CHAPTER 2

Climate related disclosures

This article aims to:

- Provide an overview of climate related risks and its disclosures.

Background

Over the recent years, there has been an increased focus on the importance of Environmental, Social and Governance (ESG) factors. As climate-related risk is a dominant factor of ESG, companies and other stakeholders are increasingly interested because of its potential effect on companies' business models, cash flows, financial position and financial performance. On account of the growing implications of climate risk for the preparation of financial statements and lack of sufficient disclosure of climate-related information in financial statements, regulators and standard setting bodies such as Securities Exchange Commission (SEC), the European Union (EU) and the International Sustainability Standards Board (ISSB) would be issuing climate related disclosure requirements to increase transparency and clarity.

Further, it is important to note that in March 2023, the International Accounting Standards Board (IASB) initiated a project to explore - whether and how a company's financial statements can provide better information about climate-related risks. The project is a result of feedback received from stakeholders stating climate related risks may not be appropriately disclosed in the financial statements and that there is a need for better qualitative and quantitative information about the effect of climate-related risks on the carrying amounts of assets and liabilities reported in the financial statements.

Regulatory developments

The regulators around the globe are working on developing the disclosure requirements relating to climate risk. Following are some of the developments by standard setters relating to climate risk:

- **ISSB:** The ISSB has been formed to develop IFRS Sustainability Disclosure Standards that will result in a high-quality and comprehensive global baseline sustainability disclosures. In March 2022. ISSB had proposed global baselines standards for sustainability disclosures-which include two standards IFRS S1 and IFRS S2. IFRS S1 provides general requirements for disclosure of sustainability-related financial information and IFRS S2 delas with climate-related disclosures. The standards are expected to be finalised by June 2023 and applicable for periods beginning on or after 1 January 2024.
- **European Financial Reporting Advisory Group (EFRAG):** In November 2022, the European Union adopted a Corporate Sustainability Reporting Directive (CSRD), which introduces more detailed climate related and other ESG reporting requirements including assurance for many entities. The entities subject to the CSRD will have to report according to European Sustainability Reporting Standards (ESRS).

  The EFRAG has developed 12 draft European Sustainability Reporting Standards (ESRSs) providing detailed disclosure requirements based on CSRD by the European Commission. The draft ESRSs consist of ESG topics including climate change[1]. The ESRSs are expected to be finalised by June 2023 and applicable for periods beginning on or after 1 January 2024 .
- **SEC:** The SEC proposed climate rule[2] in March 2022 based on the Task Force on Climate-related Financial Disclosures (TCFD) framework and the Greenhouse Gas (GHG) Protocol. The proposed rules are expansive and intend to provide more consistent, comparable and decision-useful information to enable investors and stakeholders to evaluate the impact of climate-related matters. The final rules are expected to be issued in near future.
- **Business Responsibility and Sustainability Reporting (BRSR) mandated by SEBI:** The Securities Exchange Board of India (SEBI) mandated the BRSR disclosures for top 1,000 listed companies[3] from Financial Year (FY) 2022-23 onwards. One of the important disclosures under the BRSR relates to an entity's material responsible business conduct and sustainability issues pertaining to environmental, social matters that present a risk or an opportunity to an entity's business, rationale for identifying the same, approach to adapt or mitigate the risk along with its financial implications. These disclosures would include risk arising from climate change such as impact on operations, employees, etc.

Further, in March 2023 SEBI has approved to introduce 'BRSR Core' which consist of limited set of Key Performance Indicators (KPIs) under each E, S and G attributes/areas. The BRSR Core would include attributes such as change in GHG footprint, change in water footprint, environmental footprint, waste management etc.

The SEBI has also provided that reasonable assurance would be applicable on BRSR Core in the following manner:

a. Top 150 listed entities (by market capitalisation) from FY 2023-24 and

b. Gradually, applicability will be extended to the top 1,000 listed entities by FY 2026-27

In relation to assurance of sustainability information, the Institute of Chartered Accountants of India (ICAI) has developed Standard on Assurance Engagement (SAE) 3410, *Assurance Engagement on Greenhouse Gas Statements* and Standard on Sustainability Assurance Engagements (SSAE) 3000, *Assurance Engagements on Sustainability Information* to be applicable for assurance reports covering periods ending 31 March 2024 and voluntary for 31 March 2023.

1. The standard, ESRS E1, *Climate change* provides the disclosure requirements on the impact of climate change, mitigation efforts, the plans and capacity of the undertaking to adapt its strategy business model and other such climate change related disclosures.
2. The SEC proposes rules to enhance and standardise climate-related disclosures for investors.
3. As per market capitalisation as on 31 March of previous year

About climate risk

The TCFD categories climate risk as follows:

Physical risk	Transition risk
• Effects of climate risk on the physical environ-ment • Examples: Floods, hurricanes, wildfires, drought, rising temperatures and sea levels, weather pattern changes.	• Risks arising from transition to a lower-carbon economy • Examples: Changing customer behaviour, availability of capital, stigmatisation of industries, stranded assets.

About TCFD: The TCFD was established by Financial Stability Board (FSB) with an aim to develop recommendations on the types of information that companies should disclose to support investors, lenders, and insurance underwriters in appropriately assessing and pricing risks related to climate change. The TCFD recommendations are structured around the four thematic areas representing core elements of how organisations operate: governance, strategy, risk management, and metrics and targets. The four thematic areas are supported by recommended disclosures that build out the framework with information aimed at helping investors understand how companies assess climate related risks and opportunities.

Although the effects of climate risks are relevant to all entities, certain industries are more susceptible by their nature. TCFD has identified the following high-risk industries:

Finance	Energy	Transportation	Material and buildings	Agriculture, food, forestry products
▪ Banks ▪ Insurance companies ▪ Asset owners ▪ Asset managers	▪ Oil and gas ▪ Coal ▪ Electric utilities	▪ Air freight ▪ Passenger air ▪ Maritime ▪ Rail ▪ Trucking ▪ Automobiles, components	▪ Materials, mining ▪ Chemicals ▪ Construction materials ▪ Capital goods ▪ Real estate	▪ Beverages ▪ Agriculture ▪ Packaged foods, meats ▪ Paper, forest products

Source: KPMG US Handbook, Climate risk in the financial statements, February 2023

However, it is important to note that the list of industry stated is only an indicator of risk but the nature and extent of risk to which an entity is exposed depends on numerous factors such as its business model, assets, geographical locations, services provided and supply chains.

Further, the climate related risks should be assessed in terms of business risks and opportunities such as changes to the viability of certain business activities, changes to market demand, changes to supply chain continuity etc.

Disclosure of climate related risks in the financial statements

In current times, all companies face climate-related risks and opportunities, but some are affected more than others. Therefore, investors and regulators are increasingly seeking greater transparency of climate-related information in financial statements. However, the disclosure of the impact of climate-related matters in the financial statements depends on specific facts and circumstances including the nature and extent of those impacts on the company, however, certain stakeholders have expressed concerns regarding an information gap with respect to disclosure of climate-related risks such as:

- A lack of evidence that material climate-related risks are reflected in the financial statements.
- A lack of transparency regarding climate-related assumptions and judgements made in preparing the financial statements.

What information is relevant to stakeholders?

Through the disclosure, a user wants to understand how climate risk impacts the entity and its environment including the business model, strategy and the assumptions and judgements used to make estimates. Therefore, it is important to understand how management presents its assessment of the impacts of climate-related risk. Following are some of the key factors that management should consider while disclosing its impact assessments are:

- **Business model and governance:** If the management has identified an emerging climate-related reporting risk which has an impact on its business model and governance of the organisation, then the same should be disclosed.
- **Risk, strategy, progress and viability:** Consider providing comprehensive disclosure on sustainability matters, particularly with respect to climate, to provide stakeholders information about how the climate-related risks and opportunities impact the entity, and the entity's strategy to respond, because it could affect their assessments of the entity's long-term prospects.
- **Materiality:** Considering materiality carefully will be a key issue in addressing user expectations. Materiality involves both quantitative and qualitative considerations. Further, even if the information is not material in amount, it may be material in nature thereby requiring disclosure of the same.
  - For some companies – e.g. those in higher-risk industries – the impacts may be quantitatively material.
  - For others with no significant quantitative impact in the current reporting period, management may need to provide an explanation because this could be qualitatively material to users.
  - For those that have not yet fully assessed the potential future impact on the financial statements, this fact may be qualitatively material and so an explanation may be needed.
- **Key judgements and estimates:** Many companies face uncertainty when considering the impacts of climate-related risks in recognising and measuring assets and liabilities. Investors and regulators expect robust disclosures of the most significant assumptions, estimates and judgements made in preparing the financial statements to understand whether and how they are affected by climate-related matters. While making disclosures, management should consider the specific disclosure requirements in Ind AS/IFRS standards as well as the overarching requirements of IAS 1/Ind AS 1[4] i.e. disclosure of information that is relevant to an understanding of the financial statements but is not specifically required by IFRS/Ind AS Standards or presented elsewhere in the financial statements.
- **Connectivity between financial statements disclosure and climate-related information:** There should be connectivity between non-financial reporting and financial reporting. The management should ensure consistency in the assumptions used in relevant areas of the company's financial statements and also, they are in sync with the climate-related risks discussed elsewhere in the annual report. It is pertinent to note that in case of changes in key assumptions related to climate-related risk, certain changes would not be expected to result in material adjustments in the measurement of assets and liabilities in the next financial year, but the chance of material adjustments in the longer term may be significant. In these circumstances, and given the expectations of investors, companies may need to consider disclosing key assumptions related to climate-related risk even though the risk of material adjustments in the next financial year may be considered to be low.
- **Other note disclosures:** Climate-related risks having financial consequences would impact the recognition and measurement of assets and liabilities. Therefore, climate-related risks may impact financial statements through, for example concentrations of risk and/or provisions and contingent liabilities. The company may want to consider other note on disclosure of contingent liabilities and financial instrument risks arising from climate-related factors.

4. TInd AS 1, *Presentation of Financial Statements* deals with the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. Further IAS 1/Ind AS 1 requires specific disclosures on key judgements and estimates made by management in preparing the financial statements.

The following section provides certain specific examples of potential impacts of climate related risk on the financial statements:

- **Asset useful life:** Life of the asset may be affected by commitments and strategies that affect the future operation of the business model. For example, commitments to operate the business on a carbon neutral basis or changes to the business model to respond to changing customer needs.
- **Impairment:** The longer-term assumption of 'business as usual' in impairment testing models may be affected by expectations of changes related to climate-related issues.
- **Provisions and contingent liabilities:** Obligations may arise from legal requirements, specific commitments or past practice to remedy environmental damage. Provisions for longer-term contracts may be required if they become loss-making as a result of increased direct costs, including those triggered by climate-related factors.
- **Expected credit losses:** Actual or expected adverse changes in the regulatory, economic or technological environment of borrowers could result in a significant change in their ability to meet debt obligations.

Additionally, it is important to note that, the European Securities and Markets Authority (ESMA) in its recent enforcement decisions published in March 2023 also highlighted that companies should provide more information in relation to climate-related matters in the notes to the financial statements as required by the principles of IAS 1.

Next steps

Unlike financial reporting where companies have robust systems in place to capture and report necessary data, reporting around ESG parameters is still developing, however it is developing at fast pace. The proposed standards and guidelines would support companies in providing information about their exposure to climate-related risks and opportunities. Assurance on sustainability information (including climate related matters) is also gaining importance as independent assurance helps in building trust, robustness and comparability of sustainability information. In this regard, regulators around the world are working towards bringing reforms in the sustainability assurance space. Therefore, companies should stay abreast of sustainability related developments and start accessing the disclosure requirements related to ESG and climate risk.

Source:

- KPMG US Handbook, Climate risk in the financial statements, February 2023
- The Center for Audit Quality (CAQ) publication, The Role of the Auditor in Climate-Related Information, March 2023
- KPMG IFRG Limited publication "Have you disclosed the impacts of climate-related matters clearly", January 2022 edition.