

Corporate reporting continues to evolve to meet the expectations of investors as the environment in which organisations operate changes. The 2015 Paris Agreement on Climate Change signals possible changes in the regulatory environment that could affect how businesses are allowed to operate.

The Financial Stability Board is concerned that there is systemic risk in the financial system related to climate change, a risk that, because it is both contested and long-term, may not be well understood and not considered rigorously enough by many organisations.

In this publication we look at some of the issues involved and how companies and audit committees might respond to the challenges, drawing on a report issued by the FSB Task Force on Climate-related Financial Disclosure, to integrate the implications of climate change in their corporate reporting effectively.

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Overview

Investors and other market participants today make investment decisions based on a broad range of information from multiple sources, financial and non-financial, objective and subjective, assured and not. Some of this information is presented by organisations in periodic reports included in securities filings, some is summarised by organisations and reported outside securities law requirements, and some is provided by third parties.

Corporate reporting continues to evolve to meet the expectations of investors as the environment in which organisations operate change. As we noted in 2016, ‘a periodic report that provides a summary of the “business as a whole” will continue to be a cornerstone of corporate reporting to investors.’¹ We noted then that investors should have fair and honest information about the risks and opportunities facing an organisation such that they can make informed decisions on the basis of that information.

Among the risks businesses face are changes to their regulatory and operating environment. The 2015 Paris Agreement on Climate Change, and the related undertakings made by the acceding countries, signal possible changes in the regulatory environment that could affect how businesses are allowed to operate. And there are also potential changes in the climate that could affect businesses.

The G20 has highlighted a need for better financial information about climate-related risks. The Financial Stability Board is also concerned that there is systemic risk in the financial system related to climate change, a risk that, because it is both contested and long-term, may not be well understood and not considered rigorously enough by many organisations.

Currently, there are many bodies developing guidance for reporting information related to climate change, but there is little cooperation between them, and little regulatory or investor acceptance. What should be measured, how it is measured and whether or how it can be assured and by whom are also contested. It is to this area of corporate reporting that the FSB-sponsored Task Force on Climate-related Financial Disclosure seeks to bring some discipline and focus.

The report² of the Task Force provides a helpful window into how businesses should be thinking about climate-related risks and opportunities. The Task Force hopes that its ideas will help lead to significant improvements in investor-grade information by 2021.

In this publication we draw on the report to help companies, and audit committees, think about the implications of climate-related change for their corporate reporting.

The Financial Stability Board is concerned that there is systemic risk in the financial system related to climate change

The case for better climate-related corporate information

In a speech to Lloyd's of London in September 2015, Mark Carney, Chairman of the FSB, observed:

We don't need an army of actuaries to tell us that the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix... The horizon for monetary policy extends out to 2-3 years. For financial stability it is a bit longer, but typically only to the outer boundaries of the credit cycle – about a decade. In other words, once climate change becomes a defining issue for financial stability, it may already be too late.³

The message is clear: 'long-term' should not imply 'not important' when it comes to climate-related risks.

The Paris Agreement of 12 December 2015 committed nearly 200 governments to strengthen the global response to the threat of climate change. The Paris Agreement could have short, medium and long-term implications for companies if Governments implement changes that move their economies to generate lower carbon emissions.

At the request of the G20, the Financial Stability Board established in December 2015 an industry-led Task Force on Climate-related Financial Disclosures with a mandate to design a set of recommendations for consistent disclosures that would help "financial market participants understand their climate-related risks."⁴

The Task Force, chaired by Michael Bloomberg, brought together a diverse group of experts from across the financial markets including non-financial companies, investors, insurance companies, banks, ratings agencies, assurance providers and pension plans. The Task Force was 'policy-neutral' and concentrated on how best to provide relevant, consistent, comparable and reliable information to the financial system.

Report of the FSB Task Force

As the Task Force observes, since the 2007-2009 financial crisis, there has been increased demand for transparency from organisations on their risks and how those risks are managed. Better risk information is seen as critical if assets and risk are to be priced appropriately and capital allocated efficiently.⁵

The main focus of the Task Force was on the financial impact of climate change and understanding how organisations are managing and responding to that change. There can be short term effects such as increased, or reduced, costs and longer term effects as a consequence of having to invest in alternative assets or having to rehabilitate physical resources the business uses. How an organisation is addressing changes to its operating environment as a result of climate-related matters can be important for informed decision-making.

The Task Force has developed a set of voluntary recommendations that seeks to respond to its mandate and are compatible with current capital market disclosure requirements. The Recommendations, released on 14 December 2016, have a simple aim: to ensure that investors, lenders and other financial market participants receive consistent climate-related financial disclosures that are useful in understanding material climate-related risks and opportunities.

Rather than develop something new, the Task Force built on the recent work of others in developing its Recommendations and has demonstrated how they align with others' work and requirements. These organisations are diverse, and include the G20, OECD, the Global Reporting Initiative, the Climate Disclosure Standards Board, the Sustainability Accounting Standards Board, the Basel Committee's Enhanced Disclosure Task Force, the International Integrated Reporting Council and the UN Environmental Programme Finance Initiative.

They are consistent with the current momentum for reporting on a broader range of factors that impact the sustainability of an organisation and its ability to generate long term value. Climate is not the only such factor, but it can be an important one.

The audience

Information on topics such as climate change and corporate social responsibility is often seen as being outside the mainstream of financial reporting and is provided for a broader audience than the users of an annual report.

A premise of the Task Force recommendations is that climate-related risk can be significant, should be managed at a senior level and that the financial effects of climate-related risks should be owned by the financial reporting function. We agree. However, this does not mean that the audience of the annual report needs to be broadened. The annual report still needs a clear focus.

Primary users

In our assessment of the future of corporate reporting we said that for the annual report to retain its importance as a central part of the corporate reporting function it needs to have a clear objective and remain focused on investors. They are its primary users.⁶

We think that this focus remains relevant when it comes to climate-related information. If you are considering including climate-related information in your annual report it is appropriate to think about what information an investor would find helpful.

The Task Force has taken a broader view and concluded that investors, *lenders* and *insurance underwriters* are the appropriate primary users because they assume the financial risk and reward of the decisions they make.

Our focus on investors does not imply that other stakeholders such as insurance underwriters are not entitled to information. But it is not clear to us that the annual report is the best, or even appropriate, means for communicating with this broader group. We are concerned that the annual report has become a convenient depository for information that is not focused on investors, but is intended for other stakeholders. It is important to identify when an annual report is the most effective and efficient mechanism for providing information to the intended audience. The annual report might be a convenient mechanism for providing broader information, but its main focus should be on meeting the needs of investors.

Whilst it is understandable that, given the Task Force's remit and objectives, it wanted insurance underwriters in the primary user group, we are concerned that it blurs the line between securities market oversight and prudential regulation. This line was vigorously contested in the aftermath of the financial crisis of 2007-2009, at which time we noted that although while the objectives of financial reporting and prudential regulation will often not be in conflict, "there will be situations... when the objectives do conflict."⁷ Ultimately, the distinction between financial reporting, subject to securities market oversight, and prudential regulation was maintained. We would not wish to re-open that debate now.

Climate-related information

Critical to the success of any reporting initiative is having a framework within which organisations can operate.

The Task Force has provided a helpful structure by synthesising several existing climate-related disclosure frameworks to provide a common framework for climate-related financial disclosures. It is designed to help organisations evaluate and disclose, ‘as part of their financial statement preparation and reporting processes, the climate-related risks and opportunities that are most pertinent to their business activities.’⁸

The Task Force identified four thematic areas—governance, strategy, risk management, and metrics and targets (the core elements of how organisations operate) – as the basis for disclosure.

These are supported by ‘recommended disclosures’ intended to provide information that helps investors and others understand how reporting organisations think about and assess climate-related risks and opportunities.⁹ There is supporting guidance to assist organisations generally as they develop climate-related financial disclosures, as well as supplemental guidance for specific sectors.¹⁰ This structure encourages integrated thinking across the organisation with respect to climate-related issues generally and financial statement impacts specifically (e.g., asset and liability measurement, impairment, etc.).¹¹

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's business, strategy, and financial planning.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities.
Recommended Disclosures	Recommended Disclosures	Recommended Disclosures	Recommended Disclosures
a) Describe the board's oversight of climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term.	a) Describe the organisation's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate related risks and opportunities on the organisation's businesses, strategy, and financial planning.	b) Describe the organisation's processes for managing climate-related risks.	b) Describe Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and related risks.
	c) Describe the potential impact of different scenarios, including a 2°C scenario, on the organisation's businesses, strategy, and financial planning.	c) Describe how processes for identifying assessing, and management climate-related risks are integrated into the organisation's overall risk management.	c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

Source: Recommendations of the Task Force on Climate-related Financial Disclosures

See the Appendix for a depiction of the climate-related risks and opportunities identified by the Task Force.

Climate-related risks

The Task Force encourages organisations to look throughout their value creation chain to identify areas in which they are particularly exposed to climate-related risk. For example:

- How do you manage climate-related risk to your supply chain and/or value chain, such as potential disruptions to a just-in-time supply chain from more extreme weather?
- What mitigation procedures are in place to maintain value creation activity in the case of severe weather events?
- How are you positioned to respond to changes in technology and regulation related to climate-change? What is your investment strategy for low-carbon, energy efficient systems?
- In a travel-intensive business (e.g., professional services), if travel was affected, how would your organisation's business model need to change?

Climate-related opportunities

Equally important is an assessment of the opportunities afforded by transitioning to a lower-carbon, energy-efficient economy. As green technologies evolve, become more efficient and less costly, investments today may lessen the transition and physical risks present in an organisation. For example:

- Potential cost savings from investing in or switching to low emission energy alternatives, including wind, solar, tidal or hydro;
- Switching to lower-carbon products, even if that involves price increases for your consumers (e.g., locally-sourced products rather than imports);
- Improving resilience and better resource management (e.g., diversifying your supply chains; co-investment in new technologies).

The Task Force refers to climate-related risks and opportunities, because there is value in linking the impact of climate risk on potential value creation. This is consistent with the Integrated Reporting framework. The IIRC's Framework identifies natural capital as one of those that management should consider and report on when material. Their view is consistent with the Task Force's desire to communicate how climate risk is integrated into the everyday financial decision making and operations of the organisation, and how these might affect the financial aspects of the organisation.

Scenario analysis

Reporting climate-related risks and opportunities in mainstream financial filings involves sensitivity analyses and providing information that is subject to significant estimation uncertainty.

IAS 1 *Presentation of Financial Statements* has a relatively short-term horizon (the next financial year) for sensitivity analysis in areas of significant estimation uncertainty. But, as Mark Carney noted, the horizon for climate-related matters is considerably longer. In addition, there is no agreed methodology for measuring the financial effects of climate-related risks and opportunities and the data likely to be required are not being captured in a consistent manner (if at all).

This places organisations that are particularly exposed to climate-related matters in a difficult position. Those matters may well affect the cash flows of the organisation, but the timing and amount of those flows are subject to significant uncertainty, and could be over a long horizon.

One approach suggested by the Task Force is to incorporate scenario analysis into organisations' strategic and financial planning. A 'scenario' in this context describes a path of development towards possible outcomes while challenging conventional wisdom about the future. For example, you might consider how your organisation would adapt if it was required by regulators to reduce its reliance on carbon-based energy by 30 per cent over the next 10 years; how a food producer would respond to temperature changes that led to insects that damage crops moving into habitats that affect production; or how an insurance company would cope with a 50 per cent increase in extreme weather events.

This type of analysis could benefit preparers, by helping their organisations to understand the strategic implications of climate-related risks and opportunities, and investors, by providing information about how an organisation is positioning itself in response to those risks and opportunities.

This may also be an area in which there is scope for sector synergies: organisations within a particular sector coordinating their scenario analysis, using the same scenario approach so that their data are comparable.

The Task Force acknowledges that scenario-based climate assessments are still in their infancy, although some sectors—insurers in particular—have some experience in using them. This is an area of corporate disclosure that seems suited to complementary filings, outside the 'mainstream financial filings' of an organisation. Disclosure in such filings may be the ultimate goal, but disclosure outside the annual report and securities filings (e.g., website, sustainability report) is a useful step on that path.

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Materiality and proportionality

In assessing how to present climate-related financial information in an annual report it is important to ensure that the information presented is proportionate to the particular circumstances of your entity and material to investors.

Proportionality

Climate-related risks and opportunities affect businesses in different ways. And they are not likely to be the only risks and opportunities affecting a particular business.

It is important that the annual report deals with these different factors in a balanced and proportionate manner. The level of content and emphasis should reflect your assessment of how important climate-related matters are to your business and how much attention you have given to considering the implications.

Materiality

In preparing an annual report you will be making assessments about what information is material to the people who rely on that report. At the heart of this assessment is a focus on the users of the financial information, and that you need to decide what information will be important to your users. That in turn requires a good understanding of the characteristics of your primary users and of the types of decisions they will be making on the basis of the information.

We have proposed a general materiality ‘judgement framework’:¹²

- Understand who your *primary users* are and the types of *decisions* they will use the financial report to help them make.
- Identify the information that is likely to be *relevant* to those users and, from this information set, work out what is *material* to them.
- *Present the information* in a meaningful way that emphasises those matters that are likely to be of most interest to the primary users.
- *Step back* and review the complete financial report.

Assessing climate-related information is no different, and involves identifying what information is likely to be relevant to your primary users. As with other information in an annual report, climate-related financial information is likely to be material if it has been discussed by the Board and/or the audit committee during the period.

Echoing Mark Carney’s ‘tragedy of the horizon’ speech, we agree with the Task Force’s caution that organisations should not “prematurely [conclude] that climate-related risks and opportunities are not material based on perceptions of the longer-term nature of some climate-related risks.”¹³

Assurance

The credibility of information is enhanced when it has been audited or assured independently.

Some climate-related financial information will be audited because it sits within the financial statements. Financial reporting standards require consideration of contingencies, asset impairments and other matters that can be affected by climate-related matters. For example, assets can be impaired if Government regulation prevents or reduces activities, or consumer preferences reduce demand, because of climate-related concerns.

It is less common for organisations to seek independent assurance over matters reported outside of the financial statements. We have not observed a demand for management commentary or narrative reports to be audited. There are also particular challenges in assuring forward-looking qualitative information, or quantified information for which there are not accepted standards. However, as this type of information becomes more consistent and is based on more robust data, preparers and users may seek assurance over specific aspects of it.

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Corporate Governance

Consistent, credible, reliable information about climate-related risks can be critically important to users.

Directors and senior management are responsible for providing a “full, accurate and timely disclosure of financial results, risk and other information which is material to investors’ decisions.”¹⁴ Investors use a broad set of information about how a company does business and whether its operating model is sustainable, and how it is managing (and mitigating) risks and opportunities associated with emerging policy areas, including climate change.

When climate-related risks and opportunities are material to the understanding of an organisation’s financial position, financial performance and cash flows, its business model, risk management strategies and its ability to continue to create long-term economic value, they should be discussed in an organisation’s securities market filings.

A corollary of this is that when climate-related financial information is published in securities market filings, appropriate controls governing the production and disclosure of that information are necessary. In other words, the governance processes for these disclosures would be those used for existing public financial disclosures and would likely involve review by the chief financial officer and audit committee, as appropriate.

The Task Force has linked its Recommendations to the requirements under many securities market regulations to discuss significant risks facing an organisation, how those risks are managed and the mitigation processes and opportunities in place. This avoids regulatory rule-making by competent national authorities in the short to medium term.

The Task Force has proposed a framework to enhance the relevance, consistency and reliability of the climate-related financial information that allows incremental improvement and encourages evolution. This is an approach we have seen in other areas of corporate reporting, for example in the work of the International Integrated Reporting Council and the Sustainability Accounting Standards Board.

Summary

There are many uncertainties associated with climate-related change. There are uncertainties about how, and the extent to which, the climate is changing. There are uncertainties about how different Governments will respond to the Paris Agreement. And there are uncertainties about what information should be measured and how. This makes it difficult to assess how these factors are likely to affect an individual business.

The Task Force, has contributed to the thinking about these matters, and how businesses can provide information about climate-related risks, and opportunities.

The Task Force acknowledges that 'widespread adoption of the recommendations will require the ongoing leadership by the G20,¹⁵ the FSB and others – including stock exchanges, investment consultants, and credit rating agencies.

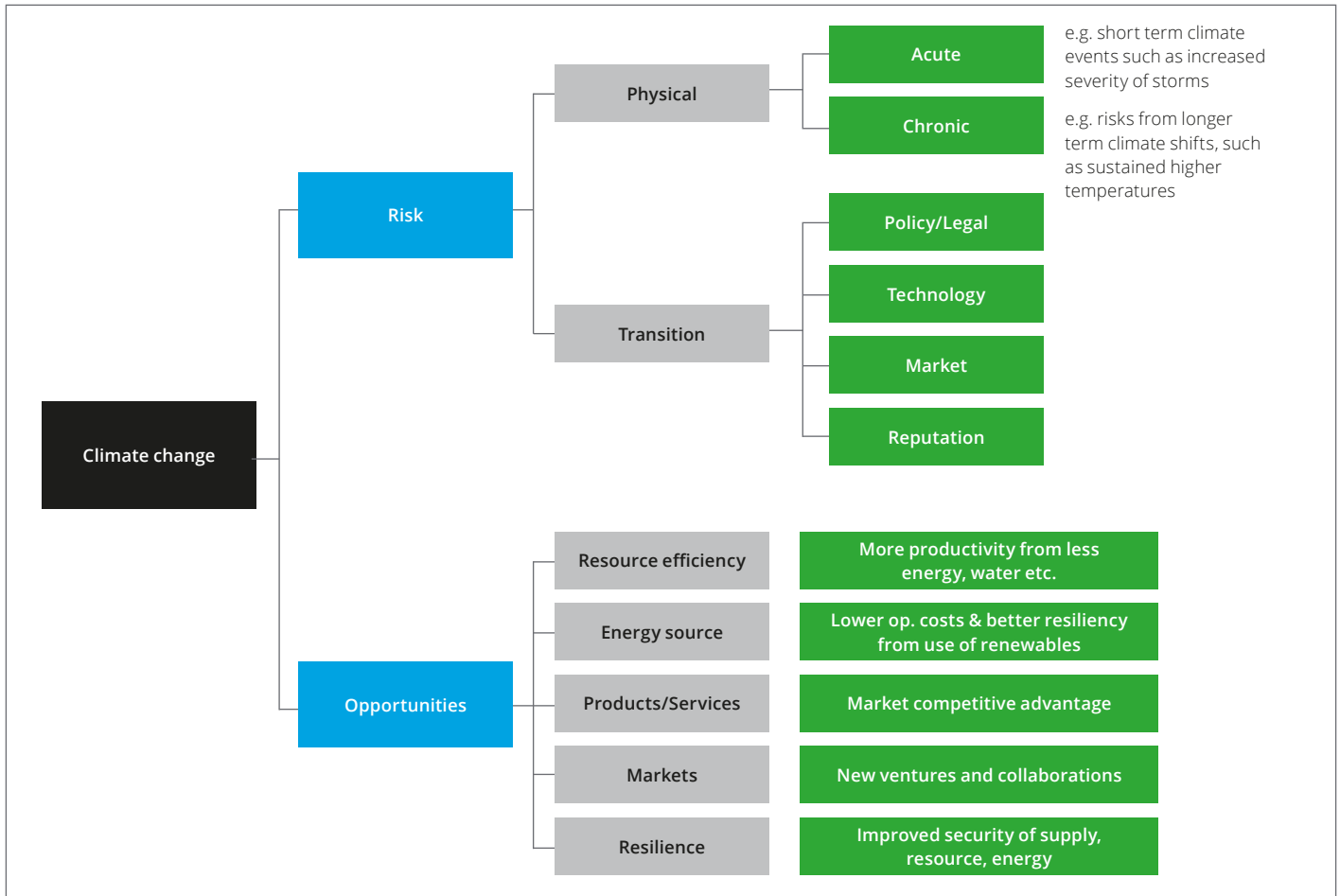
As a market-led initiative, the active involvement of directors and senior management of preparer organisations is critical, as is recognition by the primary users that the information provided is relevant and useful. For now, if climate-related risk is a known and material risk to an entity, its directors and senior management should already be providing information about those risks to investors.

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Appendix

Climate-related risks and opportunities

The main climate-related risks and opportunities that organisations should consider can be depicted in the following way:



Endnotes

1. TCFD, Recommendations of the Task Force on Climate-related Financial Disclosures (14 December 2016). Available at www.fsb-tcfd.org/publications
2. Deloitte, Thinking Allowed: The future of corporate reporting (2016).
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11. Recommendations, Section E.7
12. Deloitte, Thinking Allowed: Materiality (2015)
13. Recommendations, E.2
14. IOSCO: Objectives and Principles of Securities Regulation, No. 16
15. Recommendations, Section F.2

Notes

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