



Reporting climate risk

Connecting you to today's corporate reporting challenges

Climate change is generally accepted to be an urgent risk that entities around the world are already facing. With growing pressure from investors and other stakeholders and increased government action, entities have to take action to consider and provide meaningful and useful disclosure about climate-related risks that could impact the entity and how management are responding to these risks. With the government taking action to mandate specific climate-related disclosures for certain entities, all entities have to consider whether climate risks, and their impact on an entity's financial position, is material information for stakeholders.

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Reflecting climate risk in financial statements

In November 2019, Nick Anderson, a member of the International Accounting Standards Board (IASB), discussed how climate change risks and other emerging risks are captured by existing standards, despite not being referenced directly^[1]. This was followed up with educational material issued by the IFRS Foundation in November 2020 on the *Effects of climate-related matters on financial statements*^[2]. The International Public Sector Accounting Standards Board (IPSASB) staff have also issued a Q&A publication on climate change^[3].

As New Zealand financial reporting standards are based on IASB and IPSASB developed standards, the guidance is also relevant for financial statements prepared in accordance with NZ Generally Accepted Accounting Practice (NZ GAAP).

Impacts to measurement and recognition

The risks and uncertainties arising from climate change are likely to have some impact on the financial statements of all entities, whether directly, or indirectly (through the supply / value chain).

For example, climate change could result in:

- changes to assumptions in forecasts when considering asset impairment, including goodwill,
- effects on impairment calculations because of increased costs or reduced demand,
- changes in the useful life of assets,
- changes in the fair valuation of assets,
- changing availability of future tax profits when assessing recoverability of deferred tax assets,
- changes in provisions for onerous contracts because of increased costs or reduced demand,
- changes in provisions and contingent liabilities arising from fines and penalties,

- changes in expected credit losses for loans and other financial assets, and
- new financing arrangements and terms to be considered.

Forecasts used to assess going concern over a period of at least 12 months from the date of signing the financial statements may also be significantly affected in some cases.

The likelihood and extent of impact will require judgement because there is significant uncertainty as to how much the global temperature will increase, what the impact of different climate change scenarios on an entity's business might be, and how these factors may result in changes to cash flow projections or to the level of risk associated with achieving those cash flows.

Assumptions made will need to be consistent with:

- risk management, strategy and business model disclosure,
- commitments made by the company to investors and other stakeholders,
- commitments made by governments of jurisdictions in which the company operates, e.g., the NZ Government's commitment to 'net zero by 2050' and have a carbon neutral public sector by 2025, and
- other disclosures made by the entity (such as the new proposed climate-related disclosures or other ESG reporting).

Increased disclosure

Investors, regulators, and other stakeholders are also increasingly demanding better disclosures on climate change matters and challenging entities who are not factoring the effects of climate change into their critical accounting judgements.

Accounting standards note that "information is material if omitting, misstating or obscuring it could

reasonably be expected to influence decisions that primary users of general purpose financial statements make on the basis of those financial statements" (NZ IAS 1, with a similar sentiment in PBE IPSAS 1)^[4].

If investors could reasonably expect that climate-related risks (or other emerging risks) will have a significant impact on the entity and this would qualitatively influence investors' decisions, then information on the climate or other assumptions made should be disclosed (if not disclosed elsewhere), including information about the sensitivity of those assumptions. Such disclosure may be necessary, even if the effects of climate change on the entity are not expected in the short term.

IFRS Practice Statement 2: *Making Materiality Judgements* provides guidance and examples that help preparers in making materiality judgements^[5].

Observations

Some entities may consider that climate change is a long-term issue and not relevant to current decision making. However, investors globally are making it clear that climate risk information, along with other ESG risks, are important to their decision making and allocation of capital resources. Government actions to incentivise market action on climate change or penalise high carbon activities also bring forward the financial impacts of climate change for many entities.

Directors are also being increasingly held accountable for the entity's climate impacts and actions as noted in the May 2019 *Climate Change and the Law* report issued by Hon Chief Justice Helen Winkelmann, Hon Justice Susan Glazebrook and Hon Justice Ellen France of the Supreme Court of New Zealand to the Asia Pacific Judicial Colloquium where they stated that "Climate change is no longer an ethical issue. As a material financial risk, directors are accountable under care and diligence duties to take account of the financial consequences of climate change..."^[6]

Entities that are not well advanced in considering climate risks will need time to debate and pinpoint the risks that have a material impact on the financial statements, but action needs to be taken now.

Entities should consider both quantitative and qualitative impacts that could influence investor or other stakeholder decisions and start discussing where they are in their journey with those parties.

Consider:

- What would your future cash flow projections look like? (customer demand, increasing costs, changes to cost of capital etc.)
- How and when will your existing assets be replaced?
- Do you need to provide now for the cost of future action arising from climate-related risks?
- Can your debtors pay? Make a forward-looking assessment.

Climate scenario analysis, ESG risk evaluations, stress testing, sensitivity analysis or credit risk assessments may be needed to assess the business implications of climate risks and opportunities. How this is disclosed in a way that highlights the important information for investors without overwhelming them with too much data will be important.

Case study

High carbon industries, such as the energy sector, are starting to record significant impairments in the financial statements due to climate change assumptions.

BP provides one example where regulatory and company commitments to transition to a lower carbon economy have led to:

- changing assumptions to the future prices of commodities such as oil and gas impacting on the recoverable amount of property, plant and equipment and goodwill,
- exploration prospects no longer being viable leading to the write off of certain intangible assets, and
- considering whether to bring forward the decommissioning of oil and gas industry assets, which if required, would have increased the present value of the associated decommissioning provisions.

Refer to BP's 2020 Annual Report and Form 20F for more detail ^[7].

“Climate change is no longer an ethical issue. As a material financial risk, directors are accountable under care and diligence duties to take account of the financial consequences of climate change...”

- Chief Justice Winkelman, Justice Glazebrook, Justice France (2019)

Government proposal to mandate climate-related disclosures (CRD)

In April 2021, the New Zealand Government introduced the *Financial Sector (Climate-related Disclosures and Other Matters) Amendment Bill* (the 'Bill')^[8], which proposes mandating the provision of climate-related disclosures by approximately 200 entities.

On release of the Bill, Commerce and Consumer Affairs Minister David Clark said that *"It is important that every part of New Zealand's economy is helping us cut emissions and transition to a low carbon future. This legislation ensures that financial organisations disclose and ultimately take action against climate-related risks and opportunities."*^[9]

'Climate reporting entities' captured by the Bill include:

- listed issuers of quoted equity securities or quoted debt securities (or both),
- large registered banks,
- large licensed insurers,
- large credit unions and building societies, and
- registered managers of investment schemes.

A registered bank, credit union or building society is large if in the two preceding accounting periods, the total assets of the entity and its subsidiaries (if any) exceed \$1 billion. Licensed insurers are large if total assets meet the same criteria, or if the annual gross premium revenue of the insurer and its subsidiaries (if any) exceeds \$250 million. These figures would be with reference to the total assets or gross premium revenue of the New Zealand business for overseas companies.

This Bill follows from previous initiatives that require the public sector to achieve carbon neutrality by 2025. This includes a requirement for Crown agencies to measure, verify and report emissions annually^[10].

Disclosures will need to be made in accordance with climate standards to be issued by the External Reporting Board (XRB), with independent monitoring and enforcement to be provided by the Financial Markets Authority (FMA).

Reporting is expected to be on a 'comply or explain' approach and mandated for reporting in 2023 at the earliest^[14].

Initially, assurance will only be required over Greenhouse Gas (GHG) emissions, and where an entity states that its activities are not materially affected by climate change. Entities are not prevented from having an assurance engagement that covers the whole, or other parts, of the climate statements. Assurance of the GHG emissions will have to be provided by a CRD assurance practitioner, with accreditation to be provided by a CRD assurance body (to be approved by the FMA).

The expectation is that the new reporting standard will build on and align with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD)^[11] as well as other international developments. The XRB plans to issue an exposure draft for consultation in 2022, so, the time for implementation is expected to be short.

Observations

While consideration of climate risks may be new for many entities, we note that there are already some New Zealand entities that are disclosing information based on the TCFD recommendations on a voluntary basis or as part of ESG (environment, social, governance) reporting to meet the principles of the NZX Corporate Governance Code^[13].

Whatever the current state, we recommend that all climate reporting entities do a gap analysis or readiness assessment now as the tight timeframe is likely to be challenging, particularly for GHG emissions data if not already being collected. In our experience, and as illustrated by several case studies in the TCFD knowledge hub, even entities largely aligned with the TCFD recommendations had more to do (as illustrated by the Ørsted case study^[12]).

You can also keep informed by following the XRB's progress on the development of the new standard on their website^[14].

"It is important that every part of New Zealand's economy is helping us cut emissions and transition to a low carbon future. This legislation ensures that financial organisations disclose and ultimately take action against climate-related risks and opportunities."

- Hon David Clark, Commerce and Consumer Affairs Minister

Assurance and climate change

Assurance over financial statements

International Standards on Auditing (New Zealand) (ISA (NZ)) require auditors to identify and assess the risks of material misstatement in the financial statements of the entities they audit and design and perform audit procedures responsive to those risks.

As noted in our earlier article, climate-related events or conditions may be material to the calculation of asset and liability carrying values and may also be material information for disclosure to meet the decision-making needs of investors.

Audit committees therefore need to take action, in order to ensure that:

- there is a robust process in place to identify, assess and manage climate risks,
- the entity has access to appropriate skills and resources to assess climate risks and opportunities in a rapidly developing regulatory landscape, and
- internal controls are implemented that enable the production of quality evidence to support measurement, recognition and disclosure decisions made.

In discharging their responsibility for the integrity of corporate reporting, audit committees have a key role in ensuring that the disclosures represent a fair, balanced and understandable assessment of progress and that the impact of climate change has been adequately reflected in the financial statements.

Assurance over climate-related disclosures

The Government's proposed legislation to mandate climate-related disclosures initially only requires assurance over greenhouse gas (GHG) emissions metrics or where the entity makes an assessment that climate change is not material to its activities.

The benefits of assurance include:

- **Supporting audit committees:** assurance enables audit committees to assess the quality of climate-related disclosures and provides a mechanism to improve and instil market confidence in climate-related disclosures.
- **Stakeholder engagement and confidence:** investors, regulators, customers and employees are increasingly making decisions that factor in climate related pledges. By obtaining assurance, an entity provides a clear message of intent, commitment and confidence to these stakeholders.
- **Strategic and competitive considerations:** in a marketplace inundated with unchecked environmental, social and governance claims and "greenwashing", assurance can provide differentiation, and in the case of sustainable finance, can help with access to broader, economically viable finance options.

Currently assurance options around the TCFD or broader ESG reporting are varied, due to the lack of a global enforcement mechanism or suitable assurance criteria for consistent adoption, but international developments continue to evolve in this area.

For audit committees, it is important to determine what if any assurance is needed, noting that there might be several intermediate steps to take before the information is able to be assured. Engage early with your auditor for support through the process.

The future of assurance

Over time, many organisations have developed standards, metrics, and measurements for various components of ESG matters for voluntary use by entities. Standards such as those established by the Global Reporting Initiative (GRI) are already used in New Zealand.

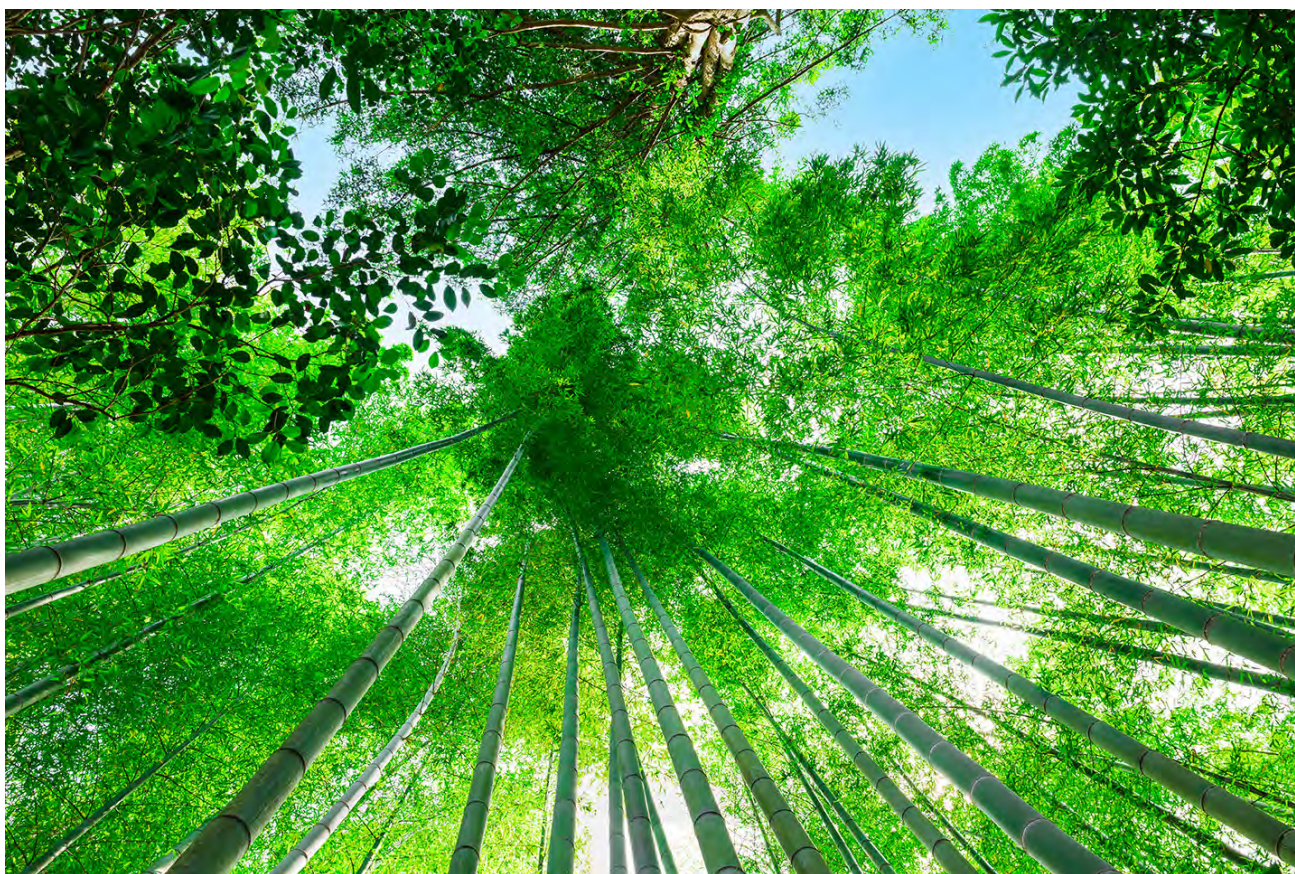
Deloitte supports the International Financial Reporting Standards Foundation's (IFRSF) proposal to establish a Sustainability Standards Board (SSB) alongside the International Accounting Standards Board and under the governance and oversight of the IFRSF. The SSB's aim would be to develop a single set of high-quality, understandable, enforceable and globally accepted sustainability standards which would be used by organisations globally.

The IFRSF has confirmed that the new SSB would build on what is already well-established, including by the five leading sustainability bodies including CDP, Climate Disclosure Standards Board, Global Reporting Initiative, International Integrated Reporting Council and Sustainability Accounting Standards Board.

The International Organization of Securities Commissions (IOSCO) has also committed to work with the IFRS Foundation "*with a view to delivering an effective system architecture for setting sustainability disclosure standards*" ^[15].

What questions should audit committees ask?

1. Has management **appropriately defined and considered** any **material climate-related risks** in preparing the financial statements?
 2. Do the financial statements include suitable **disclosures** where climate risks and their impact on the financial statements are **material information** for investors (either qualitatively or quantitatively)?
 3. Are we satisfied with the **quality of reporting from management on the effectiveness of systems of internal control and risk management** for climate-related risks and how climate change issues are considered when reviewing the company's financial performance, strategy and business plans?
- If the entity is expected to be captured by the proposed legislation mandating climate-related disclosures, or otherwise presents ESG/climate related information:
4. Does management have a plan to undertake a **gap analysis** of current disclosures against the TCFD recommendation (**or a readiness assessment** where there are no current disclosures) and **is there a plan in place** to remediate any gaps?
 5. **Is non-financial information used (or planned to be used) in the climate-related disclosures (or other ESG reporting) reliable and fit for purpose**, and is it produced with the same rigour as financial information?
 6. **What assurance will we require** to support the new climate-related disclosures and/or the adequacy of systems and controls to comply with the new reporting requirements? **Is this assurance sufficiently robust and independent?**



Snapshots of recent developments

New Zealand

Climate Change Commission Final Report

The Climate Change Commission has published its final report ^[16] which was tabled in Parliament in June 2021. The final report details the Commission's recommendations on what paths Aotearoa can take to meet its climate targets.

Government has until 31 December 2021 to set the first three emissions budgets out to 2035 along with a reduction plan detailing the policies that will be used to achieve the budgets.

Government activity

Several government agencies have responsibilities for the environment. Ministry for the Environment has information on key initiatives, and explains who does what ^[17].

You can track the status of the Financial Sector (climate-related Disclosures and Other Matters) Amendment Bill on Parliament's website ^[8].

Deloitte insights

For insights on climate change, refer to our Shaping Change site ^[18].

International

IFRS Foundation Trustees propose amendments to the Constitution

The proposed amendments would enable the creation of a new **International Sustainability Standards Board (ISSB)** under the governance of the Foundation. They also released a feedback statement summarising the main messages they received in response to their sustainability consultation paper ^[19].

You can register to attend a **Webinar** with the IFRS Foundation on 7 July 2021 to find out about the feedback gathered on this consultation and their next steps ^[20].

Strong support for ISSB at IOSCO roundtables, and from G7 Finance Ministers and Central Bank Governors

IOSCO hosted two roundtables in April and May 2021, in order to engage in a dialogue with global stakeholders on IOSCO's priorities to enhance the reliability, comparability and consistency of sustainability-related disclosures and collect views on the practical implementation of a global system architecture for these disclosures. As noted in their report of the key messages ^[15], participants of the roundtables expressed strong support for IOSCO's vision for an International Sustainability Standards Board (ISSB) under the IFRS Foundation.

The G7 Finance Ministers and Central Bank Governors of the G7 have also supported the IFRS Foundation Trustees' initiative on sustainability reporting ^[21].

Other international developments

International developments in sustainability reporting requirements and practices, as well as wider integrated reporting initiatives are fast moving topics. Deloitte tracks these developments on our iasplus website ^[22].

Recent headlines:

- **The International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) have announced their merger** to form the Value Reporting Foundation (VRF).
- **The TCFD is consulting on updates to its final recommendations** on climate-related financial disclosures as disclosure practices and the use of disclosures by financial and non-financial organisations have continued to progress since 2017.
- A new global market-led initiative has set up the **Taskforce on Nature-related Financial Disclosures (TCND)** which aims to provide entities with a complete picture of their environmental risks

and opportunities, building on the success of the TCFD.

- **The International Federation of Accountants (IFAC) has published a revised building blocks approach to reporting sustainability information.**
- **The International Valuation Standards Council (IVSC) has published a second perspectives paper titled *A Framework to Assess ESG Value Creation*.**
- Various standard setters around the world are taking action on climate change – refer to the 6 May 2021 summary of developments.

Deloitte insights

Deloitte's *Purpose-driven Business Reporting in Focus* publications ^[23] provide updates on developments in purpose-driven business practices that are impacting corporate reporting, including progress towards sustainability standards.

Deloitte's publication *A Closer Look – Investor demand for corporate reporting in line with the Paris Agreement on Climate Change* ^[24] provides background on what it means for assumptions to be 'Paris-aligned', including impacts for financial reporting with reference to educational material issued by the IFRS Foundation.

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