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Disclosing Climate-Related Matters in **Financial Statements**

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Climate Change's $150 Billion Hit to the U.S. Economy

Consequences will worsen unless more is invested in clean energy and cities adapt to changing environments, a federal report finds

By Amrith Ramkumar Follow

Nov. 14, 2023 5:00 am ET

Would you be interested to know how the impacts of climate change are reported in financial statements?

All companies face climate-related risks and opportunities, with varying levels of impact. In today's era of unprecedented environmental challenges, the imperative for transparency regarding climate-related matters has surged. With climate change impacting various industries, investors and regulators now demand increased transparency and relevant information in the financial statements regarding how a company's financial position and performance have been affected by climate-related challenges.

It is crucial for companies to deeply understand their business environments and operations to assess the potential impact of climate-related risks on their financial statements. The objective is to grasp both current and future challenges about climate risks.

Climate Change and Malaysian Financial Reporting Standards (MFRSs)

Currently, there is no specific MFRS dedicated to climate change. While climate-related risks are not covered explicitly by MFRSs, the accounting standards do encompass issues about them. Therefore, it is essential to reiterate the existing MFRSs concerning the reporting of climate-related matters in financial statements.

In July 2023, the IFRS Foundation republished its educational material "Effects of Climate-Related Matters on Financial Statements" to remind financial statement preparers to report on the effects of climate-related matters when those effects are material (in the context of the financial statements taken as a whole) in complying with the disclosure requirements of IFRS Standards (equivalent to MFRSs). The educational material highlighted a non-exhaustive list of IFRSs that may require companies to consider the effects of climate-related matters in applying the principles in the said accounting standards. The potential financial implications arising from climate-related risks may include, but are not limited to:

- Asset impairment
- Changes in the useful life of non-financial assets
- Changes in the valuation of assets
- Effects on impairment computations
- Creation of and changes in provisions for onerous contracts;
- Changes in provisions and contingent liabilities arising from fines and penalties
- Changes in expected credit losses for debt financial assets.

Please click to access Effects of Climate-Related Matters on Financial Statements on the International Accounting Standards Board (IASB) website.

Financial Reporting Considerations

The diagrams below set out some disclosure requirements in MFRSs about climate-related risks when the effect is material in the financial statements:-

MFRS 101 'Presentation of Financial Statements'

Sources of Estimation Uncertainty and Significant Judgements

If assumptions a company makes about the future pose a significant risk of leading to a material adjustment in the carrying amounts of assets and liabilities reported in financial statements, MFRS 101 requires disclosing information concerning those assumptions as well as the nature and carrying amounts of said assets and liabilities. This means disclosure of assumptions about climate-related matters might be necessary, for example, when such matters create uncertainties that affect assumptions used for estimating future cash flows during asset impairment testing or determining the best estimate of expenditure needed to fulfill decommissioning obligations.

In addition, MFRS 101 requires the disclosure of significant judgement (apart from those involving estimations) that have a significant effect on the amounts recognised in the financial statements.

Additional Information not Specifically Addressed in MFRSs

MFRS 101 requires the disclosure of material information that is not specifically required by MFRSs and is not presented elsewhere in the financial statements but is essential to an understanding of the financial statements.

Going Concern

A company is required to evaluate its ability to operate on a going concern when preparing its financial statements. Climate-related matters may create material uncertainties that cast significant doubts about a company's ability to sustain operations as a going concern. MFRS 101 requires disclosure of those uncertainties.

Financial Reporting Considerations (cont.)

The above MFRS disclosure requirements (IFRS equivalents) are illustrated below:-

YouGov plc (2023)

Principal Accounting Policies of the Consolidated Financial Statements [extract]

Consideration of climate change [extract]

In the Strategic Report, we report the energy and carbon disclosure and measure to limit the increase (pages 58 to 59). We are a naturally low-emission business and, therefore, there is limited climate change-related risk. In preparing the financial statements, the Directors have considered the impact of climate change and concluded that there has been no material impact identified on the financial reporting judgements and estimates. In particular, the Directors considered the impact of climate change in respect of the following areas:

- Revenue recognition for long-term contracts
- Going concern and viability of the Group over the next three years
- Cash flow forecasts used in the impairment assessments of non-current assets including goodwill and other intangible assets
- Carrying value and useful economic lives of property, plant and equipment
- Valuation of assets held within the Group's defined benefit pension scheme

While there is currently no medium-term impact expected from climate change, the Directors are aware of the ever-changing risks attached to climate change and will regularly assess these risks against judgements and estimates made in preparation of the Group's financial statements.

Financial Reporting Considerations (cont.)

The above MFRS disclosure requirements (IFRS equivalents) are illustrated below (cont.):-

Young & Co.'s Brewery, P.L.C. (2023)

Note 2 Basis of preparation [extract]

In preparing the group financial statements, management have considered the impact of climate change, taking into account the relevant disclosures in the strategic report. This included a review of both physical climate risks and transitional climate risks, taking into regard recommendations issued by the Taskforce on Climate-related Financial Disclosures. In particular, assets with indefinite or long lives were assessed for impairment by taking into account global warming. No issues were identified that would impact such assets carrying values or have a material impact on the financial statements and is not expected to have a significant impact on the group's going concern assessment to May 2023, nor the next five years.

Note 1 General information [extract]

Going concern [extract]

The group has also considered the impact of climate change on going concern and has determined that there is no impact on the business during the going concern period. Aligned with the group's developing ESG strategy this will continue to feature in future assessments, as the group determines the potential wider impact on the asset base, capex spend and cost of compliance.

Based on these forecasts and sensitivities, coupled with the current debt levels and the ongoing debt structure in place, the board is confident that the group is able to manage its business risks and therefore continue in operational existence for the foreseeable future. For this reason, the group continues to adopt the going concern basis in preparing its financial statements.

Indofood Agri Resources Ltd (2023)

Summary of material accounting policies information [extract]

Note 2.5 Climate-related matters

The Group considers climate-related matters in estimates and assumptions, where appropriate. This assessment includes a wide range of possible impacts on the group due to both physical and transition risks. Climate-related matters increase the uncertainty in estimates and assumptions underpinning several items in the financial statements that has estimates and assumptions involved. Even though climate-related risks might not currently have a significant impact on measurement, the Group is closely monitoring relevant changes and developments, such as new climate-related legislation.

Financial Reporting Considerations (cont.)

The diagrams below set out some disclosure requirements in MFRSs about climate-related risks when the effect is material in the financial statements (cont.):-

MFRS 116 'Property, Plant and Equipment'

Reassess Residual Values and Useful Lives of Property, Plant and Equipment

Climate-related matters may affect the estimated residual value and expected useful lives of property, plant and equipment, for example, because of obsolescence or legal restrictions on their use. MFRS 116 requires companies to update the estimated residual values and expected useful lives of assets and to reflect the changes in the amount of depreciation reported in the current and future periods.

The above MFRS disclosure requirements (IFRS equivalents) are illustrated below:-

Uniper SE, Düsseldorf (2023)

Note 15 Property, Plant and Equipment [extract]

When determining useful life, energy policy and legal aspects are taken into consideration alongside technical and commercial ones, as are voluntary commitments. Accordingly, especially in coal-fired power plants due to coal phase-out scenarios addressing the challenges of climate change, the actual useful life can be shorter than the technical useful life.

Financial Reporting Considerations (cont.)

The diagrams below set out some disclosure requirements in MFRSs about climate-related risks when the effect is material in the financial statements (cont.):-

MFRS 136 'Impairment of Assets'

Impairment Testing

Climate-related matters may give rise to indications that an asset (or a group of assets) is impaired. For instance, a decrease in demand for products emitting greenhouse gases could indicate that a manufacturing plant may be impaired, necessitating impairment testing for the asset.

In determining the value-in-use for impairment testing, companies are required to calculate cash flow projections based upon reasonable and supportable assumptions that represent the best estimate of future economic conditions. This means companies should consider whether climate-related matters affect those assumptions.

MFRS 136 requires the disclosure of key assumptions underlying cash flow projections and management's approach to determining the value assigned to these key assumptions, in particular, in relation to goodwill or indefinite-life intangible assets.

The above MFRS disclosure requirements (IFRS equivalents) are illustrated below:-

Uniper SE, Düsseldorf (2023)

Note 17 Impairment Testing in Accordance with IAS 36 [extract]

Goodwill and Other non-current assets [extract]

In addition to the growth rates and cost of capital shown in the table, the following key aspects of energy and climate policy and the regulatory environment, including related voluntary commitments, were taken into account when testing other non-current assets for impairment: specifications of the Paris climate accord, the Uniper Group's voluntary commitments to achieve carbon neutrality and legislated coal phase-out scenarios.

In the European Generation segment and CGU, a 50% reduction of Scope 1 and Scope 2 emissions by 2030 (compared with 2019 levels) and climate neutrality by 2035 were applied in the modeling. In the Global Commodities segment, a 35% reduction of indirect (Scope 3) carbon emissions by 2035 (compared with 2021 levels) and climate neutrality (in terms of Scope 1 through Scope 3) from 2050 were planned and modeled.

Financial Reporting Considerations (cont.)

The above MFRS disclosure requirements (IFRS equivalents) are illustrated below (cont.):-

Young & Co.'s Brewery, P.L.C. (2023)

Note 2 Basis of preparation [extract]

In preparing the group financial statements, management have considered the impact of climate change, taking into account the relevant disclosures in the strategic report. This included a review of both physical climate risks and transitional climate risks, taking into regard recommendations issued by the Taskforce on Climate-related Financial Disclosures. In particular, assets with indefinite or long lives were assessed for impairment by taking into account global warming. No issues were identified that would impact such assets carrying values or have a material impact on the financial statements and is not expected to have a significant impact on the group's going concern assessment to May 2023, nor the next five years.

Note 3 Summary of significant accounting policies [extract]

(h) Impairment of assets [extract]

The impact of climate change has been considered as part of the impairment assessment, including both physical and transitional risks. Due to the nature of the group's operations, climate risk is not considered to have a material impact on any CGU's value in use calculation and is therefore not expected to result in any impairment.

Note 18 Goodwill [extract]

The group monitors the latest government legislation in relation to climate related matters. At the current time, no legislation has been passed that will significantly impact the group's impairment review. The group will adjust the key assumptions used in value in use calculations and sensitivity to changes in assumptions should a change be required.

Financial Reporting Considerations (cont.)

The diagrams below set out some disclosure requirements in MFRSs about climate-related risks when the effect is material in the financial statements (cont.):-

MFRS 102 'Inventories'

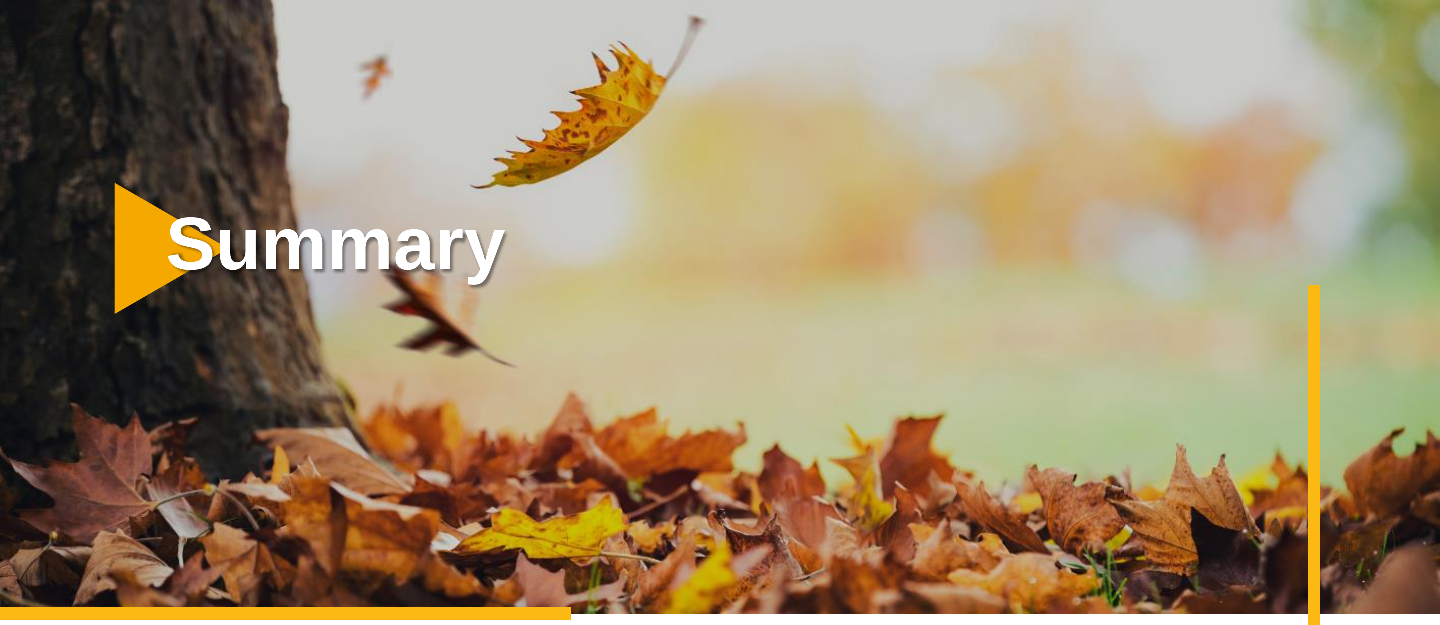
Inventories Written Down

Climate-related risks could render a company's inventories obsolete, result in lower selling prices or escalate completion costs. For instance, extreme weather events might shorten inventory lifespan or lead to additional costs, such as increased storage costs due to flooding, thereby affecting the valuation of inventories. MFRS 102 requires inventories to be measured at the lower of cost and net realisable value (NRV). Consequently, climate-related matters may necessitate inventory write-downs to their NRV.

MFRS 137 'Provisions, Contingent Liabilities and Contingent Assets'

Recognition, Measurement and Disclosure of Provisions and Contingent Liabilities

Climate-related matters may affect the recognition, measurement and disclosure of liabilities related to such things. For instance, the impact of climate-related legislation and regulations should be considered when estimating the provision of decommissioning of manufacturing facilities as well as penalties levied by governments for failing to meet climate-related targets. Moreover, contracts may become onerous due to potential loss of revenue or increased costs stemming from climate-related risks. Companies should disclose key assumptions about future events that have impacted a provision or contingent liability.



Summary

While MFRSs do not specifically mention climate change, they do require consideration of additional disclosures in financial statements when the information is material and could influence the decision-making of financial statement users. Hence, the financial statements should disclose adequate information about the implications of climate-related matters and the associated risks.

Future Development of Climate-Related Matter Disclosures

<u>Sustainability Standards</u>

On 26 June 2023, the International Sustainability Standards Board (ISSB) issued its first ISSB Standards namely, IFRS S1 'General Requirements for Disclosure of Sustainability-related Financial Information' and IFRS S2 ‘Climate-related Disclosures’.

IFRS S1 outlines the requirements for disclosing pertinent information regarding a company’s sustainability-related risks and opportunities that are useful to its financial statement users in making decisions relating to providing resources to the company; while IFRS S2 sets out the requirements for identifying, measuring and disclosing information about climate-related risks and opportunities.

Future Development of Climate-Related Matter Disclosures (cont.)

Sustainability Standards (cont.)

In Malaysia, the use of the ISSB Standards for local ESG reporting is currently under the consultation phase. Based on the consultation paper released, the ISSB Standards will be applied by the local listed and large non-listed companies (with revenue of RM 2 billion and above) on the following timeline:

	FYE 2025	FYE 2026	FYE 2027	FYE 2028	FYE 2029
Main Market	Adopt IFRS S2 with reliefs	Adopt IFRS S1 with reliefs	Full adoption of IFRS S1 and IFRS S2		
ACE Market			Adopt IFRS S2 with reliefs	Adopt IFRS S1 with reliefs	Full adoption of IFRS S1 and IFRS S2
Large Non-Listed Companies			Adopt IFRS S2 with reliefs	Adopt IFRS S1 with reliefs	Full adoption of IFRS S1 and IFRS S2

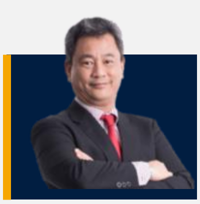
IFRS Standards

Presently, the International Accounting Standards Board (IASB) is exploring possible actions to improve the application of IFRS Standards related to reporting on the effects of climate-related and other uncertainties in the financial statements under the project titled “Climate-Related and Other Uncertainties in the Financial Statements”.

The project complements the work of the ISSB and will incorporate IFRS S1 and IFRS S2 into the existing (or new) IFRS standards to the extent that they apply to the financial statements.

In short, the project will connect the two sets of requirements for general-purpose financial reporting. Based on the IASB timetable, the direction of the project is expected to be determined in the second quarter of 2024.

This article was written by:



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