The Task Force on Climate-Related Financial Disclosures

A Happier Horizon

Three months to the Phase II report

In his pivotal speech heralding the formation of the TCFD, Governor Carney indicated that the Task Force's recommendations would be instrumental in navigating the economy and society away from a tragic horizon dominated by the effects of potentially dangerous climate change.

Climate week 2016 sees just three months to go until the Task Force publishes its recommendations in December. The Phase 1 report confirms that the Task Force will focus on recommendations that relate to disclosure in firms' **mainstream financial filings**. This short paper considers what this might mean and how the reporting community could work together to support the successful implementation of climate-related financial disclosure through mainstream reporting channels.

The mainstream report is evolving

The mainstream reporting model comprises the reporting requirements and practices that lead companies to publish the annual packages in which they deliver their audited financial results under the corporate, compliance or securities laws of the countries in which they operate. For many years, it has been the primary source of authoritative information for investors. The standards for the preparation of financial statements are mature and the infrastructure associated with preparation of the mainstream report is normally embedded into corporate practice[1]. However, as societal expectations have changed and environmental as well as economic crises have struck, the mainstream report has evolved to cover more varied subject matter, such as the reporting organization's relationship with the communities in which it works, its environmental record and ethical policies. Whilst financial results were once deemed sufficient to assess corporate performance, it is now increasingly associated with responsible business conduct, sustainable outcomes and creation of shared value. New measures of performance are therefore being developed, such as social impact measurement and most importantly for this paper, indicators of businesses' contribution to and mitigation of climate change.

There is a tension between supporters of new information in mainstream reports and those who argue that new content has made mainstream reports too long which may obscure useful information. Various efforts have been made to address this tension, such as the International Integrated Reporting Council's focus on eliciting "concise" information in integrated reports and SASB's ground-breaking work on materiality. The SEC, the European Securities and Markets Authority and the IASB are all working on disclosure effectiveness projects designed to cut red tape and minimize the disclosure burden. Data capture systems such as CDP's reporting platform, are also likely to be instrumental in facilitating structured delivery and efficient use of information through analytics functionality. In the circumstances, the challenge for the TCFD and for the reporting community will be to determine how best to add more or new information on climate change to mainstream reports without exacerbating the perception of clutter.

Existing mainstream obligations - a cool response so far

In the US, the SEC already requires inclusion of climate change information in mainstream (10-K) reports where it is material. In their February 2010 guidance, which was designed "to remind companies of their obligations under existing federal securities laws and regulations", the SEC specified the sort of information companies should disclose, including:

- the specific risks they face as a result of climate change legislation or regulation that is "reasonably likely to have a material effect on the registrant's financial condition or results of operation";
- the impact on their business (where material) of treaties or international accords relating to climate change, such as the Kyoto Protocol and the EU Emissions Trading Scheme; and
- the indirect consequences of legal, technological, political and scientific development regarding climate change.

Despite the specificity and authority of the SEC's guidance, work by Ceres suggests that the corporate response has been poor. Ceres's 2014 research found that about 40% of S&P 500 companies are silent on the subject of climate change in their mainstream reports, those that do report provide little discussion of material issues and do not quantify impacts or risks, and most S&P 500 companies that disclose via CDP's reporting system provide significantly more information through that channel than in their mainstream reports.

1. Through internal controls, accounting systems, risk registers, governance procedures etc

Implications for the task force: what can we do to make it work?

The US' experience has important implications for the Task Force. The Phase 1 report indicates that they will recommend disclosure of similar content to the SEC and through mainstream reporting channels. If the corporate response to the SEC's guidance has been poor, what can the reporting community do to ensure that the Task Force's recommendations are more actively embraced? **We propose three practical steps that the reporting community, including NGOs, standard setters, framework developers etc, could do to support the TCFD's aim to get climate disclosures into the mainstream report.**

1. Prepare reporting infrastructure

As mentioned above, the mainstream report is the culmination of activity conducted through multiple processes within the company including systems for recording and organizing activity data, ledgers, internal controls, risk registers, governance procedures, supply chain management and so on. External resources and requirements such as international financial reporting and assurance standards also provide structure for mainstream reporting and provide the basis on which consulting firms publish detailed reporting templates illustrating, for example, how consolidated financial statements are to be prepared. Collectively these internal processes and external resources represent detailed "reporting infrastructure", that is the practical tools needed to assemble the type of information suitable for disclosure in mainstream reports and fundamental to the successful implementation of reporting requirements.

The Phase 1 report hinted that the TCFD expects existing infrastructure to be used where possible for climate change and that "such disclosures should be subject to internal governance processes that are the same or substantially similar to those used for financial reporting." The reporting community will need to consider what this means in practice. Whereas financial reporting infrastructure is well developed, it is not always capable of being adapted to non-financial reporting and there is little or no equivalent infrastructure specifically aimed at climate change-related reporting. Hence companies often call for examples of how they should be preparing and presenting information, and for practical advice on what internal processes they should establish for collecting and organizing climate change related information. This could explain in part why Ceres found that S&P 500 companies disclose more to CDP, with its online structure and targeted guidance, than through their mainstream reports. The CDP information request can therefore form a key step of the mainstream reporting process by being the due diligence process through which companies collate and structure information.

In order to support successful implementation of the Task Force's recommendations, the reporting community could work on a practical set of recommendations designed to help companies with the process of gathering and organizing information in preparation for mainstream reporting. Although there is no indication that climate related-financial disclosures recommended by the Task Force will need to be assured, by being presented in the mainstream report, they will at least be read by the financial statement auditor and more sophisticated infrastructure will be required to pave the way for assurance.

2. Practical integration of climate change information into mainstream reports

When the Enhanced Disclosure Task Force made its recommendations, it was able to enhance the existing known and established mainstream-reporting infrastructure for banks. The content elements related to climate reporting (i.e. what should be reported) have developed outside the mainstream-reporting model (to enable voluntary and sustainability reporting). The Climate Disclosure Standards Board has developed a framework for reporting climate change-related information in mainstream reports that draws on relevant aspects of the mainstream reporting model in order to support coherence in reporting. Generally adoption of the framework has had more traction in companies where climate (and other non-financial reporting) is the responsibility of the finance or compliance department and we think that this is indicative of the internal changes that need to take place in order to climate reporting to make it successfully to the mainstream report.

The intentions of climate reporting could be frustrated where they are at variance with existing mainstream reporting requirements. For example, although there are some notable developments in more forward looking requirements for financial information, the mainstream focus is on known liabilities and risks arising from past events, whereas climate risk depends on predictions within the parameters of scenarios that are themselves uncertain. Similarly, if measurable climate risks to physical assets are identified, it does not automatically follow that those assets can be impaired if they are not recognized as assets for financial reporting purposes[2].

Furthermore, if they are to be market-led, the Task Force's recommendations will presumably need to reflect existing widespread market practice on climate reporting where possible. Given the variety of reporting arrangements within the market as illustrated in Appendix 2 of the TCFD's Phase 1 Report, the TCFD might need to identify the common denominators between those arrangements in order to create coherence between existing climate reporting practices and the mainstream reporting model[3]. The CDSB Framework's requirements have been developed to reflect these highest common denominators.

In order to support successful implementation of the Task Force's recommendations, the reporting community could work on practical guidance to show how climate change related financial information could best be incorporated into mainstream reports. Sustainability practitioners who are likely to be involved in the reporting process might not be familiar with the structure, rationale and expectations of the mainstream report, nor where or how information should be presented. The development of templates by the reporting community could prove particularly helpful. The mainstream reporting model (without climate disclosures) is already under review[4] in many jurisdictions. The reporting community will therefore need to think about how best to incorporate climate information into a moving target.

2. See for example CDSB's report on Carbon Asset Stranding Risks. Fossil fuel reserves do not necessarily meet the criteria for recognition as assets on the balance sheet and therefore cannot be impaired. Available at: http://cdsb.net/CASR

3. ACCA & Climate Disclosure Standards Board (2016), "Mapping the sustainability reporting landscape. Lost in the right direction" might help the TCFD to identify common elements in existing corporate sustainability reporting practice. Available at: http://cdsb.cdnf.net/sites/default/files/acca_cdsb_mapping_the_sustainability_landscape_lost_in_the_right_direction.pdf

4. See for example the FRC's roadmap for a disclosure framework "Thinking about disclosures in a broader context". Available at: https://www.frc.org.uk/getattachment/99bc28b2-c49c-4554-b129-9a6164ba78dd/Thinking-about-disclosures-in-a-broader-contex.aspx

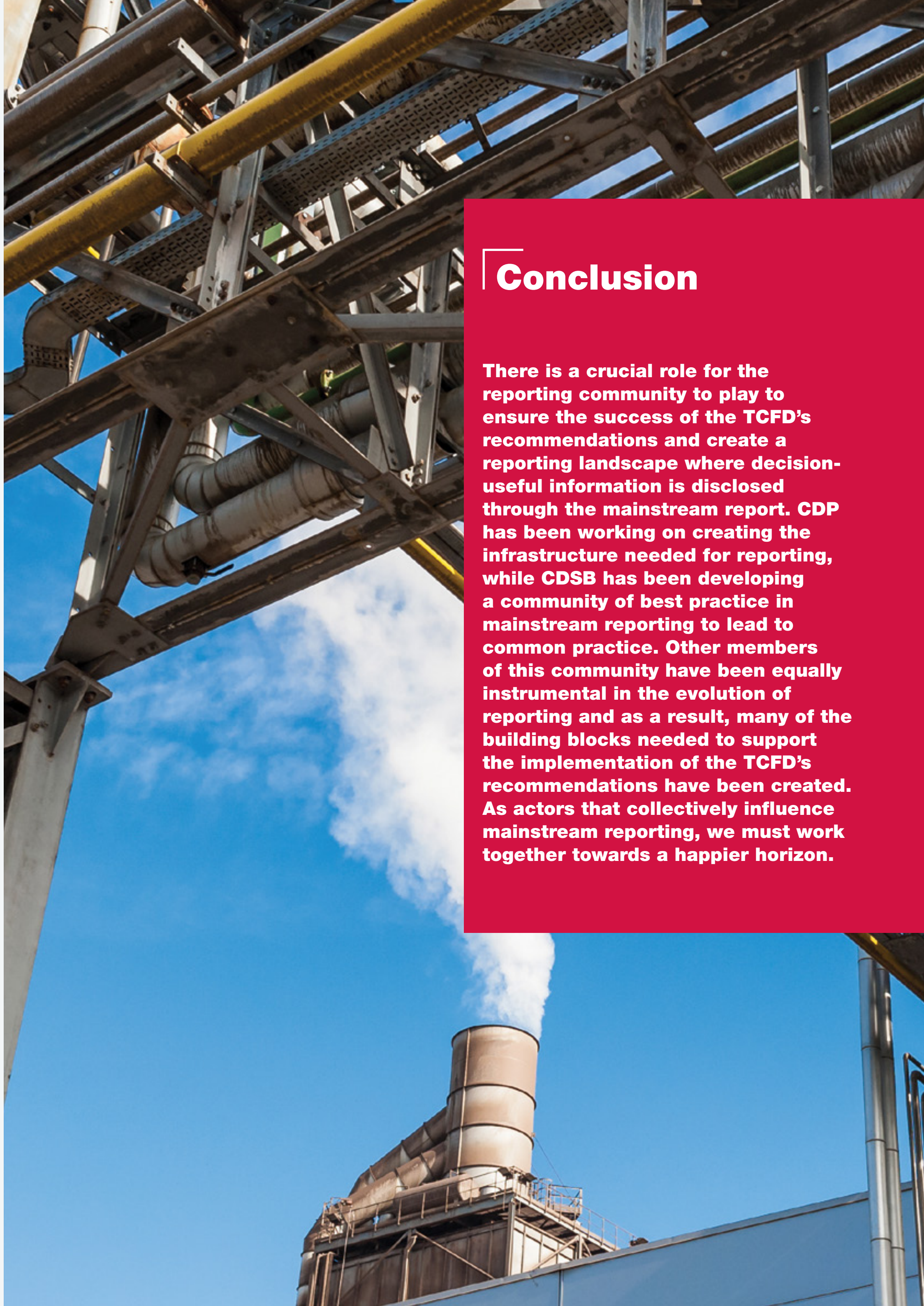
3. Materiality

As noted above, climate risk reporting has not always been successful even where legislators such as the SEC have issued guidance clarifying reporting requirements. One possible reason for this is that management may conclude that climate change does not present material risks over the business time horizons/scenarios they consider. CDSB's research into the FTSE 350's response to UK law requiring disclosure of greenhouse gas emissions and other environmental information found that 44% of companies that did not disclose information cited materiality as the main reason for doing so.

The TCFD's Phase 1 report acknowledges the "considerable disagreement over what constitutes a "material" climate risk that triggers disclosure requirements in most jurisdictions" despite the fact that existing laws already require disclosure of material climate-related risk.. The report also admits that "the divergent range of approaches [to climate reporting] reflects the lack of consensus around what constitutes a material climate risk." This could be partly due to the tension between the definition of materiality for the purposes of preparing financial statements for mainstream reproting – where materiality is "entity-specific" – and the potential application of materiality for climate reporting purposes where it can also be "context-specific".

The Phase 1 report indicates that the Task Force is thinking beyond entity-specific materiality. It acknowledges that as well as helping market participants to understand how companies are considering and managing climate-related risks, climate disclosure has the potential to reveal underlying system-wide exposures. This suggests that climate change-related information might be regarded as material for the purposes of the TCFD's recommendations because at aggregate or system wide level it has a material impact on the climate and therefore affects the context in which management and the company's stakeholders assess corporate performance and prospects. The Phase 1 report says that this category of information should be reported on where it has attracted investor or market attention if only to explain that the company has considered the risk and not just ignored or overlooked it.

The reporting community can help drive this forward by developing guidance that helps companies to distinguish between reporting content that is material to the performance and prospects of the reporting company (i.e.: entity-specific information); and reporting content that is material at aggregate/system-wide level.



Conclusion

There is a crucial role for the reporting community to play to ensure the success of the TCFD's recommendations and create a reporting landscape where decision-useful information is disclosed through the mainstream report. CDP has been working on creating the infrastructure needed for reporting, while CDSB has been developing a community of best practice in mainstream reporting to lead to common practice. Other members of this community have been equally instrumental in the evolution of reporting and as a result, many of the building blocks needed to support the implementation of the TCFD's recommendations have been created. As actors that collectively influence mainstream reporting, we must work together towards a happier horizon.

Climate Disclosure Standards Board

DRIVING SUSTAINABLE ECONOMIES

Contact list

Climate Disclosure Standards Board

Mardi McBrien
mardi.mcbrien@cdsb.net

Lois Guthrie
lois.guthrie@cdsb.net

Mike Zimoniyi
michael.zimoniyi@cdsb.net

CDP
United Kingdom

Jane Stevensen
jane.stevensen@cdp.net

James Hulse
james.hulse@cdp.net

Henry Repard
henry.repard@cdp.net

Brendan Baker
brendan.baker@cdp.net

Tony Rooke
tony.rooke@cdp.net

Tom Coleman
tom.coleman@cdp.net

North America

Lance Pierce
lance.Pierce@cdp.net

Chris Fowle
chris.fowle@cdp.net

Cynthia Simon
cynthia.simon@cdp.net

Agnes Terestchenko
agnes.terestchenko@cdp.net

Gabe Herrera
gabriel.harrera@cdp.net

France, Benelux & Monaco

Laurent Babikian
laurent.babikian@cdp.net

Stephen Tebbe
stephen.tebbe@cdp.net

Italy, Spain & Portugal

Diana Guzman
diana.guzman@cdp.net

Nordic Region

Emma Henningsson
emma.henningsson@cdp.net

Latin America

Juliana Lopes
juliana.lopes@cdp.net

Brazil

Carla Schuchmann
carla.schuchmann@cdp.net

Australia & New Zealand

James Day
james.day@cdp.net

Japan

Michiyo Morisawa
michiyo.morisawa@cdp.net

CEE

Lennart Dahlgrün
lennart.dahlgruen@cdp.net

South Africa

NBI
nbi@cdp.net

China

Sabrina Zhang
sabrina.zhang@cdp.net

Germany, Austria & Switzerland

Susan Dreyer
susan.dreyer@cdp.net

India

Damandeep Singh
damandeep.singh@cdp.net

Hong Kong & South East Asia

Laura Pitkin
laura.pitkin@cdp.net

South Korea

KoSIF
korea@cdp.net

Taiwan

BCSD Taiwan
bcsd@cdp.net

Turkey

Sabanci University
turkey@cdp.net