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Corporate Reporting: Climate Change Information and the 2021 Reporting Cycle

A Statement from the International Federation of Accountants

Overview

Significant global attention on how business and capital markets are responding to the climate crisis, including increasing regulatory and investor scrutiny, challenges professional accountants—in business and in professional practice—to play an active role in determining the way climate change information is reported in the upcoming 2021 reporting cycle and is enhanced in future years. Although financial reporting standards have not changed, investors and other stakeholders now consider climate change to be a material issue that can have financial consequences for most companies.

To address these demands, professional accountants have a critical role in

1. Aligning and integrating climate-related information and disclosures with company climate commitments, targets, and strategic decisions.
2. Quantifying, wherever appropriate, financial impacts of climate issues.
3. Ensuring climate-related reporting complies with reporting requirements without material omissions or misstatements, based on a company-specific materiality determination.
4. Supporting global initiatives to enhance climate and broader sustainability-related reporting through standards set by a new International Sustainability Standards Board (ISSB) that will address material impacts on a company's enterprise value.

IFAC's Climate Action Point of View, issued in December 2019, highlights climate change as an urgent, global issue and outlines the influence and responsibility that IFAC's 180 member organizations and their 3.5 million professional accountant members have in driving climate change mitigation, adaptation and reporting. With this Statement, we continue to advocate and support the profession's role in enabling climate action by providing transparency and insights on the financial impacts of climate change.

In this Statement, we:

- Summarize the information concerns of investors, regulators, and policy makers.
- Review current standard-setter responses.
- Recommend how, and the extent to which, companies and accountants can address these concerns in the 2021 reporting cycle.

Why this Issue is Important for the 2021 Reporting Cycle

Given the significant attention paid to the impact of climate risk on society and financial stability, many companies and investors are more closely scrutinizing the potential material impacts of climate change on companies in the context of a 2-degree Celsius or lower (ideally 1.5-degree Celsius) global temperature rise scenario which is the basis of the international Paris Agreement. Companies that have set net-zero emissions targets in order to meet the Paris Agreement, which is the case for at least one-fifth of the world's 2,000 biggest listed companies[1], will now be establishing targeted strategies and short- and medium-term targets to decarbonize their business models and reduce emissions. If these actions result in material financial implications, they will need to be reflected in a company's financial reporting.

In this current environment, professional accountants will need to keep in mind two important points:

- First, despite the issuance of various guidance and educational materials by standard-setters (described below), professional standards have not changed for the 2021 reporting cycle as they relate to the reporting and assurance of climate and sustainability information.
- Second, materiality in financial reporting remains an entity level decision and the development of accounting estimates is specific to a company's facts and circumstances and reporting requirements. Climate-related matters will not be financially material to all

companies. In addition, alignment with scenarios consistent with the Paris Agreement, or the UN's Sustainable Development Goals, is not a requirement under either IFRS or US GAAP.

Accordingly, in preparing their 2021 financial reports in the context of changing expectations about climate-related disclosures, companies must evaluate what some stakeholders would *like* companies to report and *where* they would like it reported (in the financial statements versus the "narrative" sections of annual, integrated or sustainability reports, or elsewhere) in the context of what is *required/allowed* under current professional standards (i.e., financial reporting standards and audit and assurance standards) and regulatory requirements.

Professional accountants in business and in public practice have a critical role to play in assisting companies reconcile these different perspectives while complying with existing reporting obligations, regulatory requirements, and their professional responsibilities.

The Demand for Enhanced Climate-Related Financial Disclosure

For many organizations, climate-related matters have potentially significant impacts on their business model, cash flows, financial performance, and resiliency. Consequently, there is increasing pressure from investors, regulators and policy makers for more consistent, comparable, reliable and decision-useful information to improve climate-related financial disclosures.

Investors: Organizations representing over $120 trillion in assets[2] are clear in their demands for greater transparency on climate change—not just in sustainability or integrated reporting but also, more fundamentally, in a company's financial reporting (see Investor Groups Call on Companies to Reflect Climate-Related Risks in Financial Reporting). Enhanced corporate disclosure on climate risks is also one of the three asks by the Climate Action 100+ collective engagement by 575 investors with over US$54 trillion in assets under management.

Individual investment firms like BlackRock have called for financial reporting to "reflect reasonable assumptions about the impact of climate risk and the transition to a low carbon economy….one in which global warming is limited to well below 2-degree Celsius, ideally 1.5-degree Celsius, and is consistent with a global aspiration to reach Net Zero Carbon emission by 2050." (See Sustainability Reporting: Convergence to Accelerate Progress).

Regulators: The 2020 Status Report of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) noted that while disclosure of climate-related information had increased since 2017, companies' disclosure of the potential financial impact of climate change remains low and continuing progress is needed. A key focus for the TCFD is scenario analysis that assesses potential business implications of climate-related risks and opportunities. The TCFD framework recommends companies consider a range of different climate scenarios—using at a minimum a 2-degree Celsius scenario[3], while also considering other scenarios relevant to the organization's circumstances, such as those related to Nationally Determined Contributions (NDCs). Some jurisdictions are on the path to mandate TCFD requirements while others are strongly encouraging their use.

IOSCO's June 2021 Report on Sustainability-related Issuer Disclosures presented the results of two factfinding exercises which highlighted gaps between investor needs and the current state of sustainability information they are receiving. Investee companies' sustainability disclosures are not complete, consistent, nor comparable. For example, companies report selectively against multiple different standards and frameworks, they disclose limited and inconsistent quantitative information and did not provide detailed disclosure on the impact of sustainability issues on their business strategy and financial performance.

Policy Makers: The European Commission's proposal for a Corporate Sustainability Reporting Directive, a component of a broad policy initiative to transform the European Union to a more sustainable (i.e., "green") economy, the consultation by the US Securities and Exchange Commission on climate change disclosures, the UK and New Zealand proposals to mandate TCFD reporting, and China's central bank plan to implement mandatory disclosures of climate and carbon emission information, demonstrate significant momentum to put new standards in place for enhanced climate and sustainability reporting in future years.

Navigating the 2021 Reporting Cycle

Companies will need to consider whether to provide additional disclosures where strict compliance with the specific requirements in financial reporting standards may not enable investors to understand the impact of climate-related matters on the company's financial position and financial performance.

What the Standard-Setters have said?

In determining climate-related disclosures, professional accountants should consider materials issued by standard-setters that set out existing obligations in respect of climate-related matters.

These include:

The IASB's *Educational Material: the effects of climate-related matters on financial statements prepared applying IFRS Standards* discusses the importance of materiality in considering climate-related disclosures and illustrates how IFRS Standards apply to climate-related matters and how these may be material with respect to significant judgments and estimates that management has made in the preparation of the financial statements.

"IFRS Standards do not refer explicitly to climate-related matters. However, companies must consider climate-related matters in applying IFRS Standards when the effect of those matters is material in the context of the financial statements taken as a whole. Information is material if omitting, mis-stating or obscuring it could reasonably be expected to influence decisions that primary users of financial statements (hereafter, investors) make on the basis of those financial statements, which provide information about a specific company. For example, information about how management has considered climate-related matters in preparing a company's financial statements may be material with respect to the most significant judgements and estimates that management has made."

The Climate Disclosure Standards Board published additional guidance and examples in support of the IASB's educational material (see *Accounting for Climate, Integrating Climate-Related Matters into Financial Reporting*).

The IAASB's staff audit practice alert on *The Consideration of Climate-Related Risks in an Audit of Financial Statement* explains that auditors have a crucial role and need to consider how International Standards on Auditing (ISA) relate to their considerations of climate-related risks in an audit of financial statements.

"If climate change impacts the entity, the auditor needs to consider whether the financial statements appropriately reflect this in accordance with the applicable reporting framework (i.e., in the context of risks of material misstatement related to amounts and disclosures that may be effected depending on the facts and circumstances of the entity). …Auditors also need to understand how climate-related risks relate to their responsibilities under professional standards, and applicable law and regulation."

The FASB's *Staff Educational Paper, Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards* addresses the interaction of ESG and financial reporting.

"When applying financial accounting standards, an entity may consider the effects of certain material ESG matters, similar to how an entity considers other changes in its business and

operational environment that have a material direct or indirect effect on the financial statements and notes thereto."

These educational materials highlight how companies—under existing financial reporting and auditing standards—may need to make material climate-related risk assessments and address them in their portrayal of financial condition and results that incorporate, for example:

- Useful lives and residual values of certain assets
- Cash flow forecasts
- Factoring risk into impairment models
- Expected credit losses
- The impact of climate on operating margins
- Disaggregation disclosures
- Segment aggregation
- Decommissioning provisions
- Onerous contract provisions
- Pension liabilities
- Adequacy of insurance coverage.

Depending on jurisdictions-specific regulatory requirements and practices, and the financial materiality of the issue, climate-related disclosures appear in a variety of formats and venues (see IFAC's Benchmarking Study on Global Practices in Sustainability Assurance) including:

- Narrative sections of the annual or integrated report
- A standalone sustainability or CSR report
- Regulatory filings
- The financial statements
- The company's website
- Survey responses (e.g., CDP submissions).

Companies must determine—with the support of their professional accountants—the materiality of climate-related issues, the placement of any disclosures, the alignment of climate-related

information in the narrative vs. financial statements, as well as ensure there are no material omissions or misstatements.

Disclosures should reflect company specific climate targets, changes in strategy, and capital allocation decisions that are in response to physical and transition climate-related risks that may impact asset valuations, such as property, plant and equipment or reserves. Many investors are also asking companies for the consistent application of a Paris Agreement-aligned scenario analysis, which they believe would improve the relevance and comparability of climate disclosures and help the understanding of the financial implications of climate-related risks and opportunities.

Scenario Analysis and Forward-Looking Information

Using scenario analysis to understand the potential strategic and operational impact of climate change on an organization and ultimately its financial position and prospects involves making informed assumptions about the future - such as commodity prices, demand for products and services, and changes in carbon prices due to costs associated with excess carbon emissions in some jurisdictions. These assumptions can provide the basis for considering the timing and the likelihood of climate impacts which help determine financial materiality.

Climate scenario-related assumptions can be challenging to make, particularly with respect to medium and long-term forecasts. It is therefore critical for disclosures to explain the reasoning behind critical assumptions used in accordance with the applicable financial reporting framework. This is not without precedent. Forward-looking information is already widely used, for example in fair value measurement, impairment testing, measurement of provisions, and recognition of contingent liabilities.

Scenario Analysis and Impairments

An important issue in scenario analysis is commodity price assumptions underlying cash flow forecasts used for impairment testing and measurement. There have been calls by some investors for companies to use prices that reflect market scenarios in which supply and demand for oil is aligned with the climate goals in the Paris Agreement. However, this alignment, like other disclosures related to Paris Agreement commitments, is not a requirement under either IFRS or US GAAP as long as the entity's cash flow projections used in its impairment analysis are internally and externally consistent with its other projections and public statements.

In developing impairment assumptions and estimates, companies apply their judgment, which may be difficult, subjective, or complex - but is necessary to account for the effects of inherently uncertain matters. Material assumptions should be declared and should be consistent with other

reporting. For example, in 2020 BP disclosed impairment charges and write-offs in light of its commitment to become a net-zero company by 2050 or sooner.

Auditor Reporting

To enhance trust and confidence in what companies' report, auditors and the reports they issue may also need to address climate-related judgements and assumptions used in preparing the financial statements. For example, where an auditor determines that work to test and evaluate an estimate or assumption constitutes a key/critical audit matter, the matter may need to be highlighted in the audit report. Again, this is not without precedent. For example, the independent auditor's report in the National Grid's climate disclosures in its 2019/20 and 2020/21 annual reports (captured in its Form 20-F) raised climate change as a key audit matter.

A Call to Action for the Accountancy Profession

Transparency has always been at the heart of the role played by all professional accountants. With respect to climate-related reporting, we must do our part in the following ways.

1. **Align and integrate climate-related information and disclosures**: Corporate reporting should be aligned with internal planning and decision making so that senior management, boards of directors, and investors have confidence that internal accounting and external reporting is rooted to the reality of the company's climate commitments, strategy, business model, and operations. This also involves ensuring that climate-related (or other sustainability) information can be trusted in decision making and reported through robust data collection processes and associated controls that also provide the basis for assurance.
2. **Quantify, wherever appropriate, financial impacts**: Climate scenario analysis and risk assessment can be complex areas in which accountants need to be involved—helping to translate risks and opportunities into numbers. Without quantification of the risks and opportunities, companies will find it hard to evaluate financial impact and compare climate change against their other wider enterprise risks, and investors will be less able to make informed decisions about the allocation of their capital.
3. **Ensure climate-related reporting complies with reporting requirements**: Companies must decide where and how they should report on climate-related matters, and specifically ensure requirements under existing accounting and reporting standards and regulations are met without material omissions or misstatements. For example, key questions that must be answered include: Is climate-related risk material to financial performance and therefore required to be addressed under current standards and regulatory requirements? How should

climate-related information be covered in a narrative discussion, in which case its presentation must not be misleading or inconsistent with the financial statements?

4. **Support global initiatives to enhance climate and broader sustainability-related reporting:** The move to global sustainability standards addressing enterprise value under the ISSB will enhance the quality of climate-related and overall sustainability-related information for all stakeholders.

Addressing these issues is more important than ever as businesses and capital markets strive to assess and incorporate the impacts of climate change. Professional accountants—in business and in public practice—need to be participants and collaborators that help companies appropriately understand and communicate climate-related financial impacts.

[1] Taking stock: A global assessment of net zero targets

[2] These include the Principles for Responsible Investment, the Institutional Investor Group on Climate Change, the UN Environment Programme Finance Initiative, the UN convened Net Zero Asset Owners Alliance, the Pension and Lifetime Saving Association, the Investor Group on Climate Change, and the Asia Investor Group on Climate Change, and the International Corporate Governance Network. They have been supported in their work by CERES in the USA, and the Climate Action 100+ initiative.

[3] The TCFD consultation on metrics, targets and transition plans, which closed in July 2021, makes several references to a 1.5 degrees Celsius scenario and the mainstreaming of the net-zero emissions concept.

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