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A Closer Look

Investor demand for corporate reporting in line with the Paris Agreement on climate change

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On 16 November 2020, the Institutional Investors Group on Climate Change (IIGCC – a pan-European group of investors representing assets worth over €33 trillion) released a report setting out "investor expectations that directors and auditors deliver Paris-aligned accounts – accounts that properly reflect the impact of getting to net zero emissions by 2050 for assets, liabilities, profits and losses." The report goes on to state that "[o]nly then will management, investors and creditors have the information they require to deploy capital in a way that is consistent with the Paris Agreement", calling for action by directors, audit committees and auditors to meet this objective and for the application of the requirements highlighted in the IFRS Foundation's publication 'In Brief: IFRS Standards and climate-related disclosures'. Specifically, the IIGCC calls for the annual report and accounts to include:

- An affirmation that the goals of the Paris Agreement have been considered in drawing up the accounts.
- An explanation of how critical assumptions and estimates are 'Paris-aligned', or why they are not.
- Results of sensitivity analysis linked to variations in these judgements or estimates.
- Implications for dividend paying capacity of Paris-alignment.
- Confirmation of consistency between narrative reporting on climate risks and the accounting assumptions, or an explanation for any divergence.

This document follows similar initiatives from other investor groups (for example, an open letter from investor groups around the world representing assets under management of over $103 trillion) and makes clear that the expectations on both preparers and auditors in respect of reflecting the effects of climate change will both increase and become more specific (in terms of the additional considerations and disclosures expected) as compared to previous years.

Subsequent to the IIGCC report, the IFRS Foundation published additional educational material ('the educational material') including further discussion of the effects of climate-related matters on financial statements prepared applying IFRS Standards.

Background on the Paris Agreement

The Paris Agreement (sometimes referred to as the Paris Climate Accord) was reached on 12 December 2015 by parties to the United Nations Framework Convention on Climate Change (UNFCCC) representing 196 countries.

For more information please see the following websites:

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The Paris Agreement's central aim is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2°C above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5°C. To achieve this aim, the Agreement identifies crucial areas for action, including:

- **Global peaking and 'climate neutrality'** – countries aim to reach peak greenhouse gas emissions (GHGs) as soon as possible.

- **Mitigation** – binding commitments for countries to establish and communicate their contributions and to pursue domestic measures to achieve them.

- **Sinks and reservoirs** – countries are encouraged to conserve and enhance sinks and reservoirs of GHGs, including forests.

- **Voluntary cooperation/Market- and non-market-based approaches** – encourages voluntary cooperation among signatories to pursue higher targets and establishes principles for doing so.

- **Adaptation** – establishes a global goal of enhancing adaptive capacity, strengthening resilience and reducing vulnerability to climate change. Parties should implement national adaptation plans, and communicate periodically, describing their priorities, needs, plans and actions.

- **Loss and damage** – parties commit to enhancing the understanding, action and support with respect to loss and damage arising from the adverse effects of climate change.

- **Finance, technology and capacity-building support** – reaffirms the obligations of developed nations to assist the efforts of developing countries to move towards a clean, climate-resilient futures.

- **Transparency, implementation and compliance** – information submitted by each party undergoes international technical expert review.

- **Global stocktake** – a "global stocktake" in 2023 and every five years thereafter, to assess progress towards achieving the Paris Agreement's objectives.

To date, 189 countries have ratified the Paris Agreement, thereby committing to its implementation.

What does it mean for assumptions to be 'Paris-aligned'?

As discussed in more detail below, there are several aspects of IFRS Standards that require an entity to 'predict the future' by developing expectations that affect the items recognised or disclosed in financial statements. These assumptions can be driven by external factors (macroeconomic conditions, government action, etc.), planned actions of the entity itself or a combination of the two.

In all cases, the assumptions applied in the preparation of the financial statements should reflect the entity's best estimate supported by evidence as necessary. However, it should be noted that:

- In jurisdictions which have ratified the Paris Agreement and made commitments on that basis, an entity's expectation of the effects of government action should reflect that commitment.

- Reputable, publicly available macroeconomic forecasts increasingly incorporate the forecast effects of climate change. If the entity's forecasts do not, they are likely to be challenged.

- Forecasts of the entity's own actions should reflect the entity's intentions at the reporting date (subject to specific restrictions in IFRS Standards on reflecting decisions to be taken in the future, for example the restriction in IAS 36 on incorporating a restructuring into a value in use calculation before the entity has committed to that action). However, when those intentions are inconsistent with the Paris Agreement or have changed significantly in response to the Paris Agreement (or government action resulting from it) disclosure (either as a significant judgement or estimate under IAS 1 or the more specific requirements of a particular Standard) is likely to be required. If actions inconsistent with the Agreement are expected to have consequences in terms of government action or consumer attitudes, that should also be reflected as appropriate.

In many cases (particularly longer-term macroeconomic forecasts), there will be multiple possible scenarios and/or a range of possible outcomes. This heightens the need for clear disclosure of the assumptions used and sensitivities to other possible outcomes.

What requirements are highlighted by 'In Brief: IFRS Standards and climate-related disclosures' and the educational material and how might they apply in practice?

The In Brief: IFRS Standards and climate-related disclosures was authored by Nick Anderson (a Board member with a background as an investor) and built on an earlier publication by the Australian Accounting Standards Board (AASB) and Audit and Assurance Board (AUASB). The educational material was developed in response to stakeholder requests for further information on this topic. Both publications discuss the following specific areas of financial reporting.

Issue	Relevant IFRS Standard(s)	Possible effects of climate risks highlighted in 'In Brief: IFRS Standards and climate-related disclosures and the educational material	Additional comments
Asset impairment, including goodwill, and effects on impairment calculations because of increased costs or reduced demand	IAS 36	Exposure to climate-related risks could be an indicator of impairment or could affect the estimated cash flows used in determining the recoverable amount of an asset or group of assets. If these exposures are not reflected in impairment calculations, assets such as property, plant and equipment, assets recognised in relation to mineral resources, intangible assets and goodwill could be overstated. Disclosure of the key assumptions on which cash flow projections have been based and management's approach to determining the value assigned to these key assumptions is also required (particularly for goodwill or indefinite-life intangible assets), with information about how potentially significant effects of climate-related risks have been factored into recoverable amount calculations being relevant for the users of the financial statements.	Climate-related risks can impact a value in use calculation in a number of ways, including: • Incorporation of expected changes in consumer behaviour and government action into estimates of future cash flows when they represent management's best estimate supported by appropriate evidence. • Incorporation of changes expected to occur beyond the period covered by financial budgets and forecasts via modification to the expected long-term growth rate. Such changes could arise in a variety of ways, for example from decreasing revenues as carbon-intensive production facilities are phased out or increased costs due to the introduction of government levies. • Consideration of whether a planned restructuring or replacement of assets should be incorporated into forecast cash flows. The effect of climate-related risks on either forecast cash flows or discount rates can also be a key assumption requiring disclosure under IAS 36, in which case an explanation of not only the key assumption, but also of its forecast effects on the entity's future cash flows should be provided. More detail on these and other aspects of impairment testing are available to subscribers to iGAAP on Deloitte Accounting Research Tool (DART)
Changes in the recognition and useful life of assets	IAS 16, IAS 38	Climate-related risks could affect the depreciation or amortisation of assets (through a change in their useful lives) or the recognition of those assets (whether expenses satisfy the definition of an asset when incurred). Adaption of an entity's business to address climate issues could also result in additional research and development activities, requiring disclosure and consideration of the criteria for capitalisation.	The estimated useful lives of assets could be affected by physical factors (for example, changes in rainfall affecting the viability of agricultural operations) or by economic or legislative ones (for example, fossil fuel power generation equipment being taken out of use while still operational). In either case, a change in the estimated useful life will be accounted for via a prospective change in the depreciation or amortisation rate and should be disclosed and explained. When these risks are significant, concerns over the viability of a project could mean that the criterion (common to both IAS 16 and IAS 38) that costs are only capitalised when it is probable that future economic benefits associated with the asset will flow to the entity is not met.

Changes in the fair valuation of assets	IFRS 13	The requirements of IFRS 13 to disclose key assumptions used in fair value measurements could be relevant if: • A fair value measurement incorporates a number of possible scenarios. • The fair value of an asset is affected by climate-related risks including the effect of and potential changes to laws and regulations. In sectors particularly affected by climate risks, disclosure of assumptions regarding those risks should be considered even if the effects on the financial statements cannot be quantified.	Fair valuation of assets applying the principles in IFRS 13 is required for a broad range of assets which could be affected by either climate change or actions pursuant to the Paris Agreement and these factors could affect inputs into valuation models in a number of ways (adjustment to the cash flows or discount rate used in a discounted cash flow calculation, to prices when applying the market approach etc.). If this is, or may be, the case, the use of robust assumptions supported by evidence becomes critical, as does the provision of clear disclosures on those assumptions (particularly if they are unobservable or 'Level 3') and the sensitivity of the valuation to other possible outcomes (whether that be other discrete possibilities or a range that the entity's estimate is within). When the entity's forecast sits within a range of possible outcomes, disclosures are particularly useful if they provide users with information on whether the entity's forecast is at the midpoint of that range or towards one end or the other. When fair value, rather than value in use, is used in an impairment test under IAS 36, the prohibition on including the effects of future restructurings (IAS 36:44) does not apply. The effect of a restructuring is relevant to a fair value calculation if, and only if, a third party purchaser would factor that into the price they would be willing to pay for the asset (or cash-generating unit). The entity's own intentions are not directly relevant. The broad scope of IFRS 13's requirements could also mean that the effects of climate risks on fair values becomes significant for entities whose own business might not be thought of as being directly affected by the more apparent physical and economic risks of climate change. For example, the plan assets of a defined benefit scheme and the investments held by an investment entity are required to be measured at fair value under IFRS 13 and those values should reflect the risks (including climate) to which the underlying investee is exposed.
Changes in provisions and contingent liabilities arising from fines and penalties or in provisions for onerous contracts because of increased costs or reduced demand	IAS 37	Climate-related risks could affect: • The recognition of provisions (if reductions in revenue or increases in cost mean that a customer contract becomes onerous, due to regulatory requirements to remediate environmental damage or to restructurings to redesign products or services to achieve climate-related targets). • The measurement of provisions (if regulatory changes or shortening of project lives affect the timing or amount of expenses of decommissioning assets or rehabilitating environmental damage). • The recognition of liabilities or disclosure of contingent liabilities for potential fines or penalties under environmental regulations or where litigation is brought by another interested party. Major assumptions about future events must be disclosed, which might include an explanation of how climate-related risks have been factored into the best estimate of the provision. In addition, a brief description of the nature of any contingent liability, and where practicable, an estimate of its financial effect and an indication of the uncertainties relating to the outflow of resources for settling the obligation is required.	It should also be noted that liabilities under IAS 37 or levies accounted for under IFRIC 21 are recognised only when incurred under enacted legislation. In contrast, it is not necessary to wait for the enactment or substantive enactment of a change in environmental or other regulation before it is incorporated into a value in use calculation for the purposes of impairment testing. The consequences of such expected government action should be factored in when they reflect management's best estimate of future cash flows (based on reasonable and supportable assumptions).

Changes in expected credit losses for loans and other financial assets	IFRS 9	Application of the expected credit loss approach requires lenders to consider whether any actual or expected adverse changes in a borrower's regulatory, economic or technological environment have changed significantly the borrower's ability to meet its debt obligations (and, therefore, whether credit risk has increased significantly since initial recognition). As such, banks with loans to businesses (or investments in projects) affected by climate-related risk will need to consider how those risks affect the expected credit losses on those loans or investments. Disclosure of the effect of climate-related matters on the measurement of expected credit losses or on concentrations of credit risk may also be necessary.	Uncertainty over the physical effects of climate change and the introduction of policy and regulatory measures means that when determining expected credit losses (ECLs), there is a variety of possible adverse economic scenarios that might exist in the future. Each of these scenarios may have potentially differing degrees of adverse economic conditions that could affect the probability of borrowers defaulting and the extent of losses that the lender may incur in the event of borrower default. Specifically: • There may be a greater range of downside economic scenarios to consider. • The credit losses under each of these scenarios could be more severe than previously estimated with the potential increase in the probability of individual loans defaulting or in the loss in the event of default as a result of falling collateral values.
Disclosure of market risks over financial assets	IFRS 7	IFRS 7 requires disclosure of an entity's exposure to market risks arising from financial instruments, its objectives in managing these risks and changes from the previous period. This could be relevant to entities (for example investment funds and insurance companies) holding investments in industries that may be affected by climate-related risk. Quantitative information, such as an analysis of investments by industry or sector, could specifically identify sectors exposed to climate-related risks and explain the company's policy of managing its exposure to those sectors.	Disclosures of this nature could also be relevant as investors look to assess the strategies of large institutional investors from a sustainability point of view and for consistency with any commitments made to divert capital away from carbon intensive sectors.

Both publications also discuss the more general disclosure requirements of IAS 1, specifically:

- The requirement of IAS 1:122 to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.
- The requirement of IAS 1:125 to disclose information about the assumptions management has made about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.
- The requirement of IAS 1:31 to "consider whether to provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance."

As discussed in IFRS in Focus – Closing Out 2019, these requirements have been and remain an area of heightened regulatory focus. This can be expected to continue and to incorporate an increasing focus on climate-related judgements and estimates. As such, if an entity has made a significant judgement relating to the effects of the Paris Agreement or incorporated those effects into an accounting estimate then (as for any other judgement or assumption) it should be assessed and, if material, disclosed even in the absence of a specific IFRS Standard requirement to that effect.

The educational material also highlights possible effects of climate-related matters on:

- An entity's assessment of going concern, noting that IAS 1 requires disclosure of material uncertainties related to events or conditions that cast significant doubt upon a company's ability to continue as a going concern, or of significant judgements made in concluding there are no material uncertainties related to the going concern assumption.
- The net realisable value of inventories, where either selling prices decline or costs of completion increase.
- The recognition of deferred tax assets, where climate-related matters cause a decrease in estimates of future taxable profits.

- The measurement of loan contracts including terms linking contractual cash flows to an entity's achievement of climate-related targets. For the lender, such a feature could mean that the financial asset does not give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (and, therefore, does not qualify for measurement at amortised cost under IFRS 9), whilst for the borrower it could give rise to an embedded derivative required to be separated from the host contract and measured at fair value through profit or loss.

- The measurement of insurance liabilities under IFRS 17, if climate-related matters increase the frequency or magnitude of insured events or accelerate the timing of their occurrence.

In Brief: IFRS Standards and climate-related disclosures also notes that "[t]he majority of climate-related information is currently disclosed within management commentary and not in the financial statements." When narrative reporting (for example, an MD&A or Strategic Report) includes discussion of climate-related issues (for example, by inclusion of the Task Force on Climate-related Financial Disclosures recommendations) it is important that disclosure in the financial statements is consistent with that reporting but also that it remains comprehensive. Material information should not be excluded from the financial statements simply because it is included elsewhere in the annual report. As for other content that might be relevant to both the financial statements and other elements of the annual report, this highlights the need for a joined-up approach to the production of the entire annual report.

The Deloitte Accounting Research Tool (DART) is a comprehensive online library of accounting and financial disclosures literature. iGAAP on DART allows access to the full IFRS Standards, linking to and from:

- Deloitte's authoritative, up-to-date iGAAP manuals which provide guidance for reporting under IFRS Standards; and
- Model financial statements for entities reporting under IFRS Standards.

To apply for a subscription to DART, click here to start the application process and select the iGAAP package.

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