the board in order to bring about such change:

- Climate change and the IFRS Standards
- Regulation, assurance, and climate-related financial reporting
- Investor expectations

1. Climate change and the IFRS Standards

In 2019, IASB published a paper which clarifies how existing IFRS requirements may address material climate change risks and other emerging matters (the 2019 IASB paper).⁹

The paper draws inspiration from work by the Australian Accounting Standards Board (AASB) and Audit and Assurance Board (AUASB).¹⁰ It explains that as IFRS Standards are principles-based, climate change is not explicitly referred to in the requirements.

However, despite this, IFRS standards do in fact address material climate change matters. The paper is therefore not new guidance, but rather a way of signposting current requirements in order to help bridge a gap in understanding and serves as a reminder to preparers, auditors and investors. This was followed up with educational material published by the IFRS Foundation in November 2020, complementing the 2019 IASB paper, containing a non-exhaustive list of examples when companies may need to consider climate-related matters in their reporting (the 2020 IFRS Foundation paper).¹¹

Materiality

The concept of materiality is an important factor in the consideration of what issues are relevant to investors and so should be included in IFRS financial statements. According to IAS 1.7 “*information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a reporting entity.*” Primary users are defined as existing and potential investors, lenders and other creditors.ⁱⁱⁱ IAS 1.7 goes on to explain that when assessing whether matters are material, judgement is required based on the nature or magnitude, or a combination of both. In other words, an item of information could influence primary users’ decisions regardless of its size. This is elaborated in the IFRS Practice Statement 2 on materiality (paragraphs 40-55).¹²

In the context of climate-related matters, the 2019 IASB paper clarifies that investors may expect disclosure in the financial statements, regardless of numerical impact. Therefore, companies should consider whether:

- a) climate-related matters materially affect their financial statements, due to the magnitude of the effect; and
- b) the nature of climate-related matters results in investors expecting disclosure (whether or not the company has determined the magnitude of the impact to be material).

As a result, material climate-related matters may need to be reflected in the amounts recognised in a company’s financial statements and / or require disclosure in the relevant notes to the financial statements.

ⁱⁱⁱ This is per the IFRS Conceptual Framework. Although there may be other users of financial reporting, including, but not limited to employees, suppliers, regulators, customers and wider civil society, the key beneficiary of financial reporting are those primary users. Note that primary user and investors is used interchangeably throughout the guidance.

Example K within IFRS Practice Statement 2 provides an example of a situation that might reasonably influence investors’ decisions, thus is material due to its nature, even though it is deemed as immaterial based on the magnitude of the matter. Therefore, disclosure is provided¹³. This can be equally adapted to apply to a climate-related matter as found in **Example A** (see Appendix A). The logic of this example, which relates to the banking sector, could also be applied to international energy companies, for example. In the nine months since Q4 2019, seven oil and gas companies have written-down nearly \$90bn of assets. This is due to downward adjustments to commodity price assumptions in their impairment calculations, reflecting the longer term weaker future fossil fuel conditions implied by the Paris Agreement and accelerated by the COVID-19 pandemic.¹⁴ Therefore, investors may expect peers in the oil and gas industry to also make downward adjustments to prices they use, or to provide sufficient disclosure on this matter if they do not, even if those peer companies have deemed their exposure to be limited.

As well as materiality considerations, the 2019 IASB paper states that climate-related matters might feature in financial statements because of the principles in particular IFRS Standards that apply (for example to the measurement of assets and liabilities or the disclosure of estimation uncertainty). This will be covered in greater detail in the next chapter.

It should be noted that whilst the focus of this guidance is on climate-related matters, the 2019 IFRS paper does also refer to “other emerging risks”. This may include other environmental matters, such as water supply, threats to biodiversity and land use change via activities such as deforestation, so much of the content of this guidance could be adapted and applied to address such matters.

IFRS Conceptual Framework

Preparers of financial statements are encouraged to also take note of the IASB Conceptual Framework for Financial Reporting in its description of the objectives of, and concepts for, general purpose financial reporting, both assisting preparers to develop consistent accounting policies where IFRS requirements are silent on a particular matter, and all parties to better understand and interpret IFRS requirements. Each of these considerations being relevant to an appreciation of the logic and limitations of applying IFRS to the economic phenomena associated with climate change risk.

2. Regulation, assurance and climate-related financial reporting

Under most legal frameworks in OECD and some emerging countries, management is required to disclose principal risks within the front-half of annual reports, and key assumptions used in the preparation of financial statements in the back-half. Preparers should be aware of the need for consistency of climate-related information between the front and back halves of annual reports.

There have been a number of regulatory and legal developments in various jurisdictions with regards to the narrative reporting of climate-related matters, especially since the introduction of the TCFD recommendations.^{iv} Legal and regulatory developments for a selection of jurisdictions as at the time of publication can be found in Appendix B. We expect regulators, government and other relevant bodies will increasingly focus on the consideration, and where material the reflection, of the impact of climate change on financial reporting.

Similarly, auditors are increasingly considering the implications of climate-related matters as part of their own processes and professional responsibilities. The International Auditing and Assurance Standards Board (IAASB) has recently clarified how existing International Standards on Auditing require consideration and assessment of climate-related risks in an audit.¹⁵ As with other risks, if climate-related risks have a significant impact on a company, the auditor will consider whether the financial statements have appropriately reflected this in line with the relevant accounting standards. Equally, auditors will also read and consider other information presented in the front half for material inconsistency with the financial statements. Appendix C covers the role of

assurance and the implications of climate-related matters on financial reporting in further detail.

Directors' duties and disclosure

Company directors in certain jurisdictions may also need to be mindful with regards to their fiduciary duties relating to material climate-related disclosure. The Commonwealth and Climate Law Initiative (CCLI) published a paper in October 2019, summarising legal analysis of directors' climate-related fiduciary duties in Australia, Canada, South Africa and the UK.¹⁶ The key points relevant to this discussion are:

- Directors may breach their duty of care and diligence where they fail to consider and govern for foreseeable and financially material climate risks, do so inadequately, or where they fail to monitor and oversee a robust corporate risk and reporting system that identifies and manages climate risks.
- Directors may also face personal liability for breach of disclosure obligations to provide a true and fair view of corporate performance and prospects. Disclosures may be misleading where there is a failure to disclose the material transition risks or physical risks to a company's financial position, performance or prospects, a denial or material understatement of risk exposure or material overstatement of strategic preparedness or risk management, the material misstatement of balance sheet values, or the selective application of optimistic demand forecasts or assumptions.

Noteworthy also is what is termed unlawful or improper dividends and the obligations upon directors to consider foreseeable losses in such distribution decisions to which business impact of climate change may increasingly loom as a significant factor.

^{iv} There are also initiatives and actions underway by central banks and macroprudential financial supervisors relating to climate-related risk disclosure and integration which are likely to result in significant impacts upon financial institution disclosures, operations, and lending and investment activities. See for example the Network for Greening the Financial System (www.ngfs.net)

3. Investor expectations

Investors have a significant role to play in the shift to a low-carbon future and achieving the global climate-related goals, both under the Paris Agreement (allocating capital in accordance with Article 2.1) and the UN Sustainable Development Goals (by 2030). However, in order to make effective capital allocation decisions, investors need to understand the qualitative and quantitative impacts of climate-related matters on a company's position, performance and prospects when making investment decisions. To date much of the focus by investors has predominantly been around narrative reporting of climate-related matters. This is summarised in Appendix D.

Beyond narrative climate-related reporting, an increasing number of investors are now also recognising that companies need to improve their disclosures of the financial effects of climate-related matters in their financial reporting:

- In September 2020, the largest investor groups in the world (representing over \$103 trillion in assets under management) published a letter confirming that they as investors do indeed consider climate-related risks to be material factors and thus should be reflected appropriately in financial reporting. Among other things, the letter asks that:
 - companies *"apply the IASB opinion in the letter and the spirit, including showing the key assumptions that have been made with regards to climate-related risks"*; and
 - the assumptions made by companies in preparing financial statements under IFRS Standards are compatible with the Paris Agreement.¹⁷

- In November 2020, a group of global investors (representing over \$9 trillion in assets under management) wrote letters through the Institutional Investors Group on Climate Change (IIGCC) to 36 of Europe's largest companies. Among other things, their letters call for 'Paris-aligned accounts' and outline steps that the investors expect directors to take as part of this process. These steps include:

- an explanation of how the critical accounting judgments that management uses in preparing the accounts are *"consistent with net zero carbon emissions^v in 2050, in line with the Paris Agreement"*. If management uses judgements that are not 'Paris-aligned' why not; and
- providing sensitivity analyses for the judgments or estimates used.¹⁸

^v The Intergovernmental Panel on Climate Change (IPCC) has confirmed that in order to limit global warming to 1.5°C and avoid the most catastrophic impacts of climate change, the world needs to reach net zero emissions by 2050. The IPCC defines net zero as the point when "anthropogenic emissions of greenhouse gases to the atmosphere are balanced by anthropogenic removals over a specific period." Countries, cities, companies, and others are increasingly committing to setting their own net zero targets. However, corporate net zero targets are currently approached inconsistently, and the Science Based Targets Initiative has set out a conceptual framework for setting and assessing corporate net zero targets based on robust climate science.¹⁹

4. Summary – climate change and financial reporting

The message to preparers is clear:

1. IFRS Standards require the incorporation of material climate-related matters in financial reporting and / or where there is a specific application of the standards, where climate change has an effect on financial performance or position.
2. Investors have made it clear that climate-related risks are material to their investment decision-making. They therefore expect companies to reflect material climate-related matters in their financial statements (including the related notes) and to provide additional disclosure on judgements and assumptions used in relation to climate-issues.

Climate change is inherently uncertain, be it the size of physical or transitional impacts on a business or when these might occur. This naturally poses a challenge when it comes to quantifying and managing such climate-related risks and in-turn how such risks might be reported.

Challenging as it may be, companies can no longer avoid considering, quantifying, and reporting on material climate-related matters. A range of forward-looking information is already embedded in financial reporting in areas such as fair value accounting, impairment testing, the measurement of provisions and the recognition of contingent liabilities. Such forward-looking information is a collection of judgements and estimates, based on the best information available to preparers. Climate risk is another matter that should be considered, like any other material risk to a business. To a degree, preparation of financial reports will always include a level of uncertainty and in this way the consideration of climate-related judgements and estimates is not fundamentally different.

Investors welcome company narratives that detail their governance and risk management processes as well as business strategies for

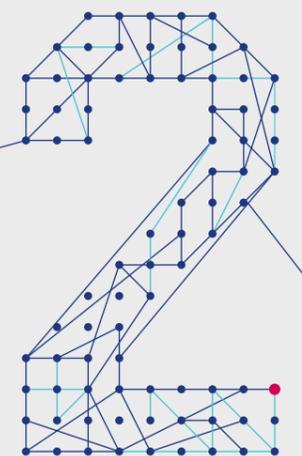
addressing climate-related matters. Investors value when these are supported with KPIs to evidence progress over time and facilitate comparison with peers as per the TCFD recommendations. Alongside such narrative reporting, investors need better information about how such matters impact the financial performance, position, and prospects of a company i.e. how climate-related matters do or could impact the company's audited financial statements.

This requires companies to disclose the significant assumptions, judgements and estimates likely to be impacted by climate-related matters enabling investors to review and analyse this information. Critically, assumptions should be consistent with (or not contradict) the narrative reporting by a company, both internally (even if not publicly available) and externally. This includes the narrative covering strategy and risk management; scenario analyses undertaken by the company; commitments made by the company to investors and other stakeholders, such as the Science Based Target Initiative; and commitments made by governments of jurisdictions in which the company operates, e.g. under the Paris Agreement and related to Nationally Determined Contributions by governments.

The integration of material climate-related information is starting to occur. As noted previously, some of the largest oil and gas companies, including BP, Repsol, Shell and Total, have written down their assets by nearly \$90 billion in the nine months since Q4 2019. This in part reflects the use of projected oil prices that are more in line with Paris-aligned climate assumptions, accelerated by the COVID-19 pandemic. However, investors are clear that, where material, such reflection and disclosure of climate-related matters needs to occur not only in one sector, but by companies in all sectors.

Chapter 2

How should climate-related matters be factored into a company's financial reporting?



The case for inclusion of climate-related matters, where material, in the financial statements should now be clear. Therefore, this chapter addresses the question of how preparers can integrate climate-related matters into reporting in line with existing IFRS Standards, and what such disclosures might look like?

Although not a comprehensive list, the 2019 IASB paper identified a number of IFRS Standards where climate considerations might be applicable. Over the following pages the guidance will explore in detail four of the IFRS Standards that were identified in that paper, which are considered to be relevant for most companies and applicable to a range of sectors and geographies:

- *IAS 1 Presentation of Financial Statements*
- *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*
- *IAS 36 Impairment of Assets*
- *IAS 16 Property, Plant and Equipment*

Readers should be aware that this guidance is not exhaustive. There are other IFRS Standards identified by the 2019 IASB paper that should also be considered. These are IFRS 13 *Fair Value*, IFRS 9 *Financial Instruments*, IFRS 7 *Financial Instruments: Disclosures* and IAS 38 *Intangible Assets*. In addition to these IFRS standards, the 2020 IFRS Foundation paper also noted that IAS 2 *Inventories*, IAS 12 *Income Taxes* and IFRS 17 *Insurance Contracts* should also be considered. Both papers are clear that these lists are not exhaustive; there are other IFRS Standards that have not been referenced that may also need to be considered. CDSB will consider developing supplemental guidance on these and other relevant IFRS Standards in the future.

For each of the four standards covered, this guidance identifies essential accounting and disclosure matters relevant from a climate perspective. These are not exhaustive but illustrate the key matters that companies might need to consider. Alongside this discussion, a number of illustrative examples have been developed, which are found in Appendix A. These examples are not intended to be comprehensive or to represent best practice. Rather, they are intended to illustrate the range of climate-related matters that might need to be considered, the relevant accounting considerations and a starting point as to how to begin reflecting climate-issues in financial reporting.

1. IAS 1 – Presentation of Financial Statements

The pace and severity of physical climate Under IAS 1, companies must consider whether to provide information not specified under other IFRS Standards if that information is necessary for primary users to understand the impact of events or conditions, such as climate-related matters on companies' financial position, performance and cash flow. This falls under two broad categories – sources of estimation uncertainty and information not presented elsewhere. Other relevant matters addressed by IAS 1 are disaggregation of line items and going concern issues.

Sources of estimation uncertainty

Under IAS 1:

“An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

- their nature, and*
- their carrying amount as at the end of the reporting period.”* (IAS 1.125)

IAS 1 also explains that the disclosures on assumptions should be presented:

“...in a manner that helps the users of financial statements to understand the judgements that management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:

- the nature of the assumption or other estimation uncertainty;*
- the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;*
- the expected resolution of an uncertainty and the range of reasonably possible*

outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and an explanation of changes made to past assumptions concerning those assets and liabilities if the uncertainty remains unresolved.” (IAS 1.129)

Accordingly, if assumptions related to the impact of climate change have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year and / or could influence investors' decision-making, then disclosures about the nature of the assumptions should be provided.

Appropriate disclosure of assumptions and estimates is critical for investors so that they can understand the judgements that management have made in relation to climate-related matters. In doing so, investors can determine whether they think a company is appropriately valued, engage with management about these issues and make better investment decisions. Companies should therefore consider whether climate-related issues should result in additional disclosure in relation to the following matters:

- the key assumptions, estimates and judgements that have been made;
- a sensitivity analysis of key assumptions used, especially where there is significant uncertainty and a wide range of possible outcomes may be possible; and
- assumptions and estimates under different climate scenarios and the resulting impact on the financial numbers, particularly if such analysis has been undertaken as part of the company's climate-related reporting per the TCFD recommendations.

Note that assumptions used when undertaking scenario analysis will not necessarily be the same as the assumptions used when preparing the financial statements. Scenario analysis covers a range of possible scenarios with different assumptions, whereas a judgement must be made on assumptions used in the financial statements based on management's best estimate.

Example B (Appendix A) illustrates the additional disclosures that companies could provide due to the uncertainty of assumptions used.

Information not presented elsewhere

As summarised previously, the 2019 IASB paper explains that under IAS 1, when assessing materiality of matters, judgement is required based on the nature (qualitative) or magnitude (quantitative), or a combination of both. Building on this, IAS 1 provides a catch-all that provides for the disclosure of additional information, which may not be required under any of the individual IFS Standards but would be expected by users because it would be deemed material. Specifically:

“A fair presentation also requires an entity... to provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity’s financial position and financial performance.” (IAS 1.17(c))

Similarly, in relation to disclosure in the notes to the financial statements, IAS 1 states:

“The notes shall... provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.” (IAS 1.112(c))

Information will be relevant if it could reasonably be expected to influence decisions made by investors as per the illustrative example of an extractives company in **Example C**. The disclosure of climate-related information not required under IFRS Standards but expected by investors, applies equally to other industries in relation to other accounting matters.

Disaggregation of line items

IAS 1 also provides for the disaggregation of line items on the face of the financial statements, where such presentation is relevant for an investor’s understanding of a company’s financial position or performance. For example, in relation to the statement of financial position, IAS 1 states:

“An entity shall present additional line items, ... headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity’s financial position.” (IAS 1.55)

This also applies to the statement of profit or loss in IAS 1.85.

Therefore, in a situation where a company may be transitioning from carbon intensive activities to a Paris-aligned or 1.5°C strategy, investors may be particularly interested in the disaggregation of profit and loss and financial position items by ‘business as usual’ / ‘brown’ and ‘low-carbon’ / ‘green’ activities or products. This is demonstrated in **Example D**.

Going Concern considerations

IAS 1.25 outlines that *“when preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern.”*

Climate-related risk can lead to going concern issues. For example, it has been a significant driver of a bankruptcy of a major company: Pacific General & Electricity, in relation to the California wildfires. For many companies, at least in the shorter term the impact of climate-related risks will not be significant enough to cause a material impact on the going concern assumption. However, this will likely become an increasingly important matter for companies over time, especially for those operating in carbon intensive industries or whose businesses are exposed to significant physical climate risks.

IAS 1.26 states that management should take into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period. Equally important is the requirement that where there are material uncertainties related to conditions or events that may cast significant doubt upon the company’s ability to continue as a going concern, the company should disclose these uncertainties (also IAS 1.25). Therefore, for sectors currently at greater risk, some disclosure may be needed to identify certain climate-related matters that could be a longer-term risk to a company’s ability to continue as a going concern if its current strategy and business model were to remain unchanged.

2. IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

The pace and severity of physical climate change risks, as well as accompanying transition risks such as government policy and regulatory measures, may impact the recognition, measurement and disclosure of provisions, contingencies and onerous contracts.

Provisions

When it comes to measurement, climate-related risks and uncertainties may affect the best estimates of new and existing provisions.

IAS 37 outlines the three conditions for recognising a provision:

- “a) an entity has a present obligation (legal or constructive) as a result of a past event;*
- b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and*
- c) a reliable estimate can be made of the amount of the obligation.” (IAS 37.14)*

In addition, under IAS 37.59, *“provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate”*.

Accordingly, new provisions may need to be recognised due to new obligations arising from climate-related risk, such as requirements to prematurely retire assets that produce emissions. Similarly, a provision may need to be recognised due to existing obligations previously not considered probable, now being viewed as probable in occurrence, for example, the loss of a legal case for polluting activities now being considered probable rather than possible.

Constructive obligations

IAS 37 recognises that an event that does not result in an obligation immediately may do so at a later date, because of a change in law or because of an act by a company (such as specific commitments made or past practice) which results in a constructive obligation (IAS 37.21).

A constructive obligation is:

“an obligation that derives from an entity’s actions where:

- a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and*
- b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.” (IAS 37.10)*

Example 2b in Appendix C to IAS 37 illustrates this via an oil company which causes contamination in a country where there is no environmental legislation. The oil company has a widely published environmental policy and record to clean up all contamination it causes. Accordingly, even though there is no legal requirement to clean up contamination, the company’s past practice constitutes a constructive obligation to do so.

Example E illustrates further how a new provision can arise, due to the creation of a constructive obligation.

Potential changes to law and regulation

Where the details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as it is drafted (IAS 37.22). Therefore, legal obligations in relation to climate-matters cannot be recognised until the company is virtually certain of the enactment of a law (which may not be until the law has been enacted). However, this does not stop management from describing these potential changes in the notes to its financial statements in accordance with IAS 1 if management believes this would be a material item for investors.

Present value

Provisions should be recorded at the present value of the expenditures the company expects to settle the obligation (IAS 37.45), the risks and uncertainties in relation to climate-related matters should be taken into account when determining the cash flows and discounts rate to measure the provision. This is relevant in relation to the provisions recognised for decommissioning / asset retirement obligations.

Decommissioning / asset retirement obligations

A decommissioning or asset retirement obligation may need to be recognised for an obligation associated with the decommissioning or retirement of a tangible long-lived asset, such as coal, oil and gas, chemicals and cement plants to the extent that the company is obliged to rectify damage already caused, as per IAS 37.19.

If the underlying asset undergoes a write-down or reduction in useful life, the relevant decommissioning obligation may be affected especially if it cannot be separated from the related asset. This may result in a revision to the carrying amount of the asset retirement obligation. An increase in the provision may need to be recognised, due to the acceleration of the timing of the cash flows required for the decommissioning. Increases in the decommissioning provision could also be driven by regulatory changes or increasing retirement costs.

Equally, where provisions may not have been previously provided for decommissioning costs, because the useful life of the related asset cannot be determined, such as pipelines, this may need to be revisited, as this may increasingly become a more difficult rationale to justify for some equipment.

Example F explores the accounting considerations and resulting disclosure in relation to asset retirement obligations.

Onerous contracts

A provision may also need to be recognised for contracts assessed as onerous due to the cost of fulfilling a contract increasing as a result of climate-related issues (such as costs to repair physical damage from climate-related events, changes to commodity prices and changes to the costs of raw materials). IAS 37 defines an onerous contract as

“a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.” (IAS 37.68)

Where the entity identifies an onerous contract, it recognises the present obligation under the contract as a provision after taking account of any impairment losses on assets dedicated to the contract.

Example G shows how climate-related matters could result in an onerous contract being recognised.

Disclosure

Per IAS 37.85 for each class of provision, alongside a description of the obligation, expected timing of the outflows, along with an indication of the uncertainties about the timing of those outflows should be provided. Companies may also need to disclose their major assumptions about future events, which may include an explanation of how climate-related risks have been factored into the best estimate of the provision.

In combination with IAS 1, investors may value the assumptions underlying asset retirement obligations to be sufficiently disclosed in the financial statements to help users understand the level of sensitivity of asset retirement obligations to changes in the key assumptions used. For example, such disclosures might include sensitivity analysis as to the timing of the asset retirement obligations. Similarly, investors may benefit from disclosure on the company's accounting policies as to illustrate how and when such decommissioning estimates are updated.

Contingent Liabilities

Unless the possibility of any outflow in settlement is remote, under IAS 37, companies are required to provide for each class of contingent liability, a brief description of the nature of the liability. Where practicable, an estimate of its financial effect and an indication of the uncertainties relating to the timing or amount of outflow of resources for settling the obligation should be disclosed (IAS 37.86).

New contingent liabilities may need to be disclosed in relation to climate for possible obligations, or for existing contingencies previously considered remote becoming possible. Similarly disclosure of contingent liabilities for potential litigation and fines or penalties may be required because of the introduction of climate-related regulations, where there may be a dispute over whether the company has broken a regulation, but the probability that it will have to make a payment is lower than 50%.

3. IAS 36 – Impairment of Assets

Under IAS 36, companies shall:

“assess at the end of each reporting period whether there is any indication that an asset may be impaired. If such an indication exists, the entity shall estimate the recoverable amount of the asset.” (IAS 36.9)

If impairment reviews and calculations do not consider the effect of material climate-related risks (including determining if these are potential indicators of impairment), the carrying amounts of assets such as (but not limited to) property, plant and equipment, assets recognised in relation to mineral resources, intangible assets and goodwill could be overstated. The standard also explains that intangible assets with indefinite useful lives and goodwill must be tested annually.

Impairment assessment and calculation

IAS 36.12 provides a non-exhaustive list of external and internal indicators that should be considered by companies when determining whether an asset might be impaired.

Additionally, under IAS 36.6, *“the recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs of disposal and its value in use. ... Value in use is the present value of the future cash flows expected to be derived from an asset or cash-generating unit”.*

IAS 36.30-.57 discuss the requirements for measuring value in use. Specifically:

“The following elements shall be reflected in the calculation of an asset's value in use:

- a) an estimate of the future cash flows the entity expects to derive from the asset;*
- b) expectations about possible variations in the amount or timing of those future cash flows;*
- c) the time value of money, represented by the current market risk-free rate of interest;*
- d) the price for bearing the uncertainty inherent in the asset; and*
- e) other factors, such as illiquidity, that market*

participants would reflect in pricing the future cash flows the entity expects to derive from the asset.” (IAS 36.30)

Examples of climate-related events that could affect the related cash flows for the impairment calculations include physical climate risks, expected changes in consumer behaviour and / or expected government action, with latter two both transition climate risks.

Physical climate risks

Increasing risk from physical climate impacts, may be an indicator of an impaired asset. Physical climate risks can be both chronic and acute. Chronic physical risks are those that relate to longer-term shifts in climate patterns, such as increased long-term sea level rise or temperature rise. Acute physical risks refer those that are event-driven, including increased severity and frequency of extreme weather events, such as floods or forest fires. If these are considered indicators of impairment, companies will need to make a judgement about the impact on cash flows from such risks as part of its impairment calculations.

Example H illustrates how the potential impact of physical climate risks on suppliers will also need to be considered, especially as costs are passed up the supply chain.

Expected changes in consumer behaviour

Revenue streams and growth forecasts may need to change to reflect changing customer preferences and market trends, as well as changes in the cost of resources and production. If these are applicable to the company's situation, when estimating future cash flows for the value-in-use calculation, companies should include the best estimate of any forecast changes in consumer behaviour expected as result of climate-related matters causing positive or negative changes in either the volume or price of future sales. For example, there could be a decrease in demand for products that produce high carbon emissions or conversely an increase in demand for sustainable goods. As above, the same consideration should be applied down the supply chain as company's suppliers may themselves be reacting to changing expectations of society, resulting in changes to a company's cost base.

Expected government action

Companies also need to consider the costs of compliance with new policies or legislation, as well as the growing cost of insurance. Expected government actions such as the introduction of a carbon price should be factored into cash flow forecasts. It is not appropriate to wait for the enactment of a change before it is incorporated into the estimate of future cash flows. If the company's best estimate is that, whilst the exact nature or form of the government legislative or regulatory action is not certain, but there will nonetheless be an effect on the company's cash flows, then the expected changes in cash flows should be included in the value-in-use calculation, although this will require some judgement by the company. This could include determining an external carbon price that should be used over relevant period.

Example I incorporates both expected changes in government action and consumer demand in the assessment and calculation of an impairment loss.

Cash flows beyond the forecast / budget

IAS 36.33-38 discusses the basis for estimating future cash flows, outlining that the budgets and forecasts that are used should cover a maximum period of five years, unless a longer period can be justified. Beyond this period projections should be extrapolated using a steady or declining growth rate unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

Critically, cash flows beyond the forecast or budget period may need to be considered in line with the assets' useful lives, if a company's best estimate is that these will be affected by climate-related matters. In such a scenario, it would be inappropriate to exclude climate-related matters from a value-in-use calculation by simply extrapolating the budgeted or forecast cash flows over a set period of time. Instead, the extrapolation of budgeted or forecast cash flows should be modified to

incorporate the anticipated timing, profile and magnitude of the effect of climate change. This is illustrated in **Example I**.

The impact on any cash flows arising from residual values of the asset after its useful life should also be considered, in the impairment test, for example diesel trucks which are no longer in demand and the cash inflow (or outflow) should be considered in the impairment calculation (see **Example J**).

Impairment disclosures

Per IAS 36.132, while companies are "encouraged to disclose assumptions used to determine the recoverable amount of assets (cash-generating units) during the period", there is no requirement to do so unless the carrying value includes goodwill or an intangible asset with an indefinite useful life. As covered previously, under IAS 1 such disclosure may nonetheless be expected as it would be a material item for the users of these accounts.

Climate-related risk may also be a consideration in impairment assessments for goodwill and intangible assets with indefinite lives. Under IAS 36.134 disclosures may be expected in relation to goodwill or intangible assets with indefinite lives on matters including:

- the key assumptions affecting the recoverable amounts;
- management's approach to determining each key assumption;
- the period for which cash flows have been projected, justifying if this exceeds five years; and
- the growth rate assumed beyond the projection period, justifying if it exceeds the long-term average growth rate for the country or market of operation.

Example J addresses how climate matters can impact the impairment accounting in relation to goodwill and the resulting disclosure.

4. IAS 16 Property, Plant and Equipment

Climate-related factors, such as a changing consumer preferences or introduction carbon taxation, may affect the useful lives of assets.

Per IAS 16:

"The residual value and the useful life of an asset shall be reviewed at least each financial year-end." (IAS 16.51)

Therefore, as part of this review preparers should consider whether climate-related factors might impact the useful life and the residual value of assets held by the company. Changes in one or both will in turn affect the amount of depreciation recognised each year and may also be an indicator of impairment. For example, the 2015 announcement in the UK for coal plants to be phased out by 2025 would have resulted in the useful lives of UK coal assets to be capped at 10 years, triggering an impairment and residual value assessment and affecting the depreciation amounts recognised.

Example K of an airline group and **Example L** of an haulage transportation company respectively illustrate this matter.

Note that IAS 38 Intangibles also has a similar requirement to review the amortisation period, as well as amortisation method, for an intangible asset with a finite useful life at least each financial year-end (IAS 38.104).

Chapter 3

Next steps for preparers



Climate risk is a financial risk that will impact all organisations. Recent guidance and this document set out the need to embed climate risk into the measurement of assets and liabilities in company financial statements. This is not just a narrative disclosure issue, but also impacts the quantification and valuation of assets and liabilities.

In preparing this guidance CDSB have identified some key takeaways that may be useful for preparers starting out in integrating material climate-related matters into their financial reporting:

Take a methodical approach to assessing materiality

Identifying what climate-related information is material to the business and thus should be included in a company's financial reporting can be a challenge. The following four step process can be used for assessing and integrating climate-related issues into financial reporting:

1. Identify the climate-related factors, including the regions and sectors in which the company operates and impacts (short and long-term), that have the potential to be material.

There are many sources of guidance for this. For example, engage with your key investors to help you better understand the issues that are material and relevant to them, your company and your industry. The SASB Standards may also aid in identifying which climate related-matters are material to your specific industry. CPA Canada, for example, has published a process for assessing the materiality of climate-related matters in relation to narrative reporting and includes a list of potential sources of material climate change information (page 6).²⁰ Similarly, CPA Australia, as part of a paper on accounting assumptions and auditing of climate risk disclosure has produced a list of variables (page 34), although set in the context of Australia's Nationally Determined Commitment under the Paris Agreement that could also be considered, this can equally be applied to other geographies.²¹

2. Assess whether the climate-related matters identified in step 1 are, in fact, material to the company.

This could include consideration of whether any climate-related matters have a quantitatively material impact on the financial statements or are qualitatively material, in that omission of such information from the financial statements could reasonably be expected to influence decisions of users. An analysis of the assets and liabilities on the balance sheets could be conducted to understand how climate-related risks might affect them at each stage of their useful life. As part of this assessment, consider developments such as the planned introduction of a carbon tax, the impact of new regulation, or announcements that are virtually certain.

3. Organise the climate-related information in a way that communicates the information clearly and concisely

Consider each climate-related matter in the context of the applicable standards and determine which accounting matters are or could be impacted by the climate-related matters in question. This in turn will help determine what data or information must be reported, bearing in mind that more than one standard may apply to a material climate-related matter.

4. Review the draft climate-related disclosures to determine whether all material information has been identified

As part of this consider whether information disclosed in the financial statements is consistent with disclosures in the narrative report, or equally internal reporting to management.

Consistency with narrative and TCFD reporting

Although the focus of this guidance has been on climate-related matters in relation to financial reporting, preparers should be mindful that narrative and financial reporting in relation to climate should not be considered in silos. Both types of reporting are important for investor decision making and related to each other. As a minimum, assumptions and judgements used in preparing the financial statements should not contradict information disclosed as part of the climate-related narrative, including TCFD reporting by a company.

KPMG's publication on Climate in the Annual Report illustrates how climate-related matters are relevant and considered throughout the annual report (both the narrative and financial reporting) in a UK context.²²

If companies have started to undertake scenario analysis as part of their TCFD reporting, the findings could help in the preparation of the financial reporting. The assumptions and findings of scenarios could be used in the financial report as a sensitivity analysis to illustrate to investors the financial implications across a range of relevant and possible climate scenarios.

Company collaboration and buy-in

In order to ensure a complete and robust integration of climate-related matters into financial reporting, those preparing the financial statements should work in collaboration with others across the organisation, especially those who own the source data and who may have a deeper understanding of climate-related matters with regards to the organisation. Input from and coordination with a variety of teams within the organisation is necessary to ensure appropriate consideration and reflection of climate-related matters in the financial statements and this should not be the responsibility of solely the finance team. Similarly, the support of experts, whether internal or external, may be required to assess both whether and which climate-related matters may be material to the business and how this is then appropriately reflected in the reporting.

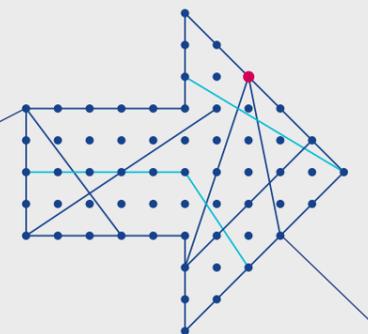
Importantly, for successful collaboration to occur, buy-in from key internal stakeholders should be obtained early in the reporting process. Key internal stakeholders may include the CEO, CFO, chief sustainability officer (CSO), General Counsel, director of Strategic Planning & Analysis, director of Investor Relations, and managers responsible for climate-related matters, such as sustainability, corporate social responsibility and ESG experts. Additionally, there should also be consultation from and engagement with the Audit Committee. After gaining buy-in from all key internal stakeholders, leadership and ownership of the climate disclosure function should be given to one or more senior managers with sufficient authority to ensure effective implementation of such risks into the financial reporting and internal control processes of the organisation, such as the CFO.

Iterative process

Although the importance of considering and reflecting climate-issues in financial reporting should not be understated, preparers should also recognise that this is still an emerging practice. Considering the potentially significant and systemic risks of climate-related matters, combined with its inherent uncertainty, integration into financial reporting will be an iterative process. Users understand that companies will develop and improve their disclosures over time as best practice and further guidance is developed. To this effect, this guidance has sought to consider those standards that are widely relevant for most companies across most sectors and geographies. Therefore, this guidance should not be viewed as complete or exhaustive.

Companies should seek to develop a realistic implementation path over time to effectively integrate climate-related matters into financial reporting. As firms address these risks and as policies, technologies and regulations emerge, these can also evolve over time. Like the implementation of the TCFD recommendations, it may take more than one reporting cycle for climate-related integration in the financial statements to be to the standard that is expected by investors, however the first steps need to be taken by companies now.

Appendices



Appendix A – Illustrative examples

A number of illustrative examples have been developed to bring to life the various accounting and disclosure considerations under the four IFRS Standards covered in this guidance. Note that these examples are not intended to be comprehensive or to represent best practice. Rather, they are intended to illustrate the range of climate-related matters that might need to be considered, the relevant accounting considerations and a starting point as to how to begin reflecting climate-issues in financial reporting.

The index table below summarises the relevant standards considered in each example – standards in bold denote the main standard addressed, while those in brackets are not discussed in detail in this guidance. The industry in which the company in the example operates is also noted, however the accounting considerations and related disclosures in each example will be relevant for companies in other sectors.

Example	Relevant accounting standards	Industry
A	IAS 1 , (IFRS 7)	Banking
B	IAS 1 , IAS 36, IAS 37	Oil & gas
C	IAS 1 , IAS 36, (IFRS 8)	Coal
D	IAS 11	Construction
E	IAS 37 , IAS 1	Manufacturing – electrical and electronics
F	IAS 37 , IAS 16, IAS 36, IAS 1, (IFRIC 1)	Cement
G	IAS 37 , IAS 1	Manufacturing – general
H	IAS 36 , IAS 16, IAS 1	Brewing
I	IAS 36 , IAS 16, IAS 1	Automotive
J	IAS 36 , IAS 1	Hospitality – hotel
K	IAS 16 , IAS 1, IAS 36, (IAS 8)	Airline
L	IAS 16 , IAS 36, (IAS 8)	Road haulage

Example A

Background

A national bank holds a very small amount of debt originating from a region currently facing severe forest fires, which are expected to only increase in severity in future years due to climate change. Other national banks in that country significant amounts of debt originating from that region and, hence, are significantly affected by the fires in that region.

Application of accounting standards

Paragraph 31 of IFRS 7 Financial Instruments: Disclosures requires an entity to disclose information that “enables users of its financial statements to evaluate the nature and extent of risk arising from financial instruments to which the entity is exposed at the end of the reporting period.”

When preparing its financial statements, the bank assessed whether the fact that it holds a very small amount of debt originating from that region was material information.

In making that assessment, the bank considered the exposure to that particular debt faced by other national banks operating in the same sector (external qualitative factor).

In these circumstances, disclosure of the fact that the bank is holding a very small amount of debt (or even no debt at all) originating from that region, while other national banks operating in the same sector have significant holdings, provides the entity’s primary users with useful information about how effective management has been at protecting the bank’s resources from unfavourable effects of climate change in that region (or simply the bank’s exposure to climate risk in that region compared to its peers).

Disclosure

The bank assessed the information about the lack of exposure to that particular debt as material, due to the nature of the matter, and disclosed that information in its financial statements.

Example B

Scenario

A company operates globally in the exploration, production and sale of crude oil and natural gas reserves. In 2020, in line with the Paris Agreement and the UN’s Sustainable Development Goals, the company announced its intention to achieve net zero emissions by 2050 and will be revising its five-year projections to do so. Part of this will also entail a move into the renewable energy sector.

Accordingly, the company has revised its assumptions for assessing the recoverable amounts of the related fixed assets. In doing so it uses lower gas and oil prices, projected declines in the use of oil and gas products, and increases in carbon prices (such as the costs of paying for excess carbon emissions in some jurisdictions). The company also uses these assumptions for reviewing the provisions it has recorded in accordance with its legal obligations to dismantle production operations and clean up the related locations. In 2020 the use of these assumptions has resulted in a significant impairment loss for its gas production assets and an increase in the related environmental provisions.

Application of accounting standards

Under IAS 1.122, when disclosing the judgements that management has made, an entity should indicate which judgements have “*the most significant effect on the amounts recognised in the financial statements*”. Under IAS 1.125 an entity should also disclose the assumptions and other “*major sources of estimation uncertainty at the end of the reporting period that have a significant risk of material adjustment*” to the carrying amounts of the related assets and liabilities. Furthermore, entities should consider disclosing the sensitivity of financial statement items to changes in the significant assumptions and estimates used.

Disclosures

The company provides disclosures in the notes to the financial statements as follows:

Significant accounting policies

In this note the company explains the significant estimates and assumptions that it uses for impairment testing include price trends, changes in demand for oil and oil products and increasing costs of CO2 emissions. It notes the nature of uncertainties related to these items (such as changing responses to climate change, climate policies and regulations, new technologies, and consumer behaviours). The company also indicates its policies for measuring asset impairment and the provision for dismantling / environmental clean-up requires significant judgements and estimates, which could then significantly affect the amounts recorded for these assets and liabilities, as well as the related income / expenses recognised during the year. The entity also makes clear the actual results could differ significantly depending on the estimates made.

Impairment

Price trends: The company explains that, based on changing industry trends as well as the new assumptions it has adopted as part of its new low-emissions strategy, it has performed an impairment test on the related assets. It indicates the significant assumptions that it used in its impairment testing and includes the amounts that it used in 2019 so that investors can determine the potential effects that the use of these different assumptions had on the financial statements (as per IAS 1.125).

	2019	2020	2021	2022	2023	2024	2025	2030	2035	2040	2050
Crude oil (\$/barrel)	75	58	58	58	58	57	57	56	54	53	53
Natural gas (\$/MBtu)											
US	3.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2	2	2
EU	7.6	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.9	4.9	4.9
Japan	10.1	5.9	5.9	5.9	5.9	6	6	6.1	6.3	6.4	6.4
China	8.2	5.3	5.3	5.3	5.4	5.4	5.4	5.5	5.6	5.7	5.7
CO2 (\$/tonne)	23	37	43	48	53	58	63	89	114	140	140

Management provides the following additional information:

- the source of the prices for oil, gas and CO2 and that they are aligned with the International Energy Agency’s Sustainable Development Scenarios.
- explains the scenario and provides projected pricing information assuming policies are in place to achieve the temperature goals under the Paris Agreement. The scenario used provides projected prices for the years 2025 and 2040 only. Accordingly, the company explains it has extrapolated the yearly prices based on the projections for these two periods, and, without more reliable information, has assumed consistent pricing post 2040.

Impairment loss: The company also notes that as a result of the use of these assumptions, and its revised business plans, it recorded an impairment loss of \$3,165 million (\$2,530 million after tax) on its oil production assets for the year ended 31 December 2020. The net carrying value (recoverable amount) of the impaired assets was \$10,550 million on 31 December 2020. These assets form part of the Production Operations segment.

Sensitivities: Any changes to the assumptions used or estimates made could significantly affect the reported amounts of related assets, operating profits and income in the following year. Therefore, management includes the sensitivities of the assets and operating amounts to changes in the related prices used, without consideration of offsetting effects from other variables or any changes to the company’s plans (as per IAS 1.129). Discount rate information is also disclosed which investors would benefit from.

	\$ million			
	Increase (decrease)	Assets	Operating profits	Net income
Change in oil prices	10% / (10%)	XX / (XX)	XX / (XX)	XX / (XX)
Change in gas prices	10% / (10%)	XX / (XX)	XX / (XX)	XX / (XX)
Change in CO2 prices	10% / (10%)	XX / (XX)	XX / (XX)	XX / (XX)
Change in margins	5% / (5%)	XX / (XX)	XX / (XX)	XX / (XX)
Change in discount rates	100 bps / (100 bps)	(XX) / XX	(XX) / XX	(XX) / XX

Provisions

The company also provides further information about the provision for dismantling hydrocarbon production operations as well as environmental clean-up costs (see **Example F**).

Example C

Scenario

A multinational company operating in the extractives industry has significant operations in the production and sale of thermal and coking coal. The company’s coal mines have estimated remaining useful lives ranging from 20-40 years. It sells to other companies that operate in countries which have not signalled any intention to reduce their use of coal in residential electricity generation. In fact, many have recently invested in new coal-fired power plants.

However, at the same time there are commitments to reduce the use of coal in several other regions, and government policies to restrict or end the use of coal are growing. Companies operating in the coal industry are facing increasing risks of reputational damage by continuing to mine and sell coal. Various coal indices are projecting declines in coal prices because of global commitments to reduce CO₂ emissions.

Application of accounting standards

In accordance with IAS 36.9, management have noted that declines in coal prices can be indicators of impairment and have therefore estimated the recoverable amounts of their coal assets based on value in use. When determining the assumptions to use in the measurement of the recoverable management considered the following information:

- According to the International Energy Agency (IEA), in June 20X0 global investments in coal-fired power generation activities began to decline.
- However, although some countries intend to be free of coal by 20Z0, the use of thermal coal in the provision of residential power continues in other parts of the world.
- Additionally, industrial use of coking coal for iron and steel production continues.
- As noted above, Entity D sells to customers that reside in countries that have not indicated any plans to reduce their use of coal-fired power and in fact are continuing to invest in thermal coal use.

Based on this information, in measuring the recoverable amount of its coal assets Entity D has used a coal price that corresponds to the coal index applicable to the countries within which its customers operate, and that does not take into consideration the effects of changing regulations around the use of coal and emissions reductions. Entity D assumes a steady demand for coal as a result of the new coal-fired power plants as well as continued use of coal in such countries. Based on the impairment test performed, the recoverable amount is greater than the carrying amount of the mine assets and so no impairment loss was recognised.

Under IAS 36.130 and .131 management would not be required to disclose the indicators of potential impairment because it did not record an impairment in that period. However, in accordance with IAS 1. 31, management decides to provide information about impairment indicators, as well as the assumptions (e.g. coal price and other qualitative factors) that it used in its impairment testing because excluding this information would be considered a material omission for investors. Management has also determined that providing information about the sensitivity of coal assets to changing indicators such as supply, demand and coal prices will help investors determine the extent to which they want to adjust their own valuations and model of their company and compare it to its peers.

Disclosure

In its accounting policies note to the financial statements, management indicates that indicators of impairment can include declines in commodity supply, demand and price forecasts, and changes in the expected use of an asset. Other indicators include potential impacts from climate-related risks and the transition to a lower carbon economy, including the increased costs

of carbon emissions and policies to phase out the use of coal-fired power generation for residential use, the existence of low-carbon replacement technology, the falling prices of renewable energy and the reputational risk associated with the use of coal.

Management acknowledges that these factors could have a material effect on its coal operations, but explains their view that the need for coal as a source of commercial energy, including in the manufacture of steel and cement, will continue over the remaining useful lives of its coal plants (currently 20 years on average). Additionally, coal provides approximately 36% of global electricity, and its use continues in geographies where the entity current sells its coal, including Country C, Country A, and Country I.

Accordingly, the entity discloses that when measuring the recoverable amount of coal assets, it uses the following assumptions:

- coal prices ranging from £XX-£XX/ton, which corresponds to the coal index applicable to its customers’ countries;
- a steady demand for coal as a result of the continued use of coal and new coal-fired power plants in many of its customers’ countries; and
- discount rates ranging from xx% to xx%.

Potential impact of changes in indicators:

Additionally, management includes an indication of how changes in the key assumptions used in calculating the recoverable amount of the assets may have a significant effect on the results of asset impairment testing, as well as impact of the use of assumptions aligned with the Paris Agreement on the company’s financial statements:

Indicators	Increase (decrease)	Effects on impairment loss (£ million)	Effects on net income (£ million)
Energy coal prices (£/ton)	+10% / -10%	(XXX) / XXX	XXX / (XXX)
Energy coal demand (mt)	+10% / -10%	(XXX) / XXX	XXX / (XXX)
Changes in discount rate used	+10% / -10%	XX / (XX)	(XX) / XX

Sustainable assumptions	2020	2025	2030	2040	2050	Effects on impairment loss / net income (in £ million)
Coal prices (£/ton)*	XX	XX	XX	XX	XX	XXX / (XXXX)
Coal demand (mt)**	XXX	XXX	XXX	XXX	+XXX	XXX / (XXXX)

* As projected under the IEA’s Sustainable Development Scenario²³

** As projected by the Inevitable Policy Response²⁴

Management also determined that providing a breakdown of revenues from these countries (reconciled to total revenues) will also provide useful information to investors as countries often have their own emissions policies. The information could be located in the accounting policies note, or in a more relevant location such as the segment reporting note. If not included in the segment reporting note, then an indication to which segment these revenues belong is also useful to investors:

£ million	Current year	Prior year
Country A	XXX	XXX
Country C	XXXX	XXX
Country I	XXX	XXX
Country U	XXX	XX
Other	X	X
Total revenues	XXXXX	XXXXXX

Example D

Scenario

In recognition of the contribution of the construction industry to carbon emissions, UK housebuilders have committed to creating a framework for producing low or zero carbon homes in the next 10 years. The announcement of these green initiatives has received significant interest from investors and other stakeholders alike. Investors are becoming aware of the importance of climate change initiatives, which are growing in the public consciousness, and the effects it can have on share price and the revenue prospects of a company. Several companies within the industry have set similar targets to various timelines, so there is an appetite from investors to compare the disclosures of housebuilding companies. This would allow investors to support their investment decisions by differentiating between those companies that are true market leaders, those who are fast followers but lacking tangible implementation plans, and those that are clear laggards.

Application of accounting standards

Under IAS 1.85 companies should present additional line items presenting profit and loss when such presentation is relevant to an understanding of the entity's financial performance. Revenue / cost of sales attributed to net zero homes are considered financially material, or material by nature, as there has been significant interest from investors as a result of this announcement. Therefore, the company has decided to present its revenue and cost of sales, disaggregated by 'business as usual' (BAU) homes and net zero carbon homes.

Disclosure

The company discloses a year-on-year comparison of revenue and operating profit of the BAU sales vs zero-carbon home sales in the notes to the financial statements. Additionally, the number of homes sold in the year is reconciled to the profit recognised for both types of homes. This shows investors the average revenue and profit per home for each revenue stream.

To further enhance the usefulness to users, the detail provided in the notes to the financial statements should:

- Illustrate that the commitment is being taken
- Illustrate how the company is defining BAU homes and net zero carbon homes
- Enable investors to understand progress over time against this commitment in relation to revenue generated by both lines
- Enable investors to compare the proportion of the homes built in the net zero category compared to the BAU homes and benchmark them against industry average.
- Help investors understand how much value consumers are placing on a company making such commitment by sales improvement in relation to both existing and net zero lines
- Help investors gauge the success of company's strategy in reaching net zero

Example E

Scenario

An electrical and electronics manufacturing company considers climate change action, such as emissions reductions, as a key part of its strategy and value proposition to customers. The company has pledged a target for net zero corporate emissions by 31 December 2025, twenty-five years sooner than IPCC targets. The publicly announced climate-related target focusses on corporate emissions, predominantly those created during the manufacturing process. The company intends to announce another target that considers supply chain and product emissions after 2025. Although the company plans to increase energy efficiency measures and switch the majority of its energy procurement to green sources, according to internal analysis at the time of making the commitment, the company will still need to purchase carbon offsets to curb corporate emissions to meet its net zero target of 31 December 2025.

Management are committed to the target to demonstrate their actions with respect to climate change and have met all previously declared environmental and climate commitments. This is their second public commitment related to climate change - their first publicly announced target in 2015 was to reduce corporate emissions by 50% by 2019, which they achieved by also purchasing carbon offsets.

During quarterly results discussions since the announcement of the net zero target, investors have asked management how they plan to achieve the new target as well commenting on its positive effect on the company's share price.

Initial treatment: Reporting years ending 31 December 2020 to 2024

Application of accounting standards

Under IAS 37.14, an entity recognises a provision when it has a present obligation as a result of a past event, the payment is probable, and the amount can be estimated reliably.

An obligating event is a past event that creates a present obligation. An obligating event arises only when the entity has “no realistic alternative” to settling that obligation, which may be created via either a legal or constructive obligation. With respect to a constructive obligation, “the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation” (IAS 37.17).

There is no legal obligation for the company to reduce its emissions to net zero by 2025. However, it can be argued that the announcement of the company’s net zero emissions target is an obligating event, which creates a constructive obligation to its investors as well as its stakeholders in general. This constructive obligation arises as the company has published a public policy stating that it will reach net zero corporate emissions by 31 December 2025 combined with the company’s past practice of meeting a similar target through the purchase of carbon offsets. As a result, the company has created a valid expectation by its investors and stakeholders that it will meet the net zero target.

However, IAS 37.19 is also clear that only those obligations arising from past events existing independently of an entity’s future actions (i.e. the future conduct of its business) are recognised as provisions. In this example, it is within the control of the entity to alter the amount of its 2025 emissions during the period leading up to commencement of the measurement period and during the 2025 year.

Therefore, the obligation does not exist independently of the entity’s actions and so the announcement in itself does not result in the recognition of a provision. Similarly, the announcement does not create a contingent liability to be disclosed in the notes to the financial statements, because there is neither a present obligation nor “a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity” (IAS 37.10). In this example, the obligation is subject to future events that are currently within the control of the entity.

In the annual reports prior to 2025, there is significant discussion about the company’s new net zero strategy and its target for 2025, both in the CEO’s statement and management commentary. Although the net zero announcement does not fall under the scope of IAS 37 as a provision or contingent liability, under IAS 1.112(c) management may conclude that this is material information for users and so it is appropriate to disclose this as a commitment in the notes to the financial statements, for example in the general accounting policies note under a heading of “Climate commitments”. The company selects to do so, to give users information about the financial impact of its net zero emissions strategy and to improve consistency of information between the front and back half of the financial statements.

The same judgement applies for reporting years 2021 to 2024 because it is still within the control of the entity to alter the degree of emissions for the year of 2025 until the measurement date of the target, which is 31 December 2025. Each year management should also assess and disclose whether they believe that they are on track to meeting this commitment. If there were any changes prior to 2025 such as the announcement of emissions regulations, management would have to reassess whether such events would result in a different conclusion regarding the existence of a contingent liability.

Disclosure

“As part of our climate change strategy, in 2020 we announced a target of net zero corporate emissions by 2025. Ahead of 2025 we are focussing on shifting our procurement of energy to renewable sources and investing in more energy efficient machinery to reduce corporate emissions until the measurement date of the target.”

We consider ourselves committed to achieve our target and estimate the present value expected cash flows to be incurred in 2025 to purchase carbon credits to offset corporate emissions to be \$7 million. The cost has been estimated using the average current cost of carbon listed by the Voluntary Gold Standard (VGS) and adjusted based on average annual increases in the past five years. Our best estimate of the expected cash flows is \$7 million, although this will be dependent on the price of credits at the payment date. Accordingly, the actual amount may range between \$6 to \$9 million. Following 2025, we will continue to take measures to reduce our carbon footprint yet expect to continue to buy offsets of similar values to reach net zero corporate emissions for the foreseeable future.”

Note that the present value of the expected cash flows to be incurred (\$7million in 2020) should be reviewed and adjusted in subsequent years.

Subsequent treatment: Reporting for the years ended 31 December 2025 and onwards

Application of accounting standards

In the year ended 31 December 2025, the criteria for the target announcement to meet the definition of a past event is satisfied as the emissions until the target date have been emitted. The past event is no longer dependent on the occurrence of future events that are within the control of management.

In February 2026 (before reporting its results for the year ended 31 December 2025), greenhouse gas emission data for the 2025 year is available to management and therefore they are able to determine the required number of carbon offsets to achieve net zero emissions. The carbon credits are purchased in February 2026 to be able to achieve the net zero target in the annual report for the year ended 31 December 2025, published in March 2026. The cost can be reasonably estimated, as it has been incurred and represents an outflow of resources embodying economic benefits that will be required to settle the obligation (IAS 37.10).

At the balance sheet date, the company should record a liability for the costs of the carbon credits needed to meet the company’s commitment to net zero corporate emissions. In subsequent years, if applicable, the same liability should be recorded to cover the cost of offsetting emissions produced during the year to maintain the net zero target beyond 2025.

Disclosure

Liability for carbon offsets:

The amount brought forward and carrying amount of the liability should be disclosed in a note to the financial statements, as is standard practice. Narrative information should be provided that gives a brief explain of the nature of the obligations and the expected timings of the resulting outflows and explains the assumptions used to estimate the value of the liability and when it is expected to be paid (IAS 37.85).

“A liability of \$8 million has been recognised for the Company’s obligation to meet its net zero corporate emissions target for 2025. As the volume of greenhouse gas emissions are known, management has purchased the carbon credits, post the balance sheet date, to achieve this target. The cost was \$8 million to offset the operational emissions of 250,000 tCO₂e.”

Commitment:

The description of the commitment, which could be included in the general accounting policies note to the financial statements under a heading of “Climate commitments” would read as follows:

“In 2020 we announced a target of net zero corporate emissions by 2025 as part of our climate change strategy. We consider ourselves committed to achieve our target and estimate the present value of cash outflows that are expected to be incurred in 2026 to purchase carbon

credits to offset corporate emissions from the year of 2026 to be \$6 million. The cost has been estimated using the average current cost of carbon listed by the Voluntary Gold Standard (VGS) and adjusted based on average annual increases in the past five years. Following 2026, we will continue to take measures, such as shifting our procurement of energy to renewable sources and investing in more energy efficient machinery, to reduce our carbon footprint yet expect to continue to buy offsets of similar values to reach net zero corporate emissions for the foreseeable future.”

Example F

Scenario

A company produces and sells cement for use in the construction industry. As part of this it mines for raw materials, such as limestone, for use in cement production. Under the terms of its mining agreements the company is legally obligated to dismantle its mining assets and restore the locations back to their original conditions when it stops mining. As a result of these obligations the company has recorded a provision for site restoration as part of the cost of the mining property plant and equipment when they were first constructed.

Most the company’s mining activities take place in Country B, which has an emissions trading scheme (ETS). In the past emissions allowances were free to cement companies due to the industry’s “carbon leakage factor”. However, the cement industry emissions have not declined rapidly enough. To meet emissions reduction commitments under the Paris Agreement, in 2020 the government of Country B announced that it would:

- start increasing the costs of carbon emissions from 2025;
- require products to include a specific proportion of “low-emission cement” (as defined by the government) from 2025; and
- reduce the number of free ETS allowances allocated to cement companies over the next ten years, with a complete elimination of free allowances by 2030.

After years of research, the construction industry regulator announced the approval of a low-carbon cement blend that can be used from 2021. Management have also been researching various ways in which the company can more effectively reduce its carbon emissions, particularly in relation to the materials used and fuels that it uses. From 2021 the company will:

- start replacing virgin raw materials with recycled materials or industrial by-products; and
- relocate one or more production facilities closer to the source of alternative fuels.

It will also continue to investigate cost effective ways of using carbon capture and storage.

Application of accounting standards

Under IAS 37.59, “provisions shall be reviewed at the end of each reporting period and adjusted to reflect the current best estimate...”. In line with this, management reviews its provision for dismantling and site restoration on a periodic basis. In 2019 management had estimated that the remaining useful lives of its mining assets, and so the time to settle the obligation under the provision, would be 20 years. As a result of the timeline for Country B’s emissions reduction measures, changes in the materials permitted by the cement regulator and the company’s plans to replace virgin materials with recycled content, management have determined that it will stop mining raw materials by 2030. It will therefore have to fulfil its obligation to dismantle and restore the mining area in 10 years’ time. Accordingly, management have remeasured the provision by using a revised time to settle of 10 years.

IFRIC 1 “applies to changes in the measurement of any existing decommissioning, restoration or related liability that is both recognised as part of the cost of an item of property plant and equipment in accordance with IAS 16... and recognised as a liability in accordance with IAS 37.” IFRIC 1.4 and 1.5 address how to account for changes in the measurement of the liability that “result from changes in the estimated timing or amount of the outflow of resources embodying the economic benefits required to settle the obligation...”. IFRIC 1.5(a) states that “if the related asset is measured using the cost model...changes in the liability shall be added to, or deducted from, the cost of the related asset in the current period.”

The company carries its mining assets at cost. As a result of changes in estimated timing of cash outflows, the carrying amount of the related liability has increased. Accordingly, the company will add the increase resulting from the change in the measurement of the provision to the carrying value of the related mine assets. It also reviews the remaining useful lives of the assets (IAS 16) (see below).

IFRIC 1.5(c) indicates that if the related assets are measured at cost, and “... if the adjustment results in an addition to the cost of an asset, the entity shall consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable” and so test for impairment in accordance with IAS 36.

The adjustment to the mine assets, Country B’s plans to increase emissions regulations for the cement industry and the regulator’s acceptance of low carbon material are all indications that the related assets may be impaired. Accordingly, management also performs an impairment test on the mine assets (IAS 36. 9 and .12) and considers the carrying amount of the provision as part of this test (IAS 36.78).

Disclosure

As a result of the above, management discloses the carrying amount of the provision (IAS 37.87) and the carrying amounts of the related mine assets as well as any related depreciation and impairment charges.

Management also provides the following disclosures:

- sources of estimation uncertainty, which includes an assessment of the useful lives of assets, the long-term assumptions used when determining the measurement and timing of site restoration provisions (IAS 37.85) and assumptions used in the calculation of the recoverable amounts of the assets (IAS 1.125);
- any indicators of impairment (if material even if no impairment was recognised) (IAS 1.31);
- changes to depreciation expense as a result of changes in the useful lives of mine assets and any material changes to the residual values (IAS 1.85);
- sensitivity analyses for the key assumptions and estimates used (see **Example B** and **Example C**) (IAS 1.17(c) and 1.129(b)); and
- a rollforward of the changes to the provision (see table below for an example) (IAS 37.84)

	€ million
Provision at 1 January 2020	(135)
Accretion of discount	(15)
Change in estimate	(235)
Provision at 31 December 2020	(385)

Example G

Scenario

A manufacturing company has pledged to remove plastic from its supply chain by 2025. As a result, most of its product lines have already phased out plastics. However, the plastic-free substitute parts for one of its products are only available to the company if it enters into a non-cancellable supplier contract for bulk orders of 10,000 units per annum. This would increase the variable cost per unit from £5 to £11. Due to the specialist nature of the product, the company can only use these parts in the product it sells to one specific customer. The company also has an existing contractual obligation to provide this customer with 10,000 units of this product annually to 2030 at a fixed price of £10/unit, otherwise it will have to pay this customer £600k. The business does not hold any specialised equipment for this production line; therefore the increased costs do not in themselves represent an impairment indicator for the related property, plant & equipment.

Given the company's pledge to its investors and its customers (including prior and ongoing actions) to remove plastic from its supply chain, the company appears to have formed a constructive obligation to remove plastic from this product as well and therefore to use the more expensive plastic-free replacement parts starting in 2025. At that point, the unavoidable costs to fulfil the contract (£550k from 2025 to 2030) exceeds the economic benefits of £500k expected to be received from 2025 to 2030. The company has assessed whether there are any other future economic benefits expected to be received from this customer and has concluded that this contract is the only one. Accordingly, the company will need to assess whether the contract is onerous, and if so it will need to book an onerous contract provision starting in 2025.

Application of accounting standards

The cash flows related to the contract are clearly distinguishable from the operations as a whole, as they relate to a specific product line with one customer and therefore the contract should be assessed as onerous. The present value of the obligation under the onerous contract will be recognised as a provision, in accordance with IAS 37.68.

The amount of the provision is the lower of the cost of terminating the contract and the net cost of continuing with the contract after taking into account revenues directly related to a contract - i.e. the lowest net cost to exit. Before the onerous contract provision amount is calculated, all assets dedicated to the contract are tested for impairment. No impairment loss is applicable here.

The amount recognised as a provision shall be the best estimate of the present value of the obligation under the onerous contract at the end of the reporting period. The present value of the cost to fulfil the contract between 2025-2030 is £450k. This represents the present value of producing 10,000 units per annum over five years at a cost of £11 per unit. This also represents the lowest cost to exit. The present value of the revenue received under the contracts for those years is £400k - as such, there is a £50k provision amount (the net cost of fulfilling the contract or the loss under the contract) which should be recognised in the current year (year ended 31 December 2025).

The disclosure will need to be in accordance with IAS 37. For example, per IAS 37.85, for each class of provision made in the period, the company should provide a description of the obligation, expected timing of the outflows, along with an indication of the uncertainties about the timing of those outflows. The company may also need to disclose its major assumptions about future events, which may include an explanation of how climate-related risks have been factored into the best estimate of the provision. The company shall also disclose the, amounts used in the period, increases in the period due to passage of time and any changes in discount rates, for each provide recorded in the period.

There may also be disclosures required under IAS 1 in respect of significant estimates and judgements made in relation to determining whether there is an onerous contract and the amount recognised.

Disclosure

Based on the facts today as at 31 December 2020, management have assessed that the contract will become onerous in 2025. As this information is deemed material to investors, management have decided to disclose this in the notes to the financial statements for the years 2020 to 2024.

In 2025, the first year the contract becomes onerous, the management would book the provision of £50K assuming all facts remain the same. The company would continue to provide the relevant disclosures to enable investors to understand the company's climate-related plans and the amounts that affect the financial statements.

Example H

Scenario

A brewery group is considering the potential impact from physical climate change on their future business. They foresee that some of their suppliers of barley and hops may have difficulties in producing the quantities needed in certain areas, due to both flooding and droughts. This will most likely increase the prices of these materials leading to an increase in costs for some or all Cash Generating Units (CGUs) in the group.

At certain sites, potential flooding could also pollute the water that is used in the brewing process and for cleaning the pot brewery boilers. Thus, the water will need to be purified, or worse still, this will require the purchase and transport of water from other areas not susceptible to flooding. In the worst cases, the breweries in high-risk flooding areas will have to be closed and moved to locations with cleaner water and fewer flooding problems.

Application of accounting standards

When considering both the increased costs and polluted water, the difficulty here is assessing the likelihood of the flooding and droughts - and the timing of these events.

The potential increased prices for barley and hops will have to be considered and included in the IAS 36 impairment tests for the CGUs. This is also the case with regards to the potential increased cost of the use of water. The expected value and timing for each of these factors should be incorporated into the impairment assessment as an increase in the cash outflow for the relevant CGUs. Additionally, *"if there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset needs to be reviewed and adjusted in accordance with the Standard applicable to the asset, even if no impairment loss is recognised for the asset"* (IAS 36.17). Accordingly, management will also have to consider whether the useful lives of the related PPE should be revised.

Disclosure

If the assessment results in an impairment, it will have the following will effects the financial statements:

- property, plant and equipment (PPE) negatively impacted by impairment (e.g. a decline in the value of the related PPE)
- P&L impacted by increased impairment cost (e.g. declining margins in net profits as well as reported EBITDA). This will be offset by a decrease in depreciation for the related PPE going forward

Disclosure in the notes to the financial statements will be required in relation to the impairment loss recorded for both the goodwill and PPE, assets lives if relevant, the related segment affected and the assumptions used. Additionally, although not required under IAS 36, under IAS 1 investors may benefit from additional disclosure on the judgement management have made with regards to the costs and timing of the impact of the various physical risks, as well as sensitivity analysis on those assumptions considering the uncertainty involved.

Example I**Scenario**

An automobile manufacturer sells passenger cars, which run on internal combustion engines (ICEs). In line with global goals to reduce emissions, governments of most countries in which the company trades have announced plans to phase out the use of petrol and diesel passenger-fuelled cars over the next 20 years, with a complete ban on ICEs between 2040 to 2050. In advance of the ICE phase-out, some countries have started instituting policies to reduce automobile emissions. These include:

1. a carbon tax on fuel distributors (based on the carbon content of the fuel sold). This will likely be passed to the end-customer as an increase in the price of petrol;
2. cap and trade schemes for car manufacturers, where a manufacturer must generate a percentage of credits based on the number of cars that it manufactures. Manufacturers can purchase credits from others or pay a fine if they do not have sufficient credits in a year. The manufacture of low emissions cars can also generate credits;
3. consumer subsidies and rebates for the purchase of electric vehicles (EVs), making the cost of a new EV less than that of an equivalent car that is run on ICE; and
4. lower emission standards for all vehicles.

Management of the company have not yet developed a business strategy to transition to lower emissions vehicles.

Application of accounting standards

Most of the countries involved have a history of enacting laws and enforcing policies after announcing their plans to do. Additionally, management has noted a marked change in consumer preferences for electric vehicles over ICE's in the recent year. Therefore, the various government plans to both reduce emissions and ban the use of ICEs by 2050 as well as evolving consumer preferences are indicators of impairment for the company's property plant and equipment, especially for the factories, technical equipment and machinery that it uses to manufacture ICEs and the related cars.

The company tests the related assets for impairment in 2020. (Prior to doing so, in the light of the timing of the policy changes, management has also reviewed the remaining useful lives of these assets – see IAS 16 in Chapter 3). The recoverable amount of the Cash Generating Units (which is the greater of fair value less costs of disposal, FVLCD and value in use, VIU) is based on VIU.

IAS 36.30 indicates that when calculating VIU, among other factors, an entity shall use an estimate of future cash flows as well as expectations of variations in the cash flows that the entity expects to derive from the asset. This involves “*estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal.*”

Paragraph 33 indicates how entities should determine these cash flow projections. This includes:

- a) “*...reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.*”
- b) “*...the most recent financial budgets/forecasts approved by management....Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.*”
- c) “*estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years...*”

Projections of cash inflows

Management have based the first five years of estimated cash flows on their most recent financial projections, they determine using reasonable and supportable assumptions that represent their best estimate of economic conditions that will exist over the assets' remaining useful lives. In preparing these projections, management have included expected variations in future cash flows for each brand of cars by applying the estimated likely effects (on both projected cash flows and profit margins) of each country's measures to reduce emissions and phase out the use of ICE's over time. In order to do so, management consider:

- projected changes in oil and carbon prices and increasing concerns around pollution, especially in large cities as countries move to reduce their net emissions in line with commitments made under the Paris Agreement;
- changes to consumer preferences and behaviour (e.g. increasing purchases of low emissions cars, EVs, or using alternative modes of travel);
- the speed at which consumers are changing their behaviour and so the timing of projected declines in consumer demand for ICEs. Management's estimates of the amount and timing of the decline in demand for ICE passenger cars will vary for each country and include an expected loss of customer base / revenues;
- the extent to which the cost of replacement technologies, such as electric vehicles, are declining in each country. This includes the estimated effects of EV subsidies and rebates on consumer demand (IAS 36.30); and
- the timing of the move to more fuel-efficient vehicles in countries that are not phasing out ICEs as well as the company's expectations of the time it will take each country to implement the relevant regulations and ban the use of ICEs.

In the absence of other information, in order to estimate the decline in demand and so decline in future cash inflows and related timing of these declines, management have reviewed projected regional changes in ICE demand based on the Inevitable Policy Response's (IPR) Detailed Policy Forecasts.²⁵ They then applied an estimated percentage decline in demand to their base cash inflows.

Projections of cash outflows

The estimates and assumptions related to cash outflows for the first five years are the amounts that can be directly attributed to the assets in the CGUs and that are required to continue to use these assets. Management have based these amounts on operating costs from prior years, adjusted for variations in future demand (IAS 36.39(b)). In order to do so, management has considered:

- the additional manufacturing costs in countries that have low emissions requirements (such as the costs of technology to reduce the emissions of the existing ICE fleet, such as installing variable valve timing, as well costs of producing more fuel-efficient fleets);
- the loss of revenues from other countries versus the costs associated with continuing to sell in countries that are implementing regulations to reduce emissions but that have not announced any phase-out of the use of cars fuelled by ICEs, and whether these costs can be managed enough to produce sufficient profit margins; and
- the estimated costs of buying credits versus paying fines when manufacturing in countries that have cap and trade systems in place for manufacturers. This is particularly important because the company does not yet have a plan in place to manufacture or sell EVs.

The timing of the deadline to phase-out ICEs will affect the cash flows in different years; projected rising costs of carbon in the latter years will also affect these estimates. To help determine the expected cash flows in the face of these climate-related risks, particularly in the later years of the assets' lives, out past the first five years, management has spoken to various regulatory bodies, researched expected consumer behaviours in the face of these changes, performed market research and reviewed estimates from organisations such as the IPR and the International Energy Agency (IEA).

The projected declines in sales and demand for the first five years are expected to be less significant than the remaining years of the assets' useful lives, which is when the company anticipates the majority of policy implementation will occur. Accordingly, the remaining years of cash flows (which are estimated over the assets' average remaining useful lives), are extrapolated from the first five years of management's projections but then further adjusted to include an estimated acceleration in the timing of changes in the use of ICEs.

Based on the IPR's predictions that there will be a delay in response to climate policies, management estimates an accelerated decline in the latter period (e.g. 2040 to 2050). As the deadline for the ban on ICEs moves closer, there will be more concerted efforts to invest in, and use, other, cleaner sources of transportation. At that point demand for passenger cars with ICEs will start to fall more rapidly. The company expects that while many consumers may wait until the last possible moment to change to another fuel source, it must still anticipate an effect on early cash flows as well. However, management still adjust the estimated future cash inflows in the latter years by applying an accelerated rate of decline in demand.

Additionally, it will take time and costs to adopt new strategies, build new facilities or modify, to the extent possible, current assets to reduce car emissions or to manufacture EVs (if the company decides to do so). There will also be significant cash outflows if investments in new factories are required.

Disclosures

- As noted in **Example B**, under IAS 1.122 and .129 investors would benefit from disclosures of the significant assumptions and estimates used to determine the projected cash flows, the judgements involved and the sensitivities around these assumptions, when measuring the assets' VIU. This information is often best presented in a table format with the assumption used (carbon prices, changes in demand, commodity prices) provided for the projected year. Sensitivities could also be provided for relevant financial statement items, such as revenues, impairment charge, operating profits.
- As part of this investors would want information about how the assumptions and estimates have changed from the previous year as well as the thought process that management went through in determining variations in the projected future cash flows.
- They would also benefit from information about the indicators of impairment (see **Example C**), a further breakdown of the automobile assets by brand and the related impairment loss for each, and where it is reported in the financial statements (IAS 1.77 and IAS 1.85).
- Management may consider providing a breakdown of revenues by country, key regulations per country and the anticipated timing of such policies/regulations. This also may be best presented in a table format.
- Investors would want to understand how expected useful lives of the assets have changed, if at all and so the related yearly depreciation expense.

Example J

Scenario

A hotel group has expanded rapidly and increased their market share through acquisitions of several smaller hotel brands. This has led to the group recognising a material amount of goodwill as part of these business combinations. One of the acquisitions was a brand of hotel resorts, which has hotels located in archipelagos and other areas that have increased exposure to climate risks.

At the date of acquisition, the goodwill was calculated based on the information available at the time. However, four years later given a greater understanding of the impacts of climate change on their operations, management are now assessing the future cashflows of the cash-generating unit (CGU) through a climate risk lens. For example, this could mean that the cash flows will need to incorporate changing consumer travel patterns and a higher propensity of natural catastrophes in the regions in which the company operates, affecting its ability to generate revenue. As with all value in use calculations, these cash flows will also need to be discounted using a risk-adjusted cost of capital, taking into consideration the asset-specific risks.

Application of accounting standards

Under IAS 36.8:

“an asset is impaired when its carrying amount exceeds its recoverable amount... This Standard defines recoverable amount as the higher of an asset’s or cash-generating unit’s fair value less costs of disposal and its value in use...”

The following elements shall be reflected in the calculation of an asset’s value in use:

- a) an estimate of the future cash flows the entity expects to derive from the asset;*
- b) expectations about possible variations in the amount or timing of those future cash flows;*
- c) the time value of money, represented by the current market risk-free rate of interest;*
- d) the price for bearing the uncertainty inherent in the asset; and*
- e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.”*

If the future cash flows are modelled with a climate risk overlay and discounted at the risk-adjusted cost of capital, it is possible that the goodwill and perhaps even some of the assets relating to this specific hotel brand will need to be written down.

Any impairment would be recognised first against the goodwill allocated to the relevant CGU (be it at the brand or individual hotel level). If the value of the impairment exceeds the goodwill held, the remainder should be allocated to other related assets. For assets carried at non-revalued cost, any impairment amount is charged to the P&L. Any impairment arising on revalued assets would be recognised in Other Comprehensive Income to the extent of any credit balance in the revaluation surplus in respect of that asset, with any remaining loss would be recognised in the P&L. Further considerations and disclosures may need to be made such as explaining an increase in estimation uncertainty caused by climate change assessments. The remaining useful lives of these assets would have to be considered as well.

The fair value of goodwill at acquisition was measured at £25m, with other net assets in the CGU having a fair value of £75m. On 31 December 2020, the carrying value of the CGU is £90m, with goodwill remaining at £25m and the book value of the other net assets being £65m.

On 31 December 2020, the CGU’s recoverable amount was calculated (based on the higher of value in use or fair value less costs of disposals) using cash flows which took the following judgements made by management into account:

- shorter annual periods in which the hotels can operate, as the monsoon/hurricane season have been extended due to rising temperatures;
- higher operating costs, as the forecast costs for hotel repairs are expected to increase across all sites due to impact of extreme weather;
- business interruption costs reflecting any additional time needed to bring the sites back to their usable state and the related loss in revenues, in addition to the shorter annual periods;
- reduction in guest numbers due to additional changes in customer preferences and travel patterns; and
- higher costs of capital to reflect the increased risk of these assets.

Once these assumptions had been taken into consideration, the revised value in use of the CGU was calculated as £50m, which as fair value less costs of disposal was lower, became its recoverable amount. This has led to an impairment of £40m - £25m against goodwill and a further £15m pro-rated against the other assets of the CGU acquired.

Disclosure

Per IAS 36.130, as an impairment loss has been recognised, the entity will need to disclose the recoverable amount of the CGU that was impaired, the amount of impairment loss recognised by class of asset, and the events and circumstances that lead to the recognition of the impairment loss.

In any case, disclosures will need to include the key assumptions used, and whether a reasonable possible change to the assumptions would result in further material impairments or a reversal of previous impairments within the next year under IAS 1.125 and .129. This will include a sensitivity analysis, reasons for the sensitivity applied to each key assumption and an explanation of changes made to past assumptions. Although IAS 36 specifically requires disclosures in respect of discount rates and growth rates, disclosures about key assumptions are not limited to these two items.

Management should note that under IAS 36, goodwill impairment is required to be tested at least annually for impairment. Starting to assess climate change in and of itself would not necessarily be a trigger for impairment. Rather, indicators of impairment could be, for example: significant changes in the period (or in the near future) in consumer habits and demand for these types of hotels, announcement of regulation in terms of length of tourist season, number of flights allowed, evidence of additional damage to the hotel sites, or expected damage from natural phenomenon.

Example K

Scenario

An airline group has pledged to reduce its carbon emissions by 30% by 2030 and to be a net zero emissions company by 2050. The group has published a paper outlining its path to be a net zero company over the next three decades. The group has received a positive response from its stakeholders following the announcement, as it is the first in the aviation industry to announce such ambitious net zero targets.

To meet its interim target of a 30% reduction by 2030, the group has invested in a new fleet of aircrafts and plans to phase out the most polluting aircrafts. Per the new targets, planes that were purchased five years ago will need to be phased out by 2030, to ensure the airline meets its target to materially reduce the usage of highly carbon-emitting planes over the next 10 years. The group’s accounting policy is to hold planes at cost and depreciate them on a straight line over their expected useful lives of a period 25 years, with estimated residual value of 10%.

Application of accounting standards

Under IAS 16.50: *“The depreciable amount (cost less residual value) should be allocated on a systematic basis over the asset’s useful life...The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, any change is accounted for prospectively as a change in estimate under IAS 8.”* To be in line with the company’s 2030 pledge, the useful lives of some of the airline’s most polluting aircraft will be reduced, and therefore the depreciation charge each period will likely increase. Accordingly, management reviews the assets’ useful lives and residual values. The assets’ remaining useful lives are revised, down from 20 years to 10 years.

To reassess the residual values of the assets, management may need to consider items such as:

- emissions commitments made by other airline groups, as well as by the industry;
- potential changes to regulations in the aviation market;
- consumer behaviour;
- potential changes to technologies such as the use of low-carbon fuels and whether existing planes can be retrofitted to use such fuels; and
- the age of the assets at the end of their useful lives to the group and whether they might still have economic benefits to other airlines.

Disclosure

The changes in accounting estimates (useful life and residual value) would need to be disclosed under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors (paragraph 39). The disclosure would need to include the impact of the changes in the accounting period and the reason for it i.e. the reason for the change in the planes' expected useful lives.

If it is a significant estimate, the company would need to give details on the assumptions for reassessing the residual value of the aircrafts. This is likely to be considered a source of significant estimation uncertainty. IAS 1.125 and .129 require disclosure of the sources of estimation uncertainty and key assumptions that management have used in determining the residual values of assets as well as sensitivities. The key assumptions and judgements made, and the sensitivity of these estimates to different assumptions is a key disclosure (and one likely to be most useful to users).

Additionally, the company should disclose the expected effect on future periods with regards to the change in depreciation. This would have impacts on items such as profit from continuing operations, profit after tax, and earnings per share.

These disclosures should consistent with information provided in the 'front half' of the annual report as this may have a significant impact on the performance and position of the company (and will continue to do so going forward as a result of the increased depreciation charge and possible impairments). For example, if the airline discusses future climate change scenarios and potential effects of low-carbon strategies on the company, the current financial effects of such items, or whether or not there are any, should be disclosed in the notes to the financial statements if they are material.

Additional matters that may need to be considered:

- Impairment testing may need to be performed as the net zero commitment announcement, as well as the change in useful lives, may be indicators of impairment (IAS 36.12(f))
- If an impairment is identified, various disclosures are required under IAS 36.126-130
- If no impairment, there may still be a significant source of estimation uncertainty. Additionally, users will likely find the lack of impairment a material item in the face of the company's change in strategy and will need more information about the assumptions and estimates used by management in determining that there is no impairment
- Even if there is no significant source of estimation uncertainty (in relation to the impairment), the company may still need to revise and disclose changes in key assumptions made to reflect the change in useful lives and the commitment made in respect of these assets e.g. the discount rates used, terminal value growth rates, terminal value periods. Companies are encouraged to disclose beyond what is required under IAS 36.132 in relation to the disclosure of assumptions
- ost Balance Sheet Event disclosures may also be required if this is announced after year-end, but before the accounts are released, and if this is expected to have a material impact, as a material non-adjusting event

Example L

Scenario

A global haulage transportation company with its own fleet of trucks is considering the potential transitional impact of climate change on its future business. The company expects that the current ban on the use of older/most polluting diesel trucks in certain larger cities in Europe will spread out and cover many more cities and regions.

A banning of such trucks will make it more difficult for the company to transport their goods into larger cities – and they will be limited to the use of certain vehicles in their fleet. Additionally, it will also make the second-hand market of the older/most polluting trucks deteriorate over time. The company is already re-arranging the deployment of where its trucks are operating according to local rules.

The company is currently assessing two approaches to the situation:

1. Sell all the older/polluting trucks now while a viable second-hand market exists and buy new ones. This will result in a more flexible fleet that can drive anywhere but will result in substantial and unexpected cost from selling trucks before their anticipated end of useful life.
2. Alternatively, in order to avoid selling the trucks at a loss on the deteriorated second-hand market, the older/polluting trucks could be deployed in more rural geographies. In this case it is most likely they will not be utilised as much as they are now, since the company will have to spend a greater amount of time on relocating the trucks, especially as restrictions on such trucks expands to more geographies.

Application of accounting standards

In the first approach that could be taken by the company, the useful life of the older/polluting trucks will be impacted. Under IAS 16, the useful lives of the trucks will be shorter (also resulting in a change in accounting policy under IAS 8), but the cash inflow when the trucks are sold will likely be higher compared to if they were sold at a later date, even if the assumptions from the latest impairment test are unchanged. This, however, will demand a cash outlay from the business in the short term. Overall, it will likely be less costly in the long run due to the reduced use of diesel and the lesser need to relocate the trucks.

For the second scenario it is foreseen that the useful lives of the older/polluting trucks will have to be prolonged, while scrap value will be lower, if not negative.

For both scenarios, impairment testing may need to be performed as the ban on diesel trucks, as well as the change in useful lives, may be indicators of impairment (IAS 36.12(f)).

Disclosure

For the first scenario:

- PPE will be impacted with increased depreciation of the older/polluting trucks until they are sold. However, impairments might not be needed, although a discussion of the indicators and impairment assessments should be included in the disclosures.
- The P&L will be impacted by the increased depreciation cost

For the second scenario:

- PPE will be impacted by a longer depreciation period (than in the first scenario) but a lower scrap value.
- P&L might have decreased depreciation cost and at the same time potential increased impairments of the CGUs.

Appendix B – Climate-related legal and regulatory disclosure requirements

Climate-related legal and regulatory disclosure requirements and developments for a number of different jurisdictions is summarised below. Note this list is not exhaustive.

Canada

- CPA Canada has produced a helpful guide to support preparers developing disclosures on climate change in Management's Discussion and Analysis (MD&A), which highlights the Canadian regulatory disclosure requirements where climate change disclosures may be required.²⁶

EU

- The Non-Financial Reporting Directive ("NFRD") which came into effect in 2018 requires large listed entities to publicly disclose policies, risks and key performance indicators in relation to environmental matters. Non-binding guidelines on reporting climate-related information, including reference to the TCFD recommendations, to supplement the NFRD were introduced in 2019.
- The Taxonomy Regulation published in June 2020 requires large, listed undertakings covered by the NFRD to disclose the proportion of their turnover, capex and opex financing economic activities aligned with the environmental objectives included in the Regulation. The disclosure requirements will start applying as of 2022 for climate-related objectives.

France

- Article 173 of the French Energy Transition Law passed in 2015 requires listed companies to disclose in their annual report their financial risks related to the effects of climate change, the measures adopted by the company to reduce them and the consequences of climate change on the company's activities and the use of goods and services it provides.

New Zealand

- In September 2020, New Zealand announced it would be the first country to require

companies in the financial sector to make climate-related-financial disclosures in line with the TCFD recommendations.²⁷ The External Reporting Board (XRB) the entity responsible for accounting and auditing & assurance standards in New Zealand will also develop, consult in and issue new reporting standards and implementation guidance material to assist businesses required to disclose.^{vi}

UK

- In 2020, a Taskforce consisting of regulators and government departments, announced its roadmap to make TCFD-aligned disclosures across the economy by 2025, with a significant portion of mandatory disclosures in place by 2023.²⁸
- The Financial Reporting Council (FRC) published the findings of its Climate Thematic in 2020, finding unequivocally that all stakeholders (including companies, investors, auditors, and the regulators and the standard setters themselves) needing to be doing more on climate change, noting that "consideration and disclosure of climate change in the financial statements lags behind narrative reporting."²⁹

USA

- The U.S. Securities and Exchange Commission (SEC) is also cognizant of the investors' need for disclosure by companies on climate change matters and are aware this is not an area they have engaged in and risk falling behind international efforts, having last addressed climate change disclosure in 2010 through existing requires of Regulation S-K.³⁰ Similarly, in a 2020 speech by SEC Commissioner Lee exploring the role of the financial regulator with regards to climate change, noted the 2019 IASB guidance and questioned whether the Financial Accounting Standards Board, the standard setting body of US Generally Accepted Accounting Principles (GAAP), "should also under taken similar analysis of how climate risks may translate when applying GAAP."³¹

Appendix C – Assurance

Climate-related legal and regulatory disclosure Companies should be aware of the increased focus by auditors with regards to the impact of climate-related matters on financial reporting. In addition to IASB's clarification in relation audit and climate change, regulators and investors are making their position clear:³²

- Regulators are monitoring how auditors taking account of climate-related matters into the audit process (see the recent UK Financial Reporting Council's Climate Thematic which considered, among other issues, actions that are that or should be taken by the audit profession³³ and the US Public Company Accounting Oversight Board (PCAOB) speech making it clear that audit firms need to more actively consider the financial effects of these risks on financial statements).³⁴
- The 2020 PRI-led investor letter explicitly asks auditors to only sign off financial statements that are consistent with the 2019 IASB paper, including disclosing the key assumptions that have been made with regard to climate-related risks.³⁵

Some of the more significant areas that auditors may consider are highlighted below:

- The implications of climate-related matters on an entity and the environment in which it operates, its strategy, its business model and other business risks and the adequacy of its internal controls and risk management systems, as part of identifying and assessing the risks of material misstatement during the audit under ISA 315 (Revised 2019), Identifying and Assessing the Risks of Material Misstatement.
- Where an auditor identifies that climate-related matters may be material and relevant for accounting assumptions under ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures, they will:
 - perform risk assessment procedures to obtain an understanding of the company and its operating environment, such as whether climate-related laws and regulations could affect the company's cash flows and the recoverable amounts of its assets;

– identify and assess the risk of material misstatement to evaluate the degree of uncertainty associated with management's assumptions, for example in predicting the frequency of extreme drought impacting harvests; and

– respond to the assessed risks of material misstatement by selecting an appropriate testing strategy, for example whether climate-related data is subject to the same internal control processes as accounting and other data.

- If material disclosures are made in relation to climate-related risk and any financial impact is reflected in the financial statements this information will be audited as part of the annual audit. The related audit opinion will note whether the financial statements are prepared, in all material respects, in accordance with the relevant accounting standards.
- In planning and undertaking the audit, auditors may also use specialists to assess an entity's climate-related assumptions and financial risks, where the audit team does not have the requisite specialised skills or knowledge, in line with ISA 620, Using the Work of an Auditor's Expert.
- Auditors will read and consider other information presented in the annual report outside the financial statements, including any narrative reporting, for material inconsistency with the financial report, or with the auditor's knowledge obtained during the audit in accordance with ISA 720 (Revised), The Auditor's Responsibilities Relating to Other Information.. Therefore, if auditors identify material inconsistencies in relation to climate-related matters that are noted in the narrative report but not reflected appropriately in the financial statements they will need to respond accordingly.

vi Note at the time of publication this is not in force yet and is still to be approved by the New Zealand Parliament.

Appendix D – Investor and climate reporting

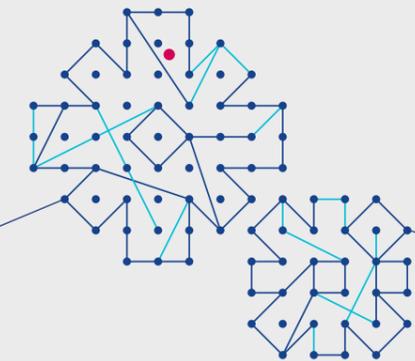
The importance investors place on TCFD reporting is clear:

- Climate Action 100+, an investor initiative supported by more than 450 institutional investors who collectively manage more than \$40 trillion asset under management, have called for companies to provide enhanced corporate disclosure in line with the TCFD recommendations.³⁶
- EY's 2020 Investor Survey found that 67% of investors surveyed make "significant use" of disclosures that are shaped by the TCFD recommendations. Of those who make significant use, 78% stated it has a significant impact on their investment decision making.³⁷

A selection of individual investor policies on engagement with companies and voting with respect to companies' disclosures on climate-related matters are outlined below.

- Blackrock in January 2020 clarified its Investment Stewardship's approach to engagement on climate-risk, outlining that a key reason for engagement with companies is to encourage more comprehensive and consistent disclosures of climate related risks, advocating for reporting in line with the TCFD recommendations.³⁸ In October 2020 Blackrock made clear the importance of financial reporting in reflecting "the impact of climate risks and the transition to a low carbon economy on the company's profits, liabilities and assets."³⁹
- BMO Global Asset Management published a climate change stewardship framework in 2019, outlining its approach to engage with investee companies, with clear expectations for companies to demonstrate alignment with the Paris agreement through climate-related narrative and financial reporting (for example through evidence Capex, asset mix, R&D).⁴⁰
- BNP Paribas Asset Management's Governance and Voting Policy clearly outlines that where a company "does not provide adequate disclosure on environmental and social issues" it will abstain from financial statement voting issues.⁴¹
- Legal & General Investment Management (LGIM) explained in its 2019 climate change policy its commitment to addressing climate change considering it a firm part of its fiduciary duty, which includes encouraging investee companies to report in line with TCFD.⁴²
- M&G Investments outlines in its approach to climate change that it encourages greater climate-related disclosures by investee companies and will vote in favour of resolutions that encourage better disclosure of climate-related matters.⁴³
- Norges Bank Investment Management, which manages the Norwegian sovereign wealth fund, has clearly set out its expectation for companies as to managing climate change, including disclosing material climate change information aligned to applicable reporting standards, in particular the TCFD recommendations.⁴⁴
- State Street Global Advisors in its letter to CEOs on 2020 Proxy Voting highlighted the importance it places on companies identifying, incorporating and disclosing financially material environmental, social and governance matters.⁴⁵

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