A Closer Look

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

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This *'A Closer Look'* was first published in December 2020 but has since been updated to address the output of the November 2021 COP26 conference in Glasgow and further expressions from stakeholders of their expectations in respect of climate-related information in financial statements, examining perceived information gaps and how they might be addressed under current IFRS Accounting Standards.

In the past few years, as the physical and economic effects of climate change have become more noticeable and the need for action to limit global temperature rises has moved up the political and social agenda, the demand for these issues to be addressed in regular, mainstream corporate reporting (including the annual report) has intensified and is no longer limited to carbon-intensive industries. Many of the concerns raised by investors point to a growing information gap between the specific requirements of IFRS Standards and information that investor groups consider important, with investor and pressure groups including ClientEarth[1] and the Carbon Tracker Initiative[2] publishing studies in 2021 which criticise aspects of corporate reporting which they see as not meeting expectations of 'Paris-alignment'.

Investor calls

Investors are calling for clear, specific and quantified information on the actions that entities are taking to decarbonise their operations and on how the physical and economic effects of climate change and the transition to a low carbon economy will impact their operations in the medium to longer term. Importantly, this call is no longer coming only from pressure groups focused primarily on the reduction of greenhouse gas emissions. It comes also from mainstream investor groups and asset managers who see that, across a wide spectrum of industries, climate is significant to the understanding of the longer-term prospects of a business and in informing capital allocation decisions. Furthermore, investors and asset managers require this information to manage their own commitments to 'decarbonise' portfolios.

For more information please see the following websites:

www.iasplus.com
www.deloitte.com

1 Accountability Emergency: A review of UK-listed companies' climate change-related reporting (2019-20)

2 Flying blind: The glaring absence of climate risks in financial reporting

To some degree, this call for climate information is and will continue to be addressed by new forms of reporting, including the wider adoption of the Task Force on Climate-related Financial Disclosures recommendations, the potential future standards of the International Sustainability Standards Board (ISSB) and jurisdictional initiatives such as the European task force on sustainability reporting standards[3]. These initiatives are intended to broaden corporate reporting in a coherent way, connecting climate and sustainability information to the 'core' reporting of financial results. Nonetheless, the financial statements remain the primary source of investor information on an entity's financial performance and position and material climate information is, or could be, already captured in IFRS financial statements.

Investors are asking for the annual report and financial statements to consider appropriately actions (both by the reporting entity itself and others) to limit global temperature rises to 1.5°C above pre-industrial levels by achieving net zero carbon emissions by 2050 (consistent with the COP26 pledge), or earlier depending on commitments made by the entity or local governments.

Climate-focused investor groups such as the Institutional Investors Group on Climate Change (IIGCC – a pan-European group of investors representing assets worth over €33 trillion) released a report in November 2020 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". 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.

While all of this information may not be required by current accounting standards, investors are calling for it as they note its importance to their investment decisions. The IIGCC document follows similar initiatives from other investor groups such as an open letter issued in September 2020 from investor groups around the world representing assets under management of over $103 trillion. Investors make it clear that the expectations on both preparers and auditors to reflect 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.

The importance of this information to capital allocation decisions made by' **mainstream investors and asset managers** has been highlighted by Larry Fink in his 2022 letter to CEOs[4] in which he states that "[f]ew things will impact capital allocation decisions – and thereby the long-term value of your company – more than how effectively you navigate the global energy transition in the years ahead."

Similarly, State Street's annual letter to Board Members[5] in January 2022 described climate changes as "central to our stewardship activities — a reflection of growing evidence that showed climate change poses systemic risks to all investors."

"We focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients. That requires understanding how companies are adjusting their businesses for the massive changes the economy is undergoing."

Larry Fink – Chairman and Chief Executive Officer, BlackRock

3 European Lab PTF on European Sustainability Reporting Standards (PTF-ESRS)

4 Larry Fink's 2022 letter to CEOs – The Power of Capitalism

5 Letter from Cyrus Taraporevala, President and Chief Executive Officer, 12 January 2022

Standard-setter and regulator responses

Standard-setters and professional bodies have reacted to this demand with the IFRS Foundation publishing 'In Brief: IFRS Standards and climate-related disclosures' (November 2019) and additional educational material ('the educational material') in November 2020 to highlight the effects of climate-related matters on financial statements prepared applying IFRS Standards. The International Audit and Assurance Standards Board (IAASB) produced similar guidance[6] on how climate-related risks should be addressed under International Standards on Auditing (ISAs). The International Federation of Accountants (IFAC) also published Corporate Reporting: Climate Change Information and the 2021 Reporting Cycle, highlighting the critical role that professional accountants have in:

- Aligning and integrating climate-related information and disclosures with entity climate commitments, targets, and strategic decisions.
- Quantifying, wherever appropriate, financial impacts of climate issues.
- Ensuring climate-related reporting complies with reporting requirements without material omissions or misstatements, based on an entity-specific materiality determination.
- Supporting global initiatives to enhance climate and broader sustainability-related reporting through standards set by the new ISSB that will address material impacts on an entity's enterprise value.

It is also becoming clear that entities who are seen as not meeting this demand may be questioned. **Capital markets regulators** are increasingly focused on the proper disclosure of climate-related issues, with a speech[7] by the Acting Chief Accountant of the U.S. SEC highlighting that "[i]nvestors in our capital markets tell us that they...want something a little bit different. When it comes to climate risk disclosures, investors are raising their hands and asking regulators for more." Climate-related issues also appeared for the first time at the heart of ESMA's Common Enforcement Priorities for 2021, which stated that "issuers and auditors must consider climate risks when preparing and auditing IFRS financial statements to the extent that the effects of those risks are material to those financial statements, even if IFRS Standards do not explicitly refer to climate-related matters", whilst in the UK the FRC's Annual Review of Corporate Reporting stated that its routine monitoring of annual reports in 2021/22 would include a focus on climate risks.

'Paris-aligned' assumptions

Although historic financial statements are, by their nature, largely backward looking, there are several aspects, as discussed below, that require an entity to 'predict the future' by developing expectations that affect the recognition, measurement or disclosure of a range of items 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 and, at a minimum, forecasts of the entity's own actions should reflect compliance with government requirements.
- 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 Paris 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 in areas such as impairment testing.

6 The consideration of Climate-Related Risks in an Audit of Financial Statement, 1 October 2020

7 Statement on OCA's Continued Focus on High Quality Financial Reporting in a Complex Environment, 6 December 2021

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.

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 future.
- **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, 192 countries have ratified the Paris Agreement, thereby committing to its implementation. Further decisions were made on how the aims of the Paris Agreement would be achieved at the COP26 conference, where nations agreed on a package of measures in the Glasgow Climate Pact – which notably included calls for the phase down of unabated coal power and inefficient subsidies for fossil fuels and reaffirmed a pledge of providing $100 billion annually from developed to developing countries to build resilience to climate change.

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

The In Brief: IFRS Standards and climate-related disclosures was authored by Nick Anderson (an IASB 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 See below on how to address information gap	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 See below on how to address information gap	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 2021, 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 information recommended by the Task Force on Climate-related Financial Disclosures) 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 information gap and how it might be addressed under current IFRS Standards

The key criticisms made by, for example, ClientEarth and the Carbon Tracker Initiative and a few possible ways in which they can be addressed are described below.

'Paris-aligned' economic scenarios

The economic scenario(s) used in preparing financial statements should be transparent and 'Paris-aligned' in reflecting timely action to limit global temperature rises

In seeking consistency, transparency and a clear commitment to timely decarbonisation, investors have criticised financial statements in particular for failing to specify which (if any) macroeconomic forecasts had been used for the purposes of developing expectation of future cash flows and thus possibly not using a forecast that reflects timely action to limit global temperature rises. Specifically, groups including the Carbon Tracker Initiative have stated an expectation that the International Energy Agency (IEA) Net Zero by 2050 scenario[8] will be used as it reflects timely action at a global level.

How does this correspond to current IFRS requirements?

Where IFRS Standards require the determination of forecast cash flows (for example, in the calculation of value in use as part of an impairment review), that forecast is required to be prepared on a 'management's best estimate' basis. However, IFRS Standards do not require use of any particular data source. For example, IFRS 13 requires that valuation techniques maximise the use of observable inputs but does not stipulate which inputs should be used beyond requiring that they reflect assumptions that market participants would use when pricing the asset or liability being measured.

Whatever data sources are used, they should reflect an entity's best estimates of its own actions (subject to the restriction discussed below on including the effects of restructurings in value in use calculations) and wider economic expectations (for example, management may be committed to decarbonisation of the entity's own operations but still have a more pessimistic view of the global outlook).

It is also worth noting that there is no single universally agreed upon Paris-aligned scenario, with a multitude of different reputable sources providing possible forecasts. One reason for this is because there are different pathways (or trajectories) for decarbonisation. In addition to the Net Zero by 2050 scenario, the IEA itself provides the 'Sustainable Development' scenario, which is based on outcomes targeted by the Paris Agreement. Other sources of reputable 1.5°C scenarios include Wood Mackenzie, IHS Markit, Network for Greening the Financial System (NGFS), and the Inevitable Policy Response commissioned by the Principles for Responsible Investment (PRI). Many central banks provide their own Paris aligned scenarios, often based on, but not entirely aligned with the NGFS scenarios. The Bank of England, for example, considers two routes to net zero: an 'Early Action' scenario (policies intensify relatively gradually over the scenario horizon) and a 'Late Action' scenario (policy to drive the transition is delayed and is then more sudden and disorderly). The IEA's Stated Policies scenario also considers the impact of existing policy frameworks and announced policy intentions, with various sources reporting that the pledges made by COP26 put the world on a trajectory of 1.8-2.1°C, rather than achieving 1.5°C.

8 World Energy Outlook 2021 - Report extract Scenario trajectories and temperature outcomes

How can this information gap be bridged?
In respect of impairment of goodwill and indefinite useful life intangible assets, disclosure of the key assumptions used in an impairment review, together with sensitivity disclosure when a 'reasonably possible' change in key assumptions would result in an impairment loss is required by IAS 36: 134.

Historically, these disclosures might sometimes have been somewhat generic (limited to, for example, discount rates and straight-line long-term growth rates), with sensitivity analyses rarely provided when headroom was not marginal and similarly limited only to changes in those generic assumptions. In recent years, however, expectations have increased and better insight is demanded in respect of both climate and other factors that may give rise to impairment. Best practice evolved to respond to these expectations and now includes a more informative description of the assumptions made in performing an impairment review and more informative and meaningful sensitivity analyses provided not only when headroom is marginal. If an impairment review was prepared using a published macroeconomic forecast, disclosure of this fact and identification of the forecast(s) used (together with the sensitivity of an impairment assessment to a Paris-aligned scenario if that is not the 'base-case' applied) would be appropriate and helpful to users.

Similarly, better practice includes greater transparency and disclosure of the assumptions (including use of macroeconomic information) used in measuring expected credit losses on financial assets, citing published forecasts when appropriate.

More broadly, IFRS Standards do not require a general disclosure of the entity's approach to forecasting. However, neither do they forbid it, and such a disclosure might be helpful when forecasts have been prepared for a number of purposes.

In addition, the requirement in IFRS Standards to disclose the effects of key sources of estimation uncertainty applies specifically when there is significant risk of a material adjustment to the carrying amount of assets and liabilities in the next 12 months. There is, however, no prohibition on providing additional, voluntary information on changes expected to occur over a longer period if this does not obscure the required information. In general, this means that the additional voluntary information should be clearly distinguished from the required information on changes expected within the coming year.

Impairment and asset lives

Climate-related issues should be resulting in more impairment of assets and shorter useful lives of carbon-intensive assets

This assertion is based on an assumption that either carbon intensive or potentially 'stranded' assets will lose value due to the effects of either climate change itself (i.e. physical climate risks) or actions to move to a low carbon economy (i.e. transition risks) and that this will be reflected in an impairment of the asset.

How does this correspond to current IFRS requirements?
Whilst these factors are certainly real, there are many reasons why they might not immediately result in an impairment loss, for example:

- Climate-related factors may only be expected to have an impact beyond the end of an asset's useful economic life.
- Higher costs may, in some cases, be recovered from customers through higher pricing. However, any assumption that higher costs or other climate-related factors will not affect profit margins should be considered carefully to determine whether customers will simply pay higher prices for the entity's goods or services rather than moving to an alternative, possibly less carbon intensive, provider.
- There may be significant headroom between recoverable amount and carrying amount of the asset such that the impact of climate-related factors would not cause the recoverable amount to decline below the carrying amount.
- Recoverable amount is defined as the higher of value in use and fair value. Even though climate-related factors may indicate a decline in fair value, there may not be a corresponding impact on the value in use. Conversely, while restructurings and the benefits arising from them may not yet be reflected in value in use, they may already be reflected in the fair value, resulting in a higher recoverable amount.

A related issue is the assessment of the useful economic life of an asset, which might be expected to be shortened (resulting in increased depreciation or amortisation annual charges) if the asset is either expected to become 'stranded' or to be replaced by a lower carbon alternative. A programme to replace assets, however, might not always reduce their expected useful lives (if, for example, diesel vehicles are planned to be replaced with electric ones only at their usual retirement date) or a shortened useful life might result in a higher residual value. Further, any effect of a change to useful life will only be accounted for prospectively (resulting in higher depreciation over possibly a number of future periods rather than a single impairment loss in the current period).

How can this information gap be bridged?
As noted above, there may be reasons why changing expectations in respect of climate do not result in an impairment loss (or an increased depreciation expense) but this should not be assumed to be the case. The assumptions used in an impairment assessment should be considered carefully. For example:

- Is an expectation of straight-line growth in cash flows beyond the detailed forecast period actually in line with the entity's long-term forecasts, or would a decline at some point in the future be more representative of the entity's expectations?

- Do cost projections appropriately incorporate increased costs arising from, for example, the introduction of government levies or the acquisition of carbon offsets or incurrence of abatement costs consistent with the entity's net zero commitments?

- If the recoverable amount is measured on a fair value basis, are the assumptions used in a discounted cash flow calculation or comparable transactions analysis consistent with market participants' view of the asset under consideration? For example, is a carbon intensive facility as desirable as a more efficient alternative?

Again, clear disclosure of the assumptions used and the basis for those assumptions, together with meaningful sensitivity analysis, is an effective means of closing the information gap.

Consistency of financial statements with commitments to decarbonise

Financial statements should be consistent with stated policies and commitments to 'carbon-neutral' operations

This criticism is often based on a perceived mismatch or inconsistency between the narrative discussion of an entity's plans to become 'carbon neutral' by a given date and financial statements which do not appear to be affected by this commitment (for example because carbon-intensive assets remain unimpaired, no liabilities are recognised for the costs of decarbonisation or no liabilities are recognised for 'carbon offset' schemes).

How does this correspond to current IFRS requirements?
There are many reasons for why the financial statements may not (yet) be affected by an entity's plans to decarbonise.

- Restrictions on reflecting future restructurings in financial statements – Generally, forecasts used in the preparation of financial statements should reflect an entity's intentions. There are, however, specific restrictions in IFRS Standards that prohibit incorporation of actions to which an entity is not yet 'committed'. For example, IAS 36 does not permit a value in use impairment calculation to incorporate the forecast cash outflows (or related cost savings or benefits) of a restructuring before there is a sufficiently detailed formal plan and a valid expectation in those affected that the plan will be carried out. The same restriction applies to recognising a provision for the cost of a future restructuring. A stated general policy to decarbonise the business, or a long-term strategy to replace carbon-intensive assets, would not therefore by itself give rise to an impairment loss or the recognition of a provision.

- Restrictions on recognising a provision for offsetting emissions in line with a stated policy – Under IAS 37, a provision would not be recognised for future emissions, even if an entity has made a public statement that it will offset future emissions. Furthermore, a provision would only be recognised in respect of past emissions if an entity is subject to legal requirements or has made a suitably specific public commitment, such that that the entity is left with no realistic alternative but to incur expenditure to offset certain past emissions. An expression of a general policy to offset emissions is therefore unlikely to give rise to recognition of a provision.

How can this information gap be bridged?
This perceived mismatch is largely a function of a conceptual difference between the narrative discussion of future intentions and historic financial reporting designed primarily to show the effects of past transactions and events. Again, previous assessments should be considered carefully to determine whether they remain appropriate and voluntary additional disclosure explaining why stated or expected actions are validly not yet reflected in the financial statements could be helpful.

As the physical and economic effects of climate change become more of a focus for investors and society as a whole, pressure on entities to react in a comprehensive, holistic way can be expected to increase, with accusations of 'greenwashing' levelled against entities that make vague claims of 'net zero' ambitions without explaining the actions they will take to reach that goal. An (actual or perceived) lack of connectivity between published climate commitments, other climate and sustainability information such as disclosures provided in line with TCFD recommendations and the financial statements (for example, a sustainability report citing specific forecasts or commitments with no visibility on whether, or how, these are reflected in the financial statements) can contribute to a perception that words are hollow until they change the numbers.

As with other information in the annual report, the organisation of climate-related content can be of critical importance. If information is scattered throughout a lengthy document with no clear cross-referencing or aggregation of related data it can be difficult for a reader to reach a coherent understanding of the possible effects of climate change on a entity's business or of the actions it has taken, or intends to take, to mitigate those effects. As such, the aggregation of climate-related information in the financial statements or clear mapping between information in different notes to the financial position (as recommended in ESMA's Common Enforcement Priorities for 2021) should be considered along with proper cross-referencing between the financial statements and other parts of the annual report.

Over time, the effect of climate change might be addressed more clearly by corporate reporting standards (through, for example, the future output of the ISSB) but until then challenges over whether IFRS financial statements appropriately capture and disclose information on climate risk can be expected to continue. Whilst there are tensions between demands for forward-looking information and the requirements of historic financial reporting, a commitment to transparency can help to bridge that divide and provide valuable information for a range of stakeholders.

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:

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