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Staff paper

Agenda reference: AP4

Joint CMAC-GPF meeting
June 2023

Climate-related risks in the financial statements

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Information for CMAC and GPF members

Purpose of the session

- To share some background on the project with members
- To understand members’ concerns about the reporting of climate-related risks in the financial statements.

Background information

Origin of the project

- Increased interest in the effects of climate-related risks on the financial statements among stakeholders, particularly users of financial statements.
- Questions about why IFRS Accounting Standards do not explicitly refer to climate-related risks
- Concerns about possible inconsistent application of Accounting Standards to climate-related risks and insufficient information about climate-related risks in financial statements

- Educational material published to explain how Accounting Standards already require entities to consider the effects of climate-related risks in the financial statements
    - November 2020 educational material on the Effects of climate-related matters on financial statements
    - November 2019 article IFRS Standards and climate-related disclosures

- In the Third Agenda Consultation, respondents attributed high-priority to a project on climate-related risks in the financial statements
- IASB added a narrow-scope maintenance project to its agenda

Purpose and focus of the project

- **Explore whether and how financial statements can better communicate information about climate-related risks;**
- Explore the nature and causes of stakeholder concerns about the reporting of climate-related risks in the financial statements;
- Consider possible courses of action, if any.

- This project will not seek to:
  - develop an Accounting Standard on climate-related risks, or extensive application guidance on how to consider the effects of such risks when applying Accounting Standards;
  - broaden the objective of financial statements or change the definitions of assets and liabilities;
  - develop accounting requirements for pollutant pricing mechanisms[1].

[1] *Pollutant Pricing Mechanisms* is on a reserve list of projects that may be added to the IASB's work plan if stakeholders and the IASB have sufficient capacity.

How does this project relate to the work of the ISSB? (1/2)

- **This project and the work of the International Sustainability Standards Board (ISSB) complement each other, helping investors to connect information included in different parts of general purpose financial reports**

General purpose financial reports include:

Sustainability-related financial disclosures (ISSB)

- Information about an entity's sustainability-related risks and opportunities that could reasonably be expected to affect its cash flows, access to finance or cost of capital over the short, medium or long term.

Financial statements (IASB)

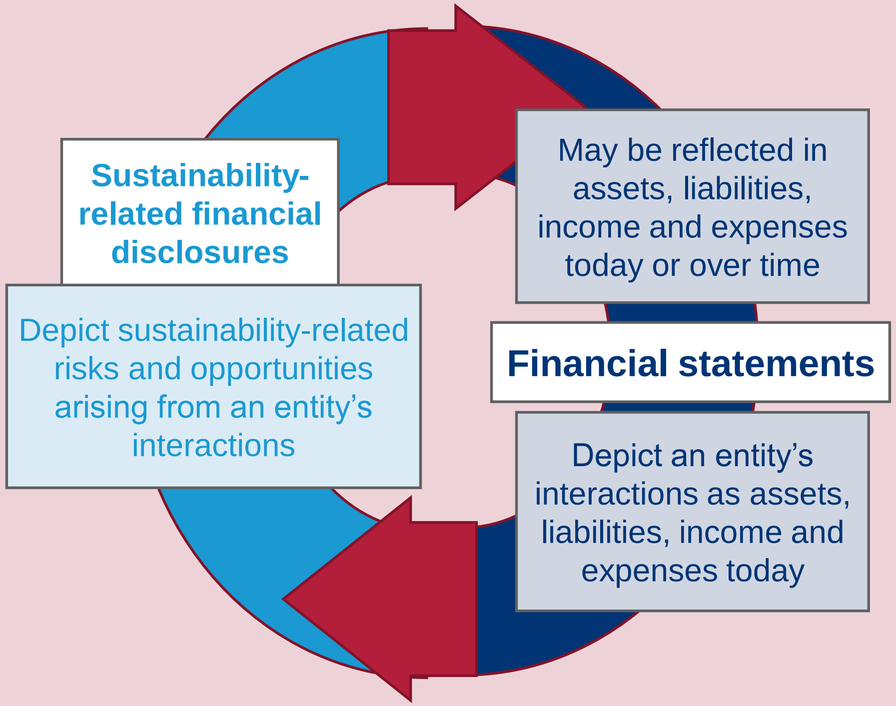
- Information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.
- Information about possible future transactions and other possible future events (forward-looking information) is typically **not** included in financial statements unless that information relates to assets and liabilities that exist at the balance sheet date.

How does this project relate to the work of the ISSB? (2/2)

How sustainability-related financial disclosures and financial statements relate to each other

General purpose financial reports

- Sustainability-related financial disclosures may provide early indications of matters that will subsequently be reflected in financial statements. For example, a company's commitment to net zero emissions could, over time, result in liabilities being reported in the financial statements.
- Sustainability-related financial disclosures may also explain the sustainability-related risks and opportunities arising from an entity's interactions that have already resulted in reported assets and liabilities.
- Together, sustainability-related financial disclosures and financial statements in general purpose financial reports provide information for investors to assess the amount, timing and uncertainty of future net cash inflows to the entity to make decisions about providing resources to the entity.



Tentative project plan

March 2023	March—July 2023	Later this year	TBD
Project commencement	Staff gather feedback from stakeholders	IASB discuss evidence gathered and decides way forward	Next steps

Feedback requested in this meeting

Questions for breakout groups

A. For CMAC members (≈20 minutes)

1. Do you experience challenges related to the reporting of climate-related risks in the financial statements? If so, please explain. (See slide 13 on possible concerns)
2. What information do you need about climate-related risks in the financial statements? Why? How would you prioritise the importance of this information (high, medium, low)? For example, do you need:
   a. qualitative and/or quantitative information about the effects?
   b. effects on inputs to reporting (eg, assumptions) and/or outputs (eg, impairment loss, provisions)?
3. Do you need information specific to the effects of climate-related risks in the financial statements, as opposed to long-term risks more broadly ? (See slide 16 on repositioning the scope of this project).

Note: In the Appendix we have included some examples of the type of feedback we are interested in.

Questions for breakout groups (cont.)

B. For GPF members (≈20 minutes)

1. Do you have any concerns about providing the information CMAC members would like? If so, please explain. (See slide 14-15 on possible causes)

C. For CMAC and GPF members (≈20 minutes)

1. How can we balance users' needs and preparers' concerns in reporting climate-related risks in the financial statements?

Note: In the Appendix we have included some examples of the type of feedback we are interested in.

Possible nature of concerns

We would like your feedback on the nature of the concerns:

Financial statement information appears inconsistent with disclosures made elsewhere about climate-related risks
Recognition, measurement and disclosures in the financial statements cannot be reconciled to an entity's other disclosures

Insufficient information about how climate-related risks are reflected in the financial statements, in terms of:
a) estimates, assumptions, judgments made;
b) separate effects of climate-related risks on amounts recognised in the financial statements

Note: This project may not address all concerns identified. The purpose of this meeting is, in part, to identify concerns to facilitate scoping of this project.

Possible causes of concerns

We would like your feedback on the possible causes of the concerns:

Unclear requirements in IFRS Accounting Standards
Requirements might not be sufficiently clear and/or specific about whether and how the effects of climate-related risks should be considered when preparing an entity's financial statements.

Limitations in IFRS Accounting Standards
Requirements appear to prohibit or do not capture climate-related risks in measuring and recognising assets and liabilities and in requiring the disclosure of relevant information.

Possible causes of concerns (cont.)

We would like your feedback on the possible causes of the concerns:

Challenges with compliance
Entities might not be (adequately) considering climate-related risks when applying IFRS Accounting Standards because of:

- lack of awareness of requirements;
- misunderstanding of requirements;
- cost and complexity (for example, judgements—including judgements about materiality—might be difficult, information might not be available); or
- other reasons?

User information needs beyond the objective of financial statements
Some information needs about climate-related risks might go beyond the objective of financial statements and may be more appropriately addressed by IFRS Sustainability Disclosure Standards. See slides 7-8 on the relationship between financial statements and sustainability-related financial disclosures.

Repositioning the scope of the project

Initial staff comments

The IASB could consider repositioning the scope of the project to cover:

- risks in addition to those related to climate (eg long-term risks); and
- opportunities as well as risks.

Things to consider

Consistency with the ISSB which in its work:

- reflects both opportunities and risks; and
- acknowledges that it is not always possible for preparers to separate the financial effects of climate-related risks and opportunities from other sustainability-related risks and opportunities.

Some of the solutions to improve the reporting of climate-related risks in the financial statements may apply to other long-term risks.

Appendix—Examples of the type of feedback we are interested in

IFRS Accounting

Impairment of assets

1 **Nature of concern**	**Inconsistencies between financial statement information and other information** Although entities have made net zero commitments they have not impaired the value of their assets as a result of those commitments.
2 **What are the causes of concern?***	**3** **What are the possible courses of action?***
Limitations in IFRS Accounting Standards IAS 36 *Impairment of Assets* requires cash flow projections to be based on the most recent budgets/forecasts for a maximum of five years, unless management is confident that its projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over a longer period.	**Minor amendments to Accounting Standards** The IASB could consider: • removing the restriction in IAS 36 for cash flow projections to cover a maximum period of five years; • amending paragraph 35 of IAS 36 to make it easier to apply the exemption to use financial budgets/forecasts of future cash flows for periods longer than five years **Possible costs** for this course of action include: • more difficult judgments about the estimates of future cash flows • risk of less reasonable and supportable information reflected in cash flow projections

*Note: For simplicity, this example does not include analysis of all causes of concern and all possible courses of action for this issue.

Recognition of liabilities

1 Nature of concern	**Inconsistencies between financial statement information and other information** Although entities have made net zero commitments they may have not recognised liabilities as a result of those commitments.
2 What are the causes of concern?*	3 What are the possible courses of action?*
Unclear requirements in Accounting Standards	**New illustrative examples** The project Provisions—Targeted Improvements is exploring possible targeted amendments to IAS 37 *Provisions Contingent Liabilities and Contingent Assets* (see Agenda Paper 3 to this meeting). The IASB could consider adding an Illustrative Example on a net zero commitment to clarify that simply making a commitment to offset future greenhouse gas emissions does not in itself give rise to a present obligation for an entity and, therefore a provision would not be recognised until the entity has emitted the gas it has promised to offset. **Possible costs** for this course of action – stakeholders may want to broaden the definition of liabilities, but that is beyond the scope of the Provisions—Targeted Improvements project and this project.
User information needs beyond the objective of financial statements	**Educational materials** The IASB could consider publishing educational material to explain the objective of financial statements, the reasons for the definition of a liability and the importance of analysing financial statements and sustainability-related financial disclosures together. **Possible costs** for this course of action – stakeholders may want to change the objective of financial statements, but that is beyond the scope of this project.

*Note: For simplicity, this example does not include analysis of all causes of concern and all possible courses of action for this issue.

IFRS Accounting

Disclosure of assumptions and other sources of estimation uncertainty

1 Nature of concern	**Insufficient information about how climate-related risks are reflected in the financial statements**
2 What are the causes of concern?*	**3 What are the possible courses of action?***
(Perceived) Limitations in IFRS Accounting Standards / Unclear requirements / Lack of compliance Under IAS 1 *Presentation of Financial Statements*, an entity is required to disclose assumptions made about the future and other sources of estimation uncertainty if they have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (paragraph 125 of IAS 1). This paragraph may be perceived to prohibit disclosures of other assumptions and sources of estimation uncertainty.	**Minor amendments to Accounting Standards** The IASB could consider whether removing the reference to 'the next financial year' from paragraph 125 of IAS 1 could result in the disclosure of more information about climate-related risks than entities currently disclose and improve the information available to users. **Possible costs** for this course of action: • could such an amendment result in the disclosure of large amounts of forward-looking information about a wide range of risks? • consider amendments to Sustainability Disclosure Standards **Minor amendments to Accounting Standards** The IASB could add requirements to disclose assumptions to specific Accounting Standards. **Possible costs** for this course of action – costly to implement?

*Note: For simplicity, this example does not include analysis of all causes of concern and all possible courses of action for this issue.

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