2 Climate change: Potential financial impacts and related disclosures

This article aims to:

- Discuss potential financial impacts associated with climate change and related disclosures to be made by companies.

Introduction

Climate change is rapidly emerging as a threat to the stability of the financial systems across the globe. More frequent and severe weather events are damaging infrastructure and disrupting supply chains. Transition to a lower carbon economy and new emission standards are expected to bring new policies, regulations and rapid changes to market dynamics. The automotive industry in India, for instance, is required to transition to Bharat Stage (BS) -VI emission standards with effect from 1 April 2020. Together these trends are likely to impose financial risks on companies and other stakeholders including investors, lenders and insurers.

There is an increase in demand for decision-useful, climate related information by a range of participants in the financial markets. Inadequate information about financial risks due to climate change can lead to mispricing of assets, misallocation of capital and can potentially give rise to concerns about financial stability since markets can be vulnerable to abrupt corrections.

Addressing the challenge, internationally, in 2015, the Financial Stability Board (FSB)[1] formed the Task Force on Climate-related Financial Disclosures (TCFD) to help investors understand their financial exposure to climate risk and help companies disclose this information in a clear and consistent way.

In 2017, the TCFD issued a report with its recommendations which focus specifically on business disclosure of how climate change affects financial performance now and in the future. They do not address disclosure of how a company may, or may not, be contributing to climate change.

In November 2019 - In Brief Nick Anderson, member of the International Accounting Standards Board (IASB) through an article on 'IFRS Standards and climate-related disclosures' has explained how existing requirements within International Financial Reporting Standards (IFRS) relate to climate change risks and other emerging risks. The article highlights how the principle-based approach of IFRS would help address disclosures regarding climate change and other emerging risks even though such risks are not explicitly referenced in the standards. Additionally, in October 2020, the International Auditing and Assurance Standards Board (IAASB) has issued a guidance material on consideration of climate-related risks in an audit of financial statements.

In this article, we aim to discuss in detail the financial impacts of climate related issues along with recommended financial disclosures to be considered by companies.

Financial impacts of climate related risks and opportunities

The financial impacts of climate-related issues on companies are not always clear or direct. For many companies, challenge would lie in identifying the issues, assessing potential impacts and ensuring that material issues are reflected in their financial statements. This could be on account of:

- Limited knowledge of climate-related issues within companies
- Tendency to focus mainly on near-term risks without paying adequate attention to risks that may arise in the longer term and
- Difficulty in quantifying the financial effects of climate-related issues.

In order to make informed decisions, it becomes imperative to understand how climate-related risks and opportunities are likely to impact a company's future financial position as reflected in its income statement, cash flow statement and balance sheet.

1. FSB is an international body that monitors and makes recommendations about the global financial system.

Climate-related risks

Climate related risks can be categorised into:

- **Transition risks:** Risks that arise due to changes in legislation, market forces or technological changes on transition to a lower-carbon economy and other regulatory standards. Some of the examples of transition related risks are as follows:

  Policy and legal risks

  – Carbon pricing and reporting obligations

  – Mandates on and regulation of existing products and services

  – Exposure to litigation.

  Technology risks

  – Substitution of existing products and services with lower emissions options

  – Unsuccessful investment in new technologies.

Market risks

- Changing customer behaviour
- Uncertainty in market signals
- Increased cost of raw materials.

Reputation risks

- Shift in consumer preferences
- Increased stakeholder concern/negative feedback
- Stigmatisation of sector.

- **Physical risks:** Risks that arise as a direct result of changes in weather and climate. Physical risks resulting from climate change can be event driven (acute) or longer-term shifts (chronic) in climate patterns. Some of the examples of physical risks are as follows:

Acute risks

- Increased severity of extreme weather events such as cyclones and floods.

Chronic risks

- Changes in precipitation patterns and extreme variability in weather patterns
- Rising mean temperatures
- Rising sea levels.

Climate-related opportunities

Efforts to mitigate and adapt to climate change could also produce opportunities for companies. For instance, resource efficiency and cost savings, adoption of low-emission energy sources, development of new products and services, access to new markets and building resilience along the supply chain.

Climate related financial disclosures

Climate-related risk is a non-diversifiable risk that is expected to affect every sector. The TCFD identifies the following types of companies that are likely to be affected by climate-related risks:

- Companies in the financial sector such as, banks, insurance groups, asset owners (investment companies), and asset managers and
- Companies in non-financial industries, such as, energy, transportation, material and buildings and agriculture, foods and forest products.

As a result, stakeholders would require adequate information to understand the impact and the steps taken by companies to address those risks.

In order to facilitate transparency regarding the climate related issues faced and addressed by companies, there is an increasing need of providing adequate climate related disclosures in the company's accounts and/or other reports.

Basis above, the TCFD structured its recommendations around four thematic areas that represent core elements of how companies operate. The recommendations were supported by specific disclosures which companies should include in financial filings or other reports to provide decision-useful information to investors and other stakeholders.

Following figure provides the core elements of climate-related disclosures as recommended by the TCFD in its report:

Governance

Company's governance around climate-related risks and opportunities.

Strategy

The actual and potential impacts of climate-related risks and opportunities on the company's businesses, strategy and financial planning.

Risk management

The processes used by the company to identify, assess and manage climate-related risks.

Metrics and targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The recommended disclosures under each of the above elements are as follows:

Governance

- Describe the board's oversight of climate-related risks and opportunities.
- Describe management's role in assessing and managing climate-related risks and opportunities.

Strategy

- Describe the climate-related risks and opportunities the company has identified over the short, medium and long term.
- Describe the impact of climate-related risks and opportunities on the company's business, strategy and financial planning.
- Describe the resilience of the company's strategy, taking into consideration different climate-related scenarios.

Risk management

- Describe the company's processes for identifying, assessing and managing climate-related risks.
- Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the company's overall risk management.

Metrics and targets

- Disclose the metrics used by the company to assess climate-related risks and opportunities in line with its strategy and risk management process.
- Describe the targets used by the company to manage climate-related risks and opportunities and performance against targets.

(**Source:** TCFD report issued in June 2017)

Disclosures in financial statements

Currently there is no mandatory international framework for reporting climate-related risks. However, IAASB in its guidance material *'Consideration of Climate-Related Risks in an Audit of Financial Statement'* highlighted that there is a growing support for climate-related financial reporting, generally within the financial statements or associated with the other information.

These risks would be instrumental in the decision-making of investors. Therefore, companies may need to consider climate related risks in the context of their financial statements rather than solely as a matter of corporate social responsibility reporting or sustainability reporting. Companies should consider the following while preparing their financial statements:

- Whether investors could reasonably expect that emerging risks, including climate-related risks, could affect the amounts and disclosures reported in the financial statements. Investors have indicated the importance of information about such risks to their decision-making; and
- What information about the effect of emerging risks, including climate-related risks, on the assumptions made in preparing the financial statements is material, and thus should be disclosed.

Some of the potential financial implications arising from climate-related and other emerging risks may include, but are not limited to:

- Asset impairment, including goodwill
- Changes in the useful life of assets
- Changes in the fair valuation of assets
- Effects on impairment calculations because of increased costs or reduced demand
- Changes in provisions for onerous contracts because of increased costs or reduced demand
- Changes in provisions and contingent liabilities arising from fines and penalties and
- Changes in expected credit losses for loans and other financial assets.

Companies would need to consider the relevant requirements of IFRS/Ind AS and would need to make adequate disclosures to address these implications.

The majority of climate-related information is currently disclosed within management commentary and not in the financial statements. As per November 2019 In Brief, applying materiality definition and principles in the materiality practice statements, would result in some of this information being reflected within the financial statements. The disclosures in the notes will be most helpful to users of financial statements if the disclosures focus on specific issues and assumptions made that are relevant to the amounts recognised in the financial statements; and if they are not of a boilerplate nature.

It is important to note that disclosures in other documents (including presentations, management commentary and sustainability reports) will not compensate for the omission of disclosures that are required to be made in the financial statements and are therefore, subject to audit in most jurisdictions. Therefore, management should report on environmental and societal issues to the extent necessary for primary users of financial statements to form their own assessment of the company's longer-term prospects and management's stewardship of the business.

Auditor's responsibility

If climate change impacts an entity, then the auditor needs to consider whether the financial statements appropriately reflect this in accordance with the applicable financial reporting framework (i.e., in the context of risks of material misstatement related to amounts and disclosures that may be affected depending on the fact 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.

In India, the Securities and Exchange Board of India (SEBI) requires top 1,000 listed companies to provide a Business Responsibility Report (BRR) as part of their annual reports. In the report, companies are required to describe the initiatives taken by them from an environmental, social and governance perspective. The current version of BRR is based on the business responsibility and sustainability indicators contained in the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs) issued in 2011 by the Ministry of Corporate Affairs (MCA). These guidelines were updated as the National Guidelines for Responsible Business Conduct (NGRBC) in 2019.

Companies are specifically required to comment on their strategies/initiatives to address global environmental issues such as climate change, global warming, etc. in the report.

Recently, SEBI has issued a consultation paper and proposed a new format of reporting, namely, Business Responsibility and Sustainability Reporting (BRSR). SEBI recommended that the new format for BRSR should be made applicable to top 1,000 listed companies by market capitalisation mandatorily from the financial year 2021-22. The new format also requires specific disclosures on strategies/initiatives to address global environmental issues such as climate change, resource scarcity, health pandemics and emergencies, natural disasters, etc.

Additionally, SEBI requires top 500 listed companies to adopt Integrated Reporting (<IR>) on a voluntary basis from the financial year 2017-2018.

The information related to IR may be provided in the following ways:

- As part of annual report with a separate section on IR
- Incorporating in management discussion and analysis, or
- By preparing a separate report (annual report prepared as per IR framework).

In case the company has already provided the relevant information in any other report prepared in accordance with national/international requirement/framework, it may provide appropriate reference to the same in its integrated report so as to avoid duplication of information. Companies may host the integrated report on their website and provide appropriate reference to the same in their annual report.

The intent of both the reports is almost similar i.e. responsible and better business reporting. SEBI prescribed a format for BRR/BRSR, whereas the IR does not contain any prescribed format for reporting.

Companies may use these reports to disclose their commitment to and performance against their economic, social and environment impacts including climate change.

Next steps

There could be innumerable challenges associated with measuring the impact of climate change. Companies would need to adopt appropriate measures to address the financial risks and opportunities related to climate change. More guidance in this area is expected to emerge in near future.

(**Source:** 'TCFD – Overview publication' issued by TCFD, Recommendations of the TCFD- Final Report issued by TCFD in June 2017, Staff Audit Practice Alert on 'The Consideration of Climate-Related Risks in an Audit of Financial Statement' issued by IAASB in October 2020, Article on 'IFRS® Standards and climate-related disclosures' dated 28 November 2019 on IASB website)