Climate Disclosure Standards Board

Uncharted waters

How can companies use financial accounting standards to deliver on the Task Force on Climate-related Financial Disclosures' recommendations?

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www.cdsb.net/uncharted-waters

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Introduction

Doubt about what the future holds characterises our times. Predictions and polls have been proved wrong and people are reeling from the shocks of unexpected results. Now, when collective senses are heightened to unpredictability, and with the effect of uncertain futures, businesses are being asked to think more long-term and to make more future-oriented disclosures in their corporate reports.

One of the main differences between the recommendations of the Task Force on Climate-related Financial Disclosures[1] (TCFD/the Task Force) and current climate reporting practices is the emphasis the TCFD puts on forward-looking information, undoubtedly in response to the Governor of the Bank of England Mark Carney's reference to the "tragedy of the horizon"[2]. Furthermore, the TCFD stresses that their recommendations are designed to result in more quantitative financial disclosures.

According to Governor Carney, *"a mix of forward-looking, and sufficiently granular, qualitative and quantitative information is needed to offer real insight into how climate-related risks and opportunities may impact a firm's existing and future business lines."*

The TCFD issued its final recommendations in June 2017. In this paper we consider what can be learnt from a selection of financial accounting standards and associated materials issued by the International Accounting Standards Board (IASB) to help or inform companies when responding to the TCFD's recommendations, including how they relate to the disclosure of financial and forward-looking or future-oriented information.

While important insights can be gleaned, financial accounting standards and guidance are unlikely completely answer questions about how companies should report on the potential future and financial implications of climate change. They are complementary to other useful resources available to inform responses to the TCFD's recommendations. Those resources include guidance on internal processes such as enterprise risk management (ERM) frameworks and practices, management tools such as science-based targets and external reporting resources such as the IASB's Management Commentary guidance.

We focus here on clues and principles in certain financial accounting standards and associated guidance issued by the IASB that give useful insights into how to report climate-related financial information.

An obstacle standing in the way of a smooth and timely market-led adjustment has been the absence of quality information on climate-related financial risks and opportunities[3]. We know that the TCFD's recommendations are designed to overcome this challenge and to elicit, amongst other information, quantitative financial disclosures for an audience of investors and other financial market participants (see Box 1).

We also know that standards and associated guidance have a role to play in wider policy and technological change.[4] Standards and guidance designed to elicit decision-useful information for investors have traditionally been the domain of financial accounting standards, so they seem a good place to start in our exploration of resources that could be useful for implementing the TCFD's recommendations. As Lovell says *"whilst the IASB…might seem at first glance to be a rather mundane, unlikely location for conducting climate change research, its innocuous boardroom in central London belies the importance that decisions taken there have for the operation of carbon markets (and of course other markets and business operations) worldwide….For issues such as climate change, relatively new on the scene, a focus on standards is particularly pertinent because new climate change policies, carbon commodities and ways of measuring greenhouse gas emissions must all somehow fit with standards that already exist."*

In this paper we:

- Summarise the Task Force's final recommendations on future-oriented climate-related financial disclosures;
- Identify financial accounting standards and other mainstream reporting materials that could aid companies in responding to various aspects of the TCFD recommendations; and
- Consider what more needs to be done and how to align the TCFD core elements and recommended disclosures with existing financial accounting standards and materials.

Financial accounting standards for climate reporting

Integrating climate-related financial disclosure with financial accounting standards and other existing reporting models

The TCFD has acknowledged the contributions of existing standard setting bodies and framework developers in developing its recommendations. For example, across the three reports that make up the final recommendations, the Task Force makes explicit reference to the Sustainability Accounting Standards Board's (SASB) Technical Bulletin on Climate Risk[5] as well as referring to the work of GRI, CDP, CDSB and others. However, given that the TCFD's recommendations are designed to elicit robust quantitative financial information in mainstream financial filings and that the financial impacts of climate change are to be categorised according to elements of the income statement and balance sheet, it seems appropriate to examine the role of financial accounting standards in climate-related financial disclosures.

The TCFD states that it considered the interconnectivity of its recommendations with financial statement and disclosure requirements (set by the IASB and Financial Accounting Standards Board FASB) to address risks and uncertainties affecting companies.

As noted previously, both the TCFD and financial accounting standard setters seek to elicit information about the financial implications of events and transactions through mainstream reports for investors. The TCFD's comments on accounting considerations are summarised in Box 1. However, there is little or no analysis in the Task Force's final reports about the interconnections between its recommendations and International Financial Reporting Standards (IFRS).

Questions about whether, how and to what extent IFRS and materials issued by the IASB could be used to help with the integration of financial and non-financial information generally have been considered by the IASB itself. In response to a March 2017 staff paper[6], the IASB concluded that, following a consultation on its agenda in 2015/16 the Board had *"not identified…any financial reporting implications of climate change that it believes are likely to require standard-setting over the next five years"* and that there are *"no potential implications [from the TCFD's work] that could lead the Board to amend its current work plan."*

As the emphasis of the TCFD's recommendations is on disclosures being made as part of management commentary or its equivalent, a more fruitful way of proceeding to support the TCFD's recommendations might be for the IASB to revisit its December 2010 Practice Statement on Management Commentary.[7]

This non-binding framework contains guidance on the presentation of management commentary that relates to financial statements prepared in accordance with IFRS.

TCFD's comments on Accounting Considerations

"The Task Force's disclosure recommendations will result in more quantitative financial disclosures, particularly disclosure of metrics, about the financial impact that climate-related risks have or could have on an organization. Specifically, asset impairments may result from assets adversely impacted by the effects of climate change and/or additional liabilities may need to be recorded to account for regulatory fines and penalties resulting from enhanced regulatory standards.

Additionally, cash flows from operations, net income and access to capital could all be impacted by the effects of climate-related risks and opportunities. Therefore, financial executives (e.g. chief financial officers, chief accounting officers, and controllers) should be involved in the organization's evaluation of climate-related risks and opportunities and the efforts undertaken to manage the risks and maximise the opportunities.

Finally, careful consideration will need to be given to the linkage between scenario analyses performed to assess the resilience of an organization's strategy to climate-related risks and opportunities… and assumptions underlying cash flow analyses used to assess asset (e.g. goodwill, intangibles, and fixed assets) impairments."

***Box 1**. Task Force on Climate-related Financial Disclosures (2017) [Online]. Available from https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf*

Management commentary is a narrative report that provides a context within which to interpret an entity's financial position, financial performance and cash flows together with management's explanation of its objectives and strategies for achieving them. It is clear from a comparison of management commentary and the TCFD recommendations that there is much common ground. For example, both require management to explain the company's principal risk exposures (specifically related to climate change in the TCFD's case), changes in those risks, together with information about how management identifies, assess and manages those risks. A follow up staff paper on wider corporate reporting issued in November 2017[8] updates the IASB on developments in wider corporate reporting and notes the publication of the TCFD's recommendations as a "major development." The update also refers IASB Board members to other publications: the guidance on disclosure of non-financial information in response to the European Commission's Non-Financial Reporting Directive (2014/95/EU); the results of the International Integrated Reporting Council's "Framework Implementation" consultation; the work of the Corporate Reporting Dialogue; the publication of a revised version of the Malaysian Code on Corporate Governance; updated guidance from the UK Financial Reporting Council on the Strategic Report; and activity by the Principles for Responsible Investment. The developments are summarised in Appendix C to the November 2017 staff paper, including reference to an earlier version of CDSB's "Uncharted Waters"[9] paper.

Certain themes emerge from these developments such as the commitment by institutional investors to incorporate environmental, social and governance issues into their analyses, support for the concept of integrated reporting, the need to maximise synergies between different reporting frameworks (including the IASB's) and better articulation of the links between financial and non-financial reporting. The staff paper invites the IASB to consider whether any aspects of the developments should be investigated further.

Whatever course of action the IASB takes in response to the review of wider corporate reporting, we contend that there is merit in making a start on exploring potential interconnections between the TCFD's recommendations and IFRS. This paper does not conduct an in-depth analysis, but undertakes a high-level review of principles from financial accounting standards that could prove useful for responding to the TCFD's recommendations. We focus on certain standards set by the IASB that contain relevant principles for companies considering how to implement the TCFD recommendations. We focus particularly on accounting aspects of standards and guidance rather than strategic and narrative aspects. The latter are also important in formulating disclosures based on the TCFD's recommendations, but here we consider how enhanced accounting practices can bridge the narrative to the financial aspects of reporting and provide better insights to investors on climate risks.

In writing this paper, we also seek to introduce certain financial accounting concepts to sustainability and corporate social responsibility professionals who might hitherto have been responsible for climate-related disclosures, but will require more familiarity with the mainstream financial reporting model for the purposes of responding to the TCFD recommendations. Generally, the TCFD's report sends out strong messages that climate change-related information should be integrated with and prepared according to existing financial, governance and risks procedures within organizations. CDSB strongly supports this but notes that this is a challenge[10] as climate reporting has developed mostly outside the mainstream reporting model to enable voluntary and sustainability reporting. There is evidence, such as leading research by the World Business Council for Sustainable Development (WBCSD)[11], which reveals a significant discrepancy between the way in which companies identify material risks in their sustainability and mainstream reports respectively. We hope, through this paper, to encourage more discussion about how climate change related information can be incorporated into the existing mainstream reporting infrastructure. The TCFD's recommendations strongly encourage companies to use scenario analysis to inform their strategic and financial planning processes and analyse and disclose how resilient their strategies are to a range of plausible climate-related scenarios. When the TCFD refers to 'forward looking' information to be disclosed on the resilience of business strategies to climate-related risks and opportunities on an organization's businesses, strategies, and financial planning under

different potential future states (including a 2° Celsius or lower scenario), they have not prescribed a time horizon, recognising its context-specific, sectoral and entity-specific nature. However, as pointed out earlier in the reference to the 'tragedy of the horizon' speech, this can require a considerably longer time trajectory than traditionally considered by both companies and investors. Many, including the Task Force, argue that existing provisions in place already require much of the information covered in the TCFD's recommendations, for example provisions requiring disclosure of principal risks (see Box 2). Carbon Tracker's "No Rhyme or Reason"[12] report examines the projections about the financial implications of climate change that were made by US coal companies in 2015 in response to existing US requirements for companies to disclose principal risks. It finds that climate change-related risks were not taken into account in forward planning for a range of reasons, including uncertainty about the impact of risks and lack of regulatory and policy commitment to deliver climate policy targets. Similarly, ClientEarth's complaints[13] to the UK Financial Reporting Council (FRC) identify shortfalls in responses to existing UK requirements and claim that SOCO International Plc and Cairn Energy Plc both failed to adequately disclose climate-related risks to investors. The Task Force's work should encourage companies and others to consider climate change-related risks and opportunities more thoroughly in fulfilling their existing obligations. In the UK, requirements capable of being applied to climate change information appear in the Companies Act 2006. This Act states that companies must provide 'a fair review of the company's business' including a proper account of 'the main trends and factors likely to affect the future development, performance and position of the company's business'; and a proper 'description of the principal risks and uncertainties facing the company'. The reporting requirements inter alia stem from the duty imposed on directors by section 172 of the Companies Act 2006
"to act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole" and in doing so to take account of social, environmental and governance objectives. These requirements are supported by FRC's Guidance on the Strategic Report[15], which provides assistance on the disclosure of non-financial risks and key performance indicators. As of January 2017, the guidance is under review in order to improve the effectiveness of section 172, to incorporate the TCFD recommendations and encourage companies to consider the broader drivers of value that contribute to the long-term success of the company. Longer-term considerations are also to be reported in the "viability statement" required under English law and in which directors must disclose the prospects of the company over a period reflecting its business and investment cycle.

TCFD's comments on existing mainstream reporting requirements

"In most G20 jurisdictions, companies with public debt or equity have a legal obligation to disclose material risks in their financial filings – including material climate-related risks.

The Task Force's recommendations are designed to help organizations meet existing disclosure obligations more effectively."

Box 2, TCFD, Recommendations of the Task Force on Climate-related Financial Disclosures[14]

Applying IFRS standards to climate reporting

The TCFD's recommendations on future-oriented climate-related financial disclosures

The TCFD has made four overarching disclosure recommendations in the core elements of Governance, Strategy, Risk Management, Metrics and Targets respectively. These are underpinned by supporting recommended disclosures.
Recommendation 2 on Strategy contains most of the expectations about what companies should report about future climate-related issues. More specifically, disclosures should describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2° Celsius or lower scenario. Section D of the main report and the Technical Supplement provide further detail on how to apply future-oriented scenarios analysis. The TCFD states that *"one of the Task Force's key recommended disclosures focuses on the resilience of an organization's strategy, taking into consideration different climate-related scenarios, including 2° Celsius or lower scenario… is a key step to better understanding the potential implications of climate change on the organization."*

The purpose of the information is so that investors, lenders and insurance underwriters can undertake robust and consistent analyses of the potential financial impacts of climate change and appropriately assess and price climate-related risks and opportunities. While organizations may choose to disclose on multiple scenarios, it appears that analysis of a 2° Celsius or lower scenario is compulsory when looking at exposure to transition risks, which greatly aids in comparability of disclosures and consistency of reporting. There is also heightened emphasis on the medium to long term time horizons in recognition of the fact that the most significant effects of climate change are likely to emerge over the medium to longer term, coupled with uncertainty in their timing and magnitude.

In this respect, it will also be interesting to see how the financial accounting standards examined below have reconciled this ambiguity of horizons. The Task Force advocates that *"disclosure of organizations' forward-looking assessments of climate-related issues is important for investors and other stakeholders in understanding how vulnerable individual organizations are to transition and physical risks and how vulnerabilities are or would be addressed".* Identifying vulnerabilities stemming from climate-related transitional and physical risks would also be a first step in ensuring how best to identify climate resilience through an organization's governance, strategy, risk management and metrics and targets processes and related disclosures.

Relevant financial accounting standards and IASB materials

Some aspects of financial accounting standards require a focus on information about known liabilities associated with events that have already occurred or that create a present obligation. However, there are some new and updated financial accounting standards that set out requirements on how to deal with future risks, particularly for the purposes of measurement in accounting, and associated disclosures. The purpose of this paper is to open a discussion on whether any of the principles or practices in those standards and other materials are relevant and transferrable to climate-related risk disclosures. The following analysis therefore focuses on financial accounting standards that could be relevant to the way in which the TCFD recommendations are implemented or where parallels can be drawn with the TCFD's recommendations.

Potential applicability of the accounting concept of recognition

Before turning to specific standards, we consider the role of "recognition" in accounting and whether it has any application in climate-related financial disclosures. "Recognition" is an accounting concept that is used for determining whether and how an item (for example revenue, liability or asset) should be incorporated into the financial statements. Generally, a distinction is made between recognised and unrecognised assets and liabilities. The Conceptual Framework for Financial Reporting[16] specifies a two-step process for the recognition of assets and liabilities[18]:

1. Does the item meet the definitions of an asset, liability and/ or economic resource discussed in the Exposure Draft of the Conceptual Framework?

2. Does the item meet the following recognition criteria:

   - It is probable that any future economic benefit associated with the asset or liability will flow to or from the entity; and

- The asset or liability has a cost of value that can be measured reliably.

Recognition criteria, particularly relating to judgements about probable or likely economic benefits have, to date, prompted questions about whether certain assets – including what the TCFD calls *carbon-related assets* – should be recognised for financial accounting purposes. The TCFD's remit is designed to enable stakeholders to "understand better the concentrations of carbon-related assets in the financial sector." The TCFD notes that *"the term carbon-related assets is not well defined, but is generally considered to refer to assets or organizations with relatively high direct or indirect GHG emissions"* and indicates that a potential financial impact of policy and climate-related risk can be the impairment of assets. Our understanding is that impairment generally applies only to recognised assets. CDSB's Discussion Paper, "Proposals for Reporting on Carbon Asset Stranding Risks"[17] considered whether certain oil, gas and mineral reserves are precluded from being recognised as assets because of their failure to meet criteria on future economic benefits and are therefore incapable of being impaired in financial statements. If that is the case, and given that the energy sector is one of the most affected by climate change, we think it is important to explore whether the asset impairment anticipated in the TCFD recommendations is intended to, or can, apply to all assets, including non-exploitable fossil fuel reserves, or only to recognised assets. CDSB's Discussion Paper further notes that the IASB's Conceptual Framework provides for disclosure to be made in the notes to the financial statements even where an asset fails to meet recognition criteria but information about it is relevant to the evaluation by investors of the financial position, performance and changes in financial position of the entity. We believe that these notes could be interpreted as a potential place where a summary of the outputs from an organisation's scenario analysis could be disclosed. Given that this clarification is necessary for financial accounting and reporting purposes, we believe that similar guidance should be treated as applicable or good practice for the purposes of implementing the TCFD's recommendations.

The Conceptual Framework for Financial Reporting is under review by the IASB at the time of writing, but we understand a final version should be published in Spring 2018. The Exposure Draft Conceptual Framework[18] refocuses the recognition criteria on providing relevant information about the asset or liability, and faithful representation about them. The Exposure Draft proposes that criteria should be based on whether recognition provides users of financial statements with relevant information about the asset or liability and any changes in income, expenses or equity. The application of this new approach to climate-related financial disclosure would, presumably, minimise the scope for information about carbon-related assets to be excluded from disclosures simply because those assets did not meet the "old" recognition criteria.

There are several financial accounting standards explored in this paper which may offer insights for helping companies to respond to the TCFD recommendations and recommended disclosures, as outlined below:

- IFRS 7[19] "Financial Instruments: Disclosures";
- IFRS 9[20] "Financial Instruments";
- IFRS 15[21] "Revenue from Contracts with Customers";
- IFRS 17[22] "Insurance Contracts";
- IAS 36[23] "Impairment of Assets"; and

- IAS 37[24] "Provisions, contingent liabilities and contingent assets".

IFRS 7 - "Financial Instruments: Disclosures"

IFRS 7 applies to risks, including credit risks, arising from certain financial instruments. It focuses on disclosures that should be made about those risks because information about exposure to risks and how they are managed can influence a user's assessment of the financial position and performance of an entity or of the amount, timing and uncertainty of its future cash flows. In that sense IFRS 7 aims to elicit information that fulfils a similar purpose to the TCFD's recommendations – that is information capable of warning investors of future risks with the potential to affect the performance and financial position of an organization. IFRS 7 requires disclosures in financial statements that enable users to evaluate:

- The significance of financial instruments for an entity's financial position and performance;
- Qualitative and quantitative information about the nature of risks arising from financial instruments to which the entity is exposed at the end of the reporting period and how the entity manages those risks. Risks from financial instruments typically include, but are not limited to, credit, liquidity and market risks. However, if quantitative data disclosed at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, any entity shall provide further information that is representative

The parallel with the TCFD's recommendations is clear when the words "climate change" are substituted for "financial instruments."

A full analysis of IFRS 7 is beyond the scope of this paper. However, three extracts and principles that seem relevant or applicable to the development of climate-related financial disclosure practice include the following:

- Clarity on the recognition
  IFRS 7 applies to recognised and unrecognised financial instruments. Building on the points made previously, this suggests that recognition criteria cannot be used to exclude information from disclosures under IFRS 7. We suggest that, as the TCFD uses the language of financial accounting (such as assets and liabilities), it would be best interpreted that this reference would both include recognised assets and liabilities, but could also include future assets and liabilities that could be created or recognised in the future. Both current and future assets and liabilities could be explored using scenario analysis, which depending on the data, models and assumptions available could have a cost or value that, one could argue, would be measured reliably.
- Clarity on categorisation
  IFRS 7 sets out how financial instruments are to be categorised or re-categorized as financial assets or liabilities. We believe that the categorisation principles in IFRS 7 could be transferable to climate-related financial disclosure , depending on the time frame of the exposure to risks arising from climate change.. We propose that it would be best to use this interpretation of categorisation in conjunction with an explanation of the circumstances in which it is appropriate to categorise or re-categorise a carbon-related asset as a liability, taking account of how those terms are defined for mainstream financial reporting purposes. A financial asset or liability is recognised as a 'net' asset or 'net' liability as a result of a number of positive and negative assumptions. During the application of scenario analysis or trend analysis, these assumptions can change across a spectrum and as a result what could previously have been a 'net' asset, now becomes a 'net' liability. Under a business as usual scenario, an asset that creates a net financial return, so its held at cost, could under a '2° Celsius or lower scenario' no longer be profitable. Unless already considered elsewhere in the financial accounts , the impairment of the asset (e.g. to zero) must now also have a future clean up cost and therefore turns to a liability. Just as financial instruments have complex built-in assumptions (e.g. market supply and demand, commodity costs or payment guarantees) that can be difficult to quantify and obscure the level of risk or opportunity within assets and liabilities, it appears that this could equally apply to climate change and scenario analysis for carbon-related assets.
- Sensitivity analysis
  As noted previously, one of the main differences between the TCFD report and existing climate-related reporting requirements is that disclosures on strategy should describe the impact of different scenarios, including a 2° Celsius or lower scenario on the organization's businesses, strategy and financial planning. The TCFD

invites organizations embarking on this to "conduct various sensitivity analyses around key climate factors as a precursor to scenario analysis". There is a brief explanation of the distinction between sensitivity and scenario analysis in the TCFD Technical Supplement. Given that sensitivity analysis is suggested by the TCFD as a precursor to scenario analysis, it might prove a popular starting approach for management for whom scenario analysis, particularly its application to climate change, is likely to be very new. The TCFD does not offer any explanation as to how sensitivity analysis might be conducted, but the relevant provisions in IFRS 7 might offer some insight. We do not examine the application of sensitivity analysis to financial instruments here. However, we note from mandatory application guidance that the entity should consider the timeframe over which it analyses sensitivity and should show the effect of changes that are considered to be reasonably possible over the period until the entity will next present disclosures, which is usually its next annual reporting period. This principle could be transferable to sensitivity analysis on climate-related risks and opportunities.

IFRS 9 – "Financial Instruments"

The new standard IFRS 9 "Financial Instruments" contains wide ranging and notoriously complex provisions on accounting for financial instruments at various stages in the life of those assets. IFRS 9 replaces IAS 39, which provided that impairment or credit losses and the resulting write-downs in the reported value of financial assets, could be recognised only when there was evidence that they had been incurred or an event had been identified. In other words, recognition depended on past and known events. IFRS 9's impairment requirements use more forward-looking information to recognise expected credit losses.

The measurement of expected credit losses associated with a financial instrument is to be based on "reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions". IFRS 9 describes how certain financial instruments should be impaired to recognise lifetime expected credit losses "considering all reasonable and supportable information, including that which is forward looking."

The standard also provides guidance on how far reporting entities should look into the future for this purpose:

"the objective of the impairment requirements is to recognise lifetime expected credit losses... considering all reasonable and supportable information, including that which is forward-looking (IFRS 9.5.5.4)... When measuring expected credit losses, an entity need not necessarily identify every possible scenario. However, it shall consider the risk or probability that a credit loss occurs... even if the possibility of a credit loss occurring is very low".

It is expected the EU Commission will issue a review of the IFRS 9 standard later this year. We hope the review will consider how IFRS 9 can be strengthened to support climate-related disclosures. In its current form, we think that two relevant points emerge for climate-related disclosure:

- A financial instrument has a defined life, which in turn affects its value. For the purposes of IFRS 9, it is clear that the future extends only so far as the life of the financial instrument. Generally, there is no equivalent defined period over which climate risks should be assessed and determining the "horizon" for reporting is therefore difficult. For carbon-related assets, we consider that TCFD recommendations are best interpreted if the assessment of future risk is linked to the whole of the expected life of that asset. This is implied already in the TCFD's work. However, this type of asset-specific forward-looking assessment should be distinguished from sensitivity analysis and scenario analysis aimed at testing the long-term resilience of the organization's business model and strategy;
- IFRS 9 requires entities to consider the risk of credit loss even if the possibility of a loss occurring is very low. We think that the Task Force tries to convey a similar message when it *"cautions organizations against prematurely concluding that climate-related risks and opportunities are not material based on perceptions of the longer-term nature of some climate-related risks."* . However, rather than consign this message to "areas for further work", we think the TCFD is best interpreted if companies were to adopt language from IFRS 9 when taking account of possible future financial impacts from climate change.

IFRS 15 – Revenue from Contracts with Customers

The relevance of mentioning IFRS 15 here is that is shows the accounting model moving towards the core principle that an entity should recognise revenue "to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services".

In very broad terms, on long term contracts with on-going performance obligations, revenue would be recognised once the good/service has crystallised. It is interesting to compare the recognition of revenue over time. Arguably, a positive outcome is spread out, whereas in the treatment of an onerous contract, a negative outcome should be provided for immediately.

We recognise that the principles concerned might not be directly transferable to climate change-related financial impacts. However, they raise questions about when and how a quantifiable climate-related financial impact should be taken into account as a potential liability – and therefore recognised or not – or as an input into the valuation of assets?

IAS 36, Impairment of Assets, and IAS 37, Provisions, Contingent Liabilities and Contingent Assets

The TCFD final report refers to both of these accounting standards as being relevant to addressing risks and uncertainties affecting companies. IAS 36 describes the way in which companies should identify whether and how impairment (or reversal of impairment) of certain assets[25] is required. Briefly, impairment of assets applies where their value on the balance sheet[26] (sometimes known as book value) exceeds the "recoverable amount", i.e. the higher of the amount for which they could be sold or transferred to another party and the present value of future cash flows expected from the asset. Where this is the case, the reporting entity is required to recognise an "impairment loss". This is relevant for climate-related disclosure because the value of assets, including what the TCFD calls carbon-related assets, could be overstated in company accounts where that valuation does not take account of the way in which it could be affected by climate change. For the purposes of IAS 36, at the end of each reporting period management is required to assess "whether there is any indication that an asset may be impaired." If there is such an indication[27] management has to estimate the recoverable amount of the asset.

For the purposes of assessing whether there is any indication that an asset may need to be impaired, management needs to take account of various factors, including:

- External sources of information such as observable evidence that the asset's value has declined more than would normally be expected, or changes in the technological, market, economic or legal environment that have already - or might in the near future - adversely affect the entity; and
- Internal sources of information, for example known or expected (in the near future) changes that suggest the use of the asset or the operation to which it contributes might restructure or cease.

There are obvious parallels with the way in which the TCFD recommendations are designed to help investors understand how climate-related risks and opportunities are likely to impact organizations' future financial position as reflected in its income statement, cash flow statement and balance sheet. Whether and to what extent those deliberations will result in impairments according to IAS 36 is not clear, particularly when risks to physical assets are identified but those assets are not recognized for financial reporting purposes. In other words, how can companies be encouraged to impair assets when they are not required to do so under existing financial reporting standards?

IAS 37 Provisions, contingent liabilities and contingent assets

The use of the word "likely" in the TCFD's final Report has led CDSB's Technical Working Group members to suggest that there might be helpful material in IAS 37 which defines an event as being probable if it is more likely than not to occur. IAS 37 "deals with the financial position of an entity at the end of its reporting period and not its possible position in the future". However, it goes on to state, *"an event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation."*

We interpret this to mean that current obligations can be regarded as arising and must be accounted for when changes in the law or public pronouncements are sufficiently evident to give rise to the obligation. There is an obvious parallel here with pronouncements about climate change through the Paris Agreement, although it is not yet clear whether this is sufficient to require entities to apply IAS 37 to account for contingent financial impacts of climate change. For example, the potential loss of revenues, stocks or contracts in target sectors under different climate scenarios at the regional level, especially in the agri-business, water sector and associated financial services.

IAS 37 contains useful information on how to deal with risk, uncertainty and provisions on what should be disclosed about contingent liabilities, even where the outflow of resources to settle an obligation is remote (as it might appear to be in the case of climate change). In particular, entities are required to provide a brief description of the nature of the contingent liability, and where practicable an estimate of its financial effect and an indication of the uncertainties relating to the outflow of resources to settle the obligation.

There are obvious parallels with the way in which the TCFD recommendations are designed to help investors understand how climate-related risks and opportunities are likely to impact organizations' future financial position as reflected in its income statement, cash flow statement and balance sheet. Whether and to what extent those deliberations will result in impairments according to IAS 36 is not clear, particularly when risks to physical assets are identified but those assets are not recognized for financial reporting purposes. In other words, how can companies be encouraged to additionally consider the disclosure of impaired assets when they are not required to do so under existing financial reporting standards?

IFRS 17 – Insurance Contracts

Relevance of financial accounting standards to climate-related financial disclosure

IFRS 17 is effective for annual reporting periods beginning after 1 January 2021 and the full standard is not available publicly until early 2018. However, its potential relevance to the TCFD recommendations is that it deals with the measurement of future cash flows associated with long-term insurance contracts. It shares with the TCFD recommendations an objective to increase transparency in financial information so as to give investors and analysts more confidence and better understanding of transactions. The focus of IFRS 17 is on "difficult to measure, long-term and complex risks with uncertain outcomes."[28] IFRS 17 therefore deals with how companies report on their balance sheet the fulfilment of cash flows and takes account of changes in the economic environment and other risk exposures.

Conclusions

There is clearly much material in financial accounting standards of potential relevance to the way in which companies prepare climate-related financial disclosures. This paper shows that

Areas of further work

We believe that to support organisations in integrating financial and non-financial information, there are some clear action areas to continue exploring in collaboration with other organisations.

First, we suggest exploring how the information disclosed by companies following the TCFD should conform with the prescriptions of existing financial accounting standards. This includes the way in which assets and liabilities are categorised, when and how future obligations are treated as crystallising, and when and how liabilities should be accounted for.

Impairment of assets, as anticipated by the TCFD, could be conducted according to IAS 36. In that case, we believe there is value in exploring whether and how the TCFD's recommendations add to, change or simply amplify financial accounting practices already adopted by companies.

The TCFD is also expecting assessments to take place over longer time frames than currently indicated in financial accounting standards. Understanding how the timing over which liabilities, write-downs and impairment is assessed for TCFD disclosures could help create comparable information.

• How, in practice, internal finance departments and external accountants will interpret, integrate and act on the TCFD's recommendations;

We are also interested in exploring whether there is merit in distinguishing between :

Financial impacts of climate change that require disclosure under existing financial accounting standards;

Potential financial impacts of climate change that, whilst not catered for in existing financial accounting standards, should be taken into account for disclosure purposes and/or financial planning over the reporting organization's normal planning horizons;

Potential financial impacts over longer time horizons as identified by reference to sensitivity analysis and scenario analysis, together with what should be disclosed about such impacts, to prove business model resilience or capital adequacy under particular scenarios rather than for the purpose of requiring asset impairment or recognition of liabilities; and

Sector-focused impacts. In the same way that the Financial Stability Board identifies Global Systemically Important Banks, we propose there is merit in identifying sectors most likely to be affected by financial impacts from climate change and ask them to report on financial impacts likely to affect those sectors;

This paper focuses on a specific set of standards, but there might be other standards and practices to draw upon. For example, IAS 1 "Presentation of Financial Statements" requires the reporting entity to disclose a summary of the significant accounting policies, measurement basis or bases and other accounting policies used that are relevant to an understanding of the financial statements.

Additional guidance

While the TCFD clearly points to the relevance of financial accounting standards and the role of financial executives in responding to their recommendations, some (or all) climate-related financial information will feature in other parts of the mainstream report, particularly management commentary, including those sections relating to risk and governance. We are intending to consider the integration of climate change into risk management practises at a later date.

As well as overlaps with management commentary reporting guidance, CDSB notes that the TCFD recommends:

- Climate-related disclosures to be subject to internal governance processes that are the same or substantially similar to those used for financial reporting."; and
- Disclosures on risk management should describe how processes for identifying, assessing and managing climate-related risks are integrated into the organization's overall risk management.

Therefore, financial accounting standards and guidance are likely to be only one source of information to which companies refer when considering how to respond to the TCFD recommendations. Guidance on risk management and governance will also be relevant but is not addressed here.

Invitation to comment

CDSB is fully supportive of climate-related management and disclosure practices being integrated into existing mainstream internal processes and external reporting. However, this paper and our other research reveals a significant challenge in achieving such integration because it is not clear whether or how climate-change related information is intended to conform with existing mainstream internal processes and external mainstream reporting practice. Through this paper, we seek to highlight some of the opportunities for learning from, adapting and conforming with multiple aspects of financial accounting and mainstream reporting practice.

However, we also expose challenges and invite relevant institutions to help address them. There is clearly more insight to be gleaned from financial accounting standards, but in considering the future and trying to outline the situation, this paper has raised further questions.

We are particularly interested in hearing from companies about how they intend to go about integrating climate change-related risk assessment, management, financial planning, reporting etc. into their existing practices. We are also interested in hearing from investors to ensure that any changes to company reporting practices in light of the Task Force recommendations yield decision-useful information for them.

CDSB welcomes discussion about and input to our work.
If you would like to comment on this paper, please contact us at info@cdsb.net.
For further information, please consult www.cdsb.net.

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27 Impairment can apply to individual assets or to "cash generating units." An asset's cash generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash flows. The example given in IAS 36 relates to a private railway used by a mining company. The private railway could be sold only for scrap value and does not generate cash inflows that are largely independent from other assets of the mine and therefore impairment testing applies to the mine as a whole.

28 Strictly, their "carrying amount" being the amount at which the asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

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Invitation to comment

CDSB welcomes discussion about and input to our work. If you would like to comment on the positions above or on the CDSB Framework, please contact us at info@cdsb.net. For further information, please consult www.cdsb.net.

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