Chapter 2

Climate change: Implications on financial reporting

This article aims to:

Highlight some of the existing principles and disclosure requirements in IFRS standards that would appropriately reflect the challenges posed by climate-related matters.

Background

Climate-related matters have directly or indirectly impacted or are likely to impact many industries on a global front. Considering the impact that climate change may have on a company's business models, cash flows, financial position and financial performance, it has garnered the interest of various stakeholders. Investors specifically are calling out for information on the financial impacts that climate change will have on the companies, as this would enable them to incorporate climate risks into their investment decision making. It has thus become pertinent to include climate-related matters in financial reporting.

The existing International Financial Reporting Standards (IFRS) do not refer explicitly to climate-related matters. Considering this, the International Accounting Standards Board (IASB), issued an educational material in November 2020, which complements an article written by its member in November 2019[1]. The educational material articulates some of the existing requirements within IFRS that would aptly reflect climate change risks and other emerging risks in the financial statements.

In this article, we aim to highlight some of the existing principles and disclosure requirements of IFRS (as explained in the educational material) that would enable appropriate disclosures on climate-related matters in the financial statements.

1. 'IFRS Standards and climate-related disclosures' by Nick Anderson

IFRS requirements

Where the effect of climate-related matters is material in the context of the financial statements taken as a whole, companies should reflect these while reporting on financial matters. Some of the areas that may be impacted are given below:

IAS 1, *Presentation of Financial Statements*

- **Sources of estimation uncertainty and significant judgements**

  Companies are required to disclose information on assumptions made about the future, which could materially adjust the carrying amounts of assets and liabilities within the next financial year. Thus, assumptions about climate-related matters that may impact estimates (such as estimates of future cash flows when testing an asset for impairment or estimates of decommissioning obligations) should be disclosed along with sensitivity analysis performed.

  Companies are also required to disclose information on management judgements that have the most significant effect on the financial statements. For example, a company that operates in an industry particularly affected by climate change performs an impairment testing on its Cash Generating Unit (CGU) (the value of the CGU is material) and identifies that no impairment is required. The judgement made while identifying the CGU for impairment testing should be disclosed.

- **Going concern**

  Financial statements are prepared on a going concern basis. When assessing whether the going concern basis of preparation is appropriate, management should consider all available information pertaining to the future, which is at least, but not limited to 12 months from the end of the reporting period. Further, information pertaining to close call scenarios should also be disclosed. In this context, management should disclose climate-related matters that create material uncertainties related to events or conditions that cast significant doubt upon a company's ability to continue as a going concern.

- **Disclosure of relevant information**

  IAS 1 has certain overarching disclosure requirements. Companies are required to disclose in the notes to the financial statements, information that is not presented elsewhere in the financial statements but is relevant to an understanding of them. Information will be relevant if it could reasonably be expected to influence decisions made by investors.

IAS 2, *Inventories*

- **Inventories to be maintained at cost or Net Realisable Value (NRV)**

  As per IAS 2, inventories are required to be carried at the lower of cost or NRV. Climate-related events such as floods, cyclones, or other events may cause a company's inventories to become obsolete, their selling prices to decline or their costs of completion to increase. If, as a result, the cost of inventories is not recoverable, IAS 2 requires the company to write down those inventories to their NRV.

IAS 12, *Income Taxes*

- **Recognition of deferred tax assets**

  A deferred tax asset is recognised in respect of deductible temporary differences and unused tax losses and credits, to the extent it is probable that future taxable profit will be available against which these amounts can be utilised. Climate-related matters may affect a company's estimate of future taxable profits (for example, low profitability due to unavailability of resources). This may result in a company being unable to recognise deferred tax assets or being required to derecognise deferred tax assets previously recognised.

IAS 16, *Property, Plant and Equipment (PPE)* and IAS 38, *Intangible Assets*

- **Capitalisation of certain costs**

  Certain costs that meet prescribed criteria in IAS 16 and IAS 38 would be capitalised as assets (as PPE or as an intangible asset). Climate-related matters may prompt expenditures to change or adapt business activities and operations, including research and development. These new costs may not satisfy the definition of an asset, and hence would not be capitalised.

- **Depreciation and amortisation and related disclosures**

  Depreciation and amortisation of PPE and intangible assets respectively, are based on estimates made by management of the expected useful lives of the assets and their estimated residual value. These estimates are to be reviewed at least annually and changes in the estimates should be reflected in the financial statements. Climate-related matters may affect the estimated residual value and expected useful lives of assets, for example, because of obsolescence, legal restrictions or inaccessibility of the assets, and therefore, the amount of depreciation and amortisation recognised each year.

IAS 36, *Impairment of Assets*

- **Companies to assess impairment of goodwill and assets**

  As per IAS 36, (non-financial) assets should be measured at their carrying amount or their recoverable amount, whichever is lower. For this purpose, companies should assess each year, whether there is any indication of impairment at the end of the reporting period. Climate-related matters may give rise to indications that an asset (or a group of assets) is impaired. For example, a decline in demand for products that emit greenhouse gases could indicate that a manufacturing plant may be impaired, requiring the asset to be tested for impairment.

- **Computing recoverable amount using value-in-use**

  'Value in use' is the present value of the future cash flows expected to be derived from an asset or CGU. A company is required to base cash flow projections on reasonable and supportable assumptions that represent a management's best estimate of the range of future economic conditions. This requires companies to consider whether climate related matters affect those reasonable and supportable assumptions.

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* and IFRIC 21, *Levies*

- **Recognition, measurement and disclosure of liabilities**

  Climate-related risks and uncertainties may impact the recognition, measurement and disclosure of liabilities in the following manner:

  – Recognition of levies imposed by governments for failure to meet climate-related targets or to discourage or encourage specified activities

  – Costs to remediate environmental damage as per regulatory requirements

  – Contracts may become onerous (for example, due to potential loss of revenue or increased costs as a result of climate-related changes in legislation); or

  – Restructurings to redesign products or services to achieve climate-related targets.

- **Disclosures pertaining to provisions and contingent liabilities**

  Companies are required to provide a brief description of the nature of the contingent liabilities, an estimate of its financial effect (where practicable) and indication of uncertainties about the amount and timing of any related outflows of economic benefits. Accordingly, adequate disclosures should be made for potential litigations, fines or penalties that may be caused by climate-related events.

  Companies should also disclose major assumptions made about future events reflected in the amount of a provision. For this purpose, companies may need to disclose how climate-related risks have been factored in while making the provisions

IFRS 7, *Financial Instruments: Disclosures*

- **Disclosure of risks arising on financial instruments due to climate change**

  IFRS 7 requires companies to disclose the nature and extent of risks arising on its financial instruments, and how the company manages those risks. Climate-related matters may expose the financial instruments of a company to various risks, which would require adequate disclosures. For example:

  – Lenders may need to provide information about the effect of climate-related matters on the measurement of expected credit losses or on concentrations of credit risk

  – Holders of equity investments, may disclose information about industries or sectors exposed to climate-related risks, when disclosing concentrations of market risk.

IFRS 9, *Financial Instruments*

- **Classification and measurement of financial assets**

  Classification and measurement of financial assets is driven by a) the business model under which the financial assets are held, and b) the nature of cash flows[2] of the financial asset. Certain contracts, for example, loan contracts may include terms linking contractual cash flows to a company's achievement of climate-related targets. These terms would need to be assessed while classifying and measuring the financial assets[3].

- **Expected Credit Losses (ECL)**

  In recognising and measuring ECL, IFRS 9 requires the use of all reasonable and supportable forward-looking information, that is available without undue cost or effort. Climate-related matters such as wildfires, floods, or policy and regulatory changes could affect the range of potential future economic scenarios, and the lender's assessment of a significant increase in credit risk. Further, certain climate-related risks could make the assets inaccessible and uninsurable, affecting the value of collaterals. This would impact the ECL computation for a lender.

2. Nature of cash flows refers to whether the cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI criteria).
3. The borrower, on the other hand may need to assess whether the contract includes embedded derivatives that need to be separated from the host contract.

IFRS 13, *Fair Value Measurement*

- **Fair value measurement of assets and liabilities**

  Market participants' views of potential climate-related legislation could affect the fair value of an asset or liability.

- **Fair value disclosures**

  IFRS 13 requires companies to provide detailed disclosures (including the disclosure of unobservable inputs used) while computing fair value of financial instruments (specifically with regard to fair value of financial instruments categorised within level 3 of the fair value hierarchy). The unobservable inputs should reflect the assumptions that market participants would use when pricing, including assumptions about risk which may include climate related risk.

IFRS 17, *Insurance Contracts*

- **Measurement of insurance contract liabilities**

  Companies generally insure businesses for business interruptions, property damage, illness, death and other events. Climate-related matters may increase the frequency or magnitude of these insured events or accelerate the timing of their occurrence, therefore, affecting the assumptions used to measure insurance contract liabilities applying IFRS 17.

- **Impact on disclosures**

  Climate-related matters may impact disclosures regarding significant judgements and changes in judgements made in applying IFRS 17 and disclosures of a company's risk, including concentration of the risk, how the company manages the risk and a sensitivity analysis.

Next steps

While the educational material highlights some of the existing principles and disclosure requirements in IFRS which would enable companies to disclose the impact of climate-related matters in the financial statements, this list is not exhaustive, and other instances may require reflection of climate related matters.

Additionally, it is important to have narrative reporting (often referred to as management discussion and analysis), as it would help in filling some information gaps and complement financial reporting.