

# Climate related risks in financial statements

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## Introduction

Disclosing the impact of climate related risk is gaining traction, with regulators and investors now demanding more information.

The first step in meeting these expectations, is to understand how your business is impacted, which includes understanding the risks and opportunities climate related risks poses on your business. The impact, both the physical risks and the global transition to low-carbon economy, is not just related to companies operating in the energy or manufacturing sectors. There can be far-reaching impacts on supply chains, customers, assets and plans for future strategic acquisitions. Assessing the impacts and providing disclosures are crucial to investors wanting to understand how climate related risks affects a company's economic growth, asset values, and future prospects as a whole.

This publication addresses the increasing expectations of regulators and investors; the potential impacts of climate related risk on your business, and the importance of climate related disclosures.

### 1. Why does climate change reporting matter to investors and regulators?

An Australian legal precedent was set in 2020, with a court case brought against a superannuation fund for allegedly failing to protect retirement savings from the financial devastation that could flow from climate change<sup>1</sup>. This was followed by a law student pursuing the Australian government because she believes investors have the right to understand how climate change impacts the value of investments like government bonds<sup>2</sup>.

Also, investors, such as BlackRock<sup>3</sup>, have expressed interest in climate-related disclosures to meet their fiduciary duty of understanding how companies are managing sustainability-related risks. This is echoed in EY 2020 global institutional investor study showing 91% of surveyed investors said that non-financial performance played a pivotal role frequently or occasionally in their decision-making. Additionally, 73% of the surveyed investors devote considerable time and attention to evaluating the physical risk implications of climate change when allocating assets and selecting investments.

Norway's \$US1 trillion sovereign wealth fund to dump billions in coal investments<sup>4</sup>

This topic has gained the attention of accounting standard setters and regulators, both locally and internationally. The IASB<sup>5</sup> published educational material in November 2020 about the Effects of climate-related matters on financial statements.

In September 2020, the New Zealand Government announced new requirements for climate-related financial disclosures by publicly listed companies and large insurers, banks and investment managers, to be developed by the New Zealand Accounting Standards Board<sup>6</sup>. The stated goal is to help New Zealand meet its international obligations to achieve its target of zero carbon by 2050 and help address climate change risks outlined in the National Climate Change Risk Assessment by making the country's financial system more resilient. It is also expected that climate change reporting would promote greater transparency and more accurate pricing signals in the market, incentivise low-emissions investment and create a level-playing field for businesses already considering climate change in their longer-term risks.

<sup>1</sup> ABC News, 'Mark McVeigh is taking on REST super on climate change and has the world watching', 18 January 2020

<sup>2</sup> ABC News, 'Australian Government sued by 23-year-old Melbourne student over financial risks of climate change', 22 July 2020

<sup>3</sup> Blackrock CFO's letter to clients, 'Sustainability as BlackRock's New Standard for Investing', 14 January 2020

<sup>4</sup> ABC News 'Norway's \$US1 trillion sovereign wealth fund to dump billions in coal investments', 13 June 2019

<sup>5</sup> International Accounting Standards Board, 'Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards'

<sup>6</sup> Ministry for the environment, 'Mandatory climate-related financial disclosures', 21 September 2020

The UK Financial Reporting Council has recently undertaken a thematic review of climate-related disclosures<sup>7</sup>. As a result, UK auditors need to ensure their audit documentation reflects how they have considered and addressed climate-related risks on all audits of listed UK public interest entities in a priority sector as identified by the TCFD<sup>8</sup>, and are recommended for all other audit engagements, for periods ending on or after 31 December 2020. For audits of entities for which this is required, an EY sustainability reporting professional is required to be involved. Australian entities can expect regulators to implement similar requirements.

It is therefore critical that companies understand the impact and disclose what it has available. Unsatisfactory management of climate-related risk not only creates a risk for the company, but raises concerns for Directors failing to perform their duties that exposes them to penalties<sup>9</sup>. The COVID-19 pandemic and our bush fires exposed the fragility of supply chains and the wider economy. We hope that if this has taught us anything, it's taught us that prevention is better than curing.

#### Questions to ask:

- ▶ Do you understand the potential financial impacts (direct and indirect) on your business?
- ▶ What areas in the financial statements could be enhanced for understanding the impacts?
- ▶ How do the impacts affect the judgements and estimates required by accounting standards?
- ▶ Are you prepared for increasing investor and/or regulatory scrutiny?

Given the increasing importance of transparency for investors and regulators, disclosure is paramount. But where should financial climate risk be disclosed? In Australia, some companies are disclosing climate related information in the Director's Report, a Sustainability Report, and/or other reports/presentations. The continued pressure by investors, regulators, and lenders to disclose this information inside the financial statements indicates such disclosures could be material to understanding the financial position and performance.

If the impact of climate change could be material, have adequate disclosures been given in the financial statements?

It can be judgemental whether disclosure of the financial impacts of climate related risks is material for a user of the financial statements. From 1 January 2020, the IASB defines material as:

*"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."*

The TCFD states that "climate-related issues are or could be material for many organisations, and its recommendations should be useful to organisations in complying more effectively with existing disclosure obligations." Reflecting on the sector in which a company operates, and its suppliers and customers could impact the extent of the disclosures.

## 2. How is your business impacted?

Some sectors/businesses may be impacted by climate risks more than others, but it is fair to say that climate risk will impact most (if not all) to some degree. It's important to also consider supply chain effects, and changing consumer attitudes and behaviours in response to climate change.

Investors may expect more from the following typical sectors where climate risk can be more prevalent - manufacturing, energy, insurance, and agriculture. However, this does not discount the need to consider impacts in many other sectors including:

- ▶ Travel & Recreation - increasing temperatures may cause declines in visitors to traditional winter locations.
- ▶ Commercial fishing - increasing water temperatures and ocean acidity can adversely impact fish stock that affects supply/demand as well as price.
- ▶ Beverage & Food - changing weather patterns can cause constraints in sourcing ingredients and raw materials that drives a need to possibly source from elsewhere, as well as affecting price and transportation costs.
- ▶ Retail - temperature changes can impact supply/demand as well as the price of raw materials (e.g. cotton for clothing).

<sup>7</sup> Financial Reporting Council, 'Climate Thematic', 20 November 2020

<sup>8</sup> Taskforce for Climate Related Financial Disclosures

<sup>9</sup> Australian Corporations Act 2001

- ▶ Banking and investing – changes in appetite of those providing capital to others can increase the cost of, or even constrain, financing for borrowers that can result in projects becoming unviable or negatively affecting the value of collateral and investment assets.

Each sector/business may also be impacted by government policies and regulatory action in response to climate change. This can include emission caps, fines, and bans.

### 3. How could financial statements be impacted?

When considering the impact on financial statements, this does not just include existing assets and liabilities but also the changes in costs of doing business, the impact of cash flow forecasts used in making judgments and estimates, and management responses such as potential divestment decisions.

Some of the key areas to consider include:

#### Presentation of Financial Statements

- ▶ Sources of estimation uncertainty and significant judgements. For example, the assumptions used to develop estimates of future cash flows to settle a decommissioning obligation.
- ▶ Material uncertainties arising from climate-related matters casting significant doubt upon a company's ability to continue as a going concern.

#### Impairment of assets (e.g. PPE, intangible assets, right of use assets)

- ▶ Key assumptions used in future cash flow projections and management's approach to determining the inputs used for assessing recoverability of asset carrying values.

#### Provisions, contingent liabilities and contingent assets

- ▶ Recognition of an onerous contract provision driven by increased costs.
- ▶ Increase in provisions for rehabilitation due to regulatory changes or shortened project lives.
- ▶ Contingent liability for potential litigation and penalties due to failing to comply with stricter environmental and other regulations.
- ▶ Penalties imposed by governments for not meeting statutory clean targets, or to discourage specified activities that dissuade from meeting clean targets.

#### Fair value measurement

- ▶ Judgement of unobservable inputs, or ranges of possible amounts, used in fair value measurements.
- ▶ Incorporating significant unobservable inputs can drive more inputs from level 3 of the fair value hierarchy and increased quantitative disclosures.
- ▶ A business combination that includes renewable energy assets may need particular attention for determining fair values.

#### PPE and intangibles assets

- ▶ Judgement on reassessing the residual values and useful lives of assets negatively affected, and whether costs can be capitalised.
- ▶ Expenditures for changing or adapting to comply with environmental regulations (or meet stakeholder expectations), if material, will increase disclosure of research and development costs.

#### Financial instruments

- ▶ Assessments of expected credit losses on loans with borrowers' found to be operating in an area now subject to flooding or bushfires; and concentrations of credit risk to those operating in sectors more greatly affected.
- ▶ Careful attention to future investing and lending decisions, which may limit exposures to sectors and/or increase the cost of funding.
- ▶ Borrowers that pay a return linked to climate related targets will need to consider whether there is an embedded derivative, whereas the lender needs to assess whether the loan can be carried at amortised cost or fails the solely payment of principle and interest test.

#### Income taxes (e.g. deferred tax assets)

- ▶ A company's downgrade of its estimate of future taxable profits may result in tax loss carry forwards no longer being recognised as deferred tax assets.

#### Inventory

- ▶ Inventory obsolescence, reduction in selling prices, or increase in costs to transform raw materials into finished goods may require write downs to net realisable value.

To discuss further, please contact your local EY adviser.

## Appendix – Examples of disclosures

### What disclosures are companies including in financial statements?

How much disclosure is enough? At one end of the spectrum is no disclosure while the other end is voluminous disclosure. Clearly neither is an ideal solution. Companies need to evaluate the appropriate level.

Many are disclosing climate risks outside of the financial statements, however, there is a push from boards, regulators and investors to consider climate risks inside the financial statements.

The following are examples derived from disclosures of a sample of anonymised companies we have seen in the market. These anonymised examples are provided for illustration purposes and should not be viewed as the only way to present information. You should consider your specific facts and circumstances, user needs, as well as relevant legislation.

### Example 1: Key judgement and estimates used in the impairment test

Governments, businesses and society in general face complex challenges in respect of climate change. Transitioning to a zero-carbon economy is presenting us with risks as well as opportunities. ABC Limited's climate change action plan comprises greenhouse gas emission reduction targets for its production sites, water and environmental management plans, and other sustainability initiatives, which are reported in the Group's Sustainability Report. The key risks for our operations comprise cost increases following the introduction of a carbon price, a contraction in carbon-intensive operations in a push to decarbonisation the economy, as well as increasing severity and rate of occurrence of extreme weather events. On the other hand, we believe there are also opportunities for our business, such as a preference for domestic operations due to increased regulation to reduce embodied carbon emissions, and more investment incentives to develop energy efficient production facilities.

The following table describes how climate related risks are considered in determining the recoverable amount of our CGUs.

Key assumptions	Basis of estimation
Climate Change Related risks	Capital and operating expenditure associated with our climate change initiatives are, to the extent necessary, taken into account when determining the recoverable amount of each CGU.
Carbon costs	In certain jurisdictions (mainly in New Zealand and the European Union), ABC Limited's operations are subject to carbon emission costs. The costs are determined based on currently enacted legislation and other external forecasts.
Discount rate	Where the recoverable amount calculation does not include specific cash flows associated with climate change related risks or inflows associated with climate related opportunities, a risk-adjusted discount rate is used to reflect these risks and uncertainties.

### Example 2: Impact on assumptions used for impairment testing

Climate change related risks impacts ABC Limited, as does the transitioning to a lower carbon economy. ABC Limited has identified the following areas it expects to be impacted:

- ▶ A decrease in demand for our products, as a result of legal and regulatory changes (e.g. carbon emission costs), technological developments, and pressure from the market or society may cause some CGU's operations to become economically unviable;
- ▶ An increase in frequency and/or magnitude of extreme weather exposes the Group's operations to both acute risks and chronic risks.

The Group's assessment of the potential impacts of climate change and the transition to a lower carbon economy continues to evolve. When there is sufficient support, the potential financial impact is incorporated in our impairment assessment. These assumptions are:

- ▶ The demand for our products and the impact of carbon emission costs on the Group's long-term pricing outlook;
- ▶ The Group's strategy to reduce emissions (e.g. transitioning to renewable power supply).

### Example 3: Rehabilitation and other environmental provisions – Key estimates

The recognition and measurement of rehabilitation and other environmental provisions requires ABC Limited to use significant estimates and make assumptions in respect of the extent of potential activities required to rehabilitate (comprising activities to mitigate the potential physical impact of climate change) and remove infrastructure.

Changes in legal requirements, climate change related risks and transitioning to a low carbon economy impacts the estimates. Similarly, the development of new restoration techniques, and know-how developed at other operations may impact estimates.

Consequently, the actual expenditure in the future may diverge from the amounts currently provided for in the balance sheet.

### Example 4: Financial risk management – Climate risk

While ABC Limited does not have a significant carbon footprint nor is it directly exposed to physical climate change risk, these factors are considered when making investment decisions. The performance of ABC Limited's investments is crucial in the context of generating return on investments, as well as in the context of the wider economy and wellbeing of the broader community in which it operates. Therefore, ABC Limited expects its investee companies to be properly managed and profitable. As a responsible investor, ABC Limited is of the view it is critical that its investees embrace and adopt a rigorous and robust approach to:

- ▶ Identify, manage and mitigate climate related risks,
- ▶ Identify and maximise climate change generated opportunities, and
- ▶ Report on how transitional and physical risks associated with climate related risks and working towards a low carbon economy is managed in a timely manner.

Last year, ABC Limited published its first Climate related risk report prepared in accordance with the recommendations of the Taskforce for Climate Related Financial Disclosures, detailing the Group's risk management, strategy, investment governance in respect to climate change related risk.

Currently ABC Limited does not have a policy of negatively screening or divesting from sectors or companies.

ABC Limited participates in industry group discussions, including Climate Action 100+, the Investor Group on Climate Change, and the Australian Council of Superannuation Investors, which educates members on climate change related risk disclosure standards, risk management strategies, as well as influences companies and their policies.

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