Impact of Climate-related Risk on Financial Statements

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In recent years, the demand for sustainability reporting has risen. In response to this increasing demand, the IFRS® Foundation announced the creation of the International Sustainability Standards Board (ISSB) in 2021. On its website, the ISSB says its goal is to "deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions."

In March 2022, the ISSB published the Exposure Drafts "IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information" (IFRS S1) and "IFRS S2 Climate-related Disclosures" (IFRS S2). As proposed, an entity would be required to include sustainability-related financial disclosures as part of its general-purpose financial reporting, which encompasses, but is not restricted to, an entity's general-purpose financial statements. The ISSB is currently redeliberating certain aspects of IFRS S1 and S2.

With respect to financial statements based on IFRS Accounting Standards, there is currently no single explicit standard on climate-related matters. However, climate risks and opportunities may impact several areas within an entity's financial statements. While the immediate impact to the financial statements may not necessarily be quantitatively significant, more stakeholders expect entities to explain qualitatively how climate-related matters are considered in preparing financial statements to the extent they are material.

The Group discussed certain impacts of climate-related risks and opportunities on an entity's financial statements prepared in accordance with IFRS Accounting Standards.

Issue: Under current IFRS Accounting Standards, how are climate-related risks and opportunities integrated in financial statements, including disclosures?

Analysis

With investors increasingly focusing on climate-related matters, entities should assess how climate change, including their commitments and actions to address climate change, may affect their financial statements and other reporting obligations. For example, entities may commit to net-zero or other climate targets, and establish a climate strategy, including a transition plan. These strategies and targets can have a direct impact on financial statements.

The Group's Discussion

A few Group members commented that this is an evolving area of reporting across several jurisdictions and that entities will need to continue to monitor developments and assess their impact on their financial statements. It was also noted that the impact on financial statements will be

affected by political initiatives and the actions of governments and regulators, and may vary from jurisdiction to jurisdiction.

The Group considered the following examples of climate-related matters and the impact they may have on an entity's financial statements. This list is not exhaustive.

Disclosures

Financial statement users expect companies to provide clear and transparent climate-related disclosures. To meet these expectations, entities should consider the specific disclosure requirements in individual IFRS Accounting Standards as well as the overarching requirements of IAS 1 *Presentation of Financial Statements*.[1]

Regarding the general requirements, entities should consider the definitions of material information in IAS 1 in determining what, if any, additional information they must provide to bridge any gap with user's expectations. Materiality involves both quantitative and qualitative considerations, so while information may not be material in amount, it may be material in nature.

Additionally, entities may consider paragraph 112 of IAS 1 that requires disclosing information relevant to understanding the financial statements but is not specifically required by IFRS Accounting Standards or presented elsewhere in the financial statements. Furthermore, paragraph 17(c) of IAS 1 notes that, in certain circumstances, entities may need to include additional disclosures to achieve a "fair presentation" in the financial statements.

When recognizing and measuring an asset's useful life or fair value, entities may use significant estimates and judgments to reflect climate risks and opportunities in their analyses. Where material, an entity should disclose how climate change and climate-related goals have been reflected in these assumptions when major sources of estimation uncertainty exist. Alternatively, entities may need to disclose why these have not been considered, especially in industries or sectors where stakeholders may expect climate risk to have a material impact on significant estimates and judgments. As their analysis may include multiple scenarios covering a wide range of possible outcomes, entities may need to provide sensitivity analyses for a range of scenarios with accompanying disclosures on how the uncertainties are incorporated in the estimates and sensitivities disclosed.

The Group's Discussion

Several Group members observed that the requirements in IAS 1 do not specifically address the disclosure of climate-rated risks. They also thought that it would be useful for the ISSB to work with the IASB to provide guidance on how these disclosures may be included in financial statements. A few Group members expressed concern that, without clear guidance, the information provided by entities in similar industries may not be comparable, given the individual entity's perspective on the

[1] Material that links to the CPA Canada Handbook is available to subscribers only. However, all relevant information is provided in this meeting report.

impact of climate change. Another Group member commented that entities may be at different stages of maturity in terms of their assessment of how climate-related risks affect their financial statements. Therefore, preparers may not be excluding this information intentionally, rather they may not have completed sufficient analysis to provide meaningful climate-related risk disclosure. Furthermore, in the absence of meaningful analysis, it will be difficult for entities to provide entity-specific, non-boilerplate disclosure. Another Group member commented that they currently observe disclosures associated with climate-related risks within an entity's management, discussion, and analysis.

One Group member noted that many measurement elements are associated with climate-related risks and that these measurements may be subject to a high degree of judgment. In preparing its financial statements, an entity is required to disclose judgments, apart from those involving estimations, which have the most significant effect on the amounts recognized in their financial statements.

Long-lived assets

Entities are required to review the residual value and the useful life of their amortizing long-lived assets at least at each financial year-end. A climate transition plan that includes the replacement of carbon-heavy assets may affect the estimated useful lives and residual values assigned to these assets. Consequently, this may impact depreciation and amortization expense. Other climate-related risks that may impact the useful life of a long-lived asset could include new regulations restricting the use of certain assets, such as mineral exploration licenses or limitations on carbon-emitting assets.

A change in a long-lived asset's useful life and/or residual value would require disclosing the nature and amount of the change in estimate. Entities may also consider if those estimates are subject to higher estimation uncertainty, which would require disclosures in accordance with paragraph 125 of IAS 1.

The Group's Discussion

The Group agreed with the analysis.

One Group member commented that modifying an asset for environmental reasons may qualify for recognition in accordance with paragraph 11 of IAS 16, *Property, Plant and Equipment*. They also noted that contractual commitments to acquire new property, plant and equipment to replace carbon-heavy or "dirty" assets should be disclosed in accordance with paragraph 74(c) of IAS 16.

Impairment

A decrease in the useful life or the residual value of a long-lived asset may be an indicator of impairment. Other indicators of impairment may include increased environmental awareness from stakeholders resulting in weakening performance of a cash-generating unit (CGU) due to:

- changes in customer preferences to more sustainable goods or services;

- increased costs from suppliers as a result of their own climate transition strategy;
- a higher market interest rate or discount rate for asset specific risk in climate-intensive CGUs;
- emerging regulatory requirements leading to growing compliance costs; and
- rising insurance or maintenance costs due to the physical impacts of climate change, (e.g., an increase in the frequency and severity of extreme weather events).

When determining an asset or a CGU's recoverable amount using value-in-use (VIU) or fair value less costs of disposal (FVLCD), there may be several considerations related to climate-related risks and opportunities. These impacts may vary depending on the location, nature of specific restrictions, and industry characteristics of an asset or a CGU. Therefore, careful consideration may be required to determine the effect, if any, climate-related risks and opportunities have on an asset or a CGU's recoverable amount. Areas an entity may need to consider in the determination of an asset or a CGU's recoverable amount may include the following:

- Forecasted cash flows: Environmental change may impact the timing or amount of projected cash flows.
- Scenario analyses: Given the uncertainty in the cash flows, entities may need to consider probability-weighted scenarios and different pricing curves in determining cash flows (e.g., anticipated cost increases from suppliers due to rising fuel costs and the possibility of passing on those higher costs to customers).
- Capital expenditures: Entities may need to incur capital expenditures to meet evolving regulatory requirements or to decrease their carbon footprint. Under a VIU model, they should consider whether those investments are required to continue to operate the assets (similar to maintenance) or whether they are betterments. Under a FVLCD model, they should consider whether a market participant would also make such investments;
- Discount rates: Entities may consider incorporating uncertainty related to climate risks and opportunities within an entity-specific risk premium in the discount rate. Alternatively, those risks may need to be considered as part of an industry-specific risk premium within the discount rate.
- Terminal value: The growth rate in the terminal period should consider how climate-related matters may impact the entity in the long term, and entities may need to consider negative growth rates, depending on the nature of the specific asset or CGU.

The Group's Discussion

The Group agreed that climate-related risks may impact the recoverable amount of an asset or CGU.

A few Group members commented that climate-related risks could positively impact an entity. For example, customers may change their purchasing behaviour to transact with companies whose

products are more environmentally sustainable. In addition, these customers may also be willing to pay a higher price for sustainably sourced or produced products. Furthermore, manufacturers may benefit from improved sustainability practices by reducing their packaging and other associated costs.

Fair value measurement

In determining fair value under IFRS 13 *Fair Value Measurement*, entities consider the price that they would receive when they sell an asset or the amount they would pay to transfer a liability in an orderly transaction in the principal market at the measurement date under current market conditions. Entities should carefully consider whether, and to what extent, climate change might affect the assumptions used to measure fair value.

Climate change can have a tangible effect on an entity's assets and liabilities now and in the future. A government's or an entity's response to climate change may be known or only anticipated. These climate-change impacts could potentially drive market participants' assumptions in determining fair value, whether the risks or opportunities are real or perceived. However, despite the increased focus on climate-related factors, incorporating such factors into a fair value measurement may be particularly challenging as inputs might not be observable at this stage. In some cases, there might be no standard framework to measure and validate climate-related risks and opportunities. In others, changes may be agreed in principle, but the timing may be unknown or subject to change. Even if the risk can be quantified and the timing estimated, the market(s) and market participants might not yet know how to adjust for it in the price of the asset or the liability.
As a result, entities need to consider whether, and how, they can factor relevant climate-related risks and opportunities into a fair value measurement. Market participants' ability to reliably incorporate climate change variables into valuations will likely improve with time.

When climate-related risks and opportunities are material to a fair value measurement, entities will need to provide relevant disclosures, particularly for those fair value measurements categorized within Level 3 of the fair value hierarchy (see paragraphs 72-99 of IFRS 13). During the transition period, as market participants begin to adjust for climate-related risks and opportunities, entities may be required to exercise significant judgment to determine appropriate assumptions. These assumptions may need to be disclosed.

The Group's Discussion

The Group agreed with the analysis.

One Group member commented that it may be difficult to determine the fair value of an asset or CGU because there is no observable market that illustrates the discount or premium associated with an entity's environmental activities. However, another Group member noted that transactions at higher or lower values because of the impact of climate-related risks and sustainability are being observed, and in the future, it may become easier to incorporate these into fair value assessments as observable transactions increase.

Provisions

For existing environmental and decommissioning obligations, a decrease in the useful life of a related item of property, plant and equipment may result in an earlier decommissioning than previously estimated. This will increase the provision and related long-lived asset. New legislation may result in new obligations, such as changes in product end-of-life requirements for recycling or new decontamination laws.

An entity's public commitment regarding its climate targets or transition plans may create a constructive obligation. The entity should assess whether a provision needs to be recognized in accordance with paragraph 14 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Additionally, the costs to provide a service or a good using greener materials or processes may be greater than initially planned. This cost increase may cause a previously profitable contract to become onerous. In this case, a provision may need to be recognized for the onerous contract.

The Group's Discussion

Several Group members commented that provisions generally are not recognized as the result of an entity making a public statement about its climate plans and/or targets because such statements often do not meet the criteria in IAS 37. One Group member commented on the need to update the measurement of an entity's existing provisions to reflect any new estimates of the expenditures required to settle the obligation. Changes to estimates may result from shifts in government action and could require more frequent updates as climate-related initiatives accelerate.

Corporate reorganization

If within its climate strategy, an entity commits to sell or dispose of certain carbon-heavy assets, a group of assets or a major line of business not aligned with its climate strategy, IFRS 5 *Non-current Assets Held for Sale* and *Discontinued Operations* may apply. This would require the entity to account for the long-lived asset or disposal group at the lower of its carrying amount and fair value less costs to sell. The entity should present the post-tax profit or loss of the discontinued operations as a single amount in the statement of comprehensive income.

Alternatively, as part of its transition plan, an entity may decide to close some of its operations and may need to recognize a restructuring provision. In light of disclosures made related to its climate transition plan, an entity should apply judgment to determine when it has raised valid expectations for those affected by the plan. This decision is also likely to be a potential indicator of impairment of the related long-lived assets.

Taxes on carbon emissions and emissions trading schemes

As regulators and governments may impose taxes and other penalties on carbon-heavy operations, entities will need to assess, based on the specific regimes, whether these would be accounted for under IAS 12 *Income Taxes* or IFRIC 21 *Levies*.

IFRS Accounting Standards do not specifically address emissions trading schemes. Depending on

the nature of an entity's operations, consideration may need to be given to IAS 2 *Inventories*, IAS 38 *Intangible Assets*, IFRS 13, IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, and IAS 37.

Contract modifications

As part of its transition plan, an entity may renegotiate contracts with stakeholders (customers, suppliers, employees), which may result in financial impacts. For example:

- Leases: An entity may seek to reduce its physical footprint, resulting in modifying or cancelling leases.
- Revenues: An entity may modify existing contracts with customers (e.g., to change the transaction price in order to pass on rising costs).
- Employee benefits and share-based payments: An entity may modify existing compensation arrangements to include climate-related vesting conditions.

Entities should consider specific guidance on the accounting for contract modifications in various IFRS Accounting Standards. They may also need to disclose information so the financial statement users understand the effect of these modifications.

Financial instruments

Sustainability-linked loans (or green bonds) are structured such that their payments (interest) vary based on specified environmental, social, and governance (ESG) targets. For example, the contractual interest rate is reduced if the borrower meets specific targets for reducing carbon emissions or increased if the borrower does not meet those targets. These sustainability-linked adjustments to contractual cash flows generally give a borrower incentive to contribute to the development of green projects and minimize their negative impact on the environment. The Group discussed the accounting for these loans from the issuer's perspective at its September 2021 meeting. From the holder's perspective, entities will need to assess whether ESG features meet the solely payments of principal and interest (SPPI) criteria under paragraph 4.1.2 of IFRS 9 *Financial Instruments* to record the loans at amortized cost.

In addition, paragraph 5.5.1 of IFRS 9 requires the use of forward-looking information to recognize expected credit losses. Entities should consider the physical risks that can reduce a borrower's creditworthiness because of business interruption, lower asset values, and unemployment. Transition risks could also result in credit quality rapidly deteriorating in affected sectors and/or countries, particularly if policy changes are quickly implemented.

Paragraph 31 of IFRS 7 *Financial Instruments*: Disclosures requires an entity to disclose information that "enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period." Paragraph 32 of IFRS 7 further indicates that these risks are not limited to credit risk, liquidity risk, and market risk. Consequently, climate-related risks arising from an entity's financial instruments should be disclosed and quantified if material.

The Group's Discussion

The Group agreed with this analysis.

Other possible areas for consideration

Other areas of the financial statements that may be impacted by climate-related risks and opportunities include:

- IAS 1 – Going concern assumption;
- IFRS 17 *Insurance Contracts* – Measurement of insurance contracts;
- IAS 2 – Net realizable value of inventories;
- IAS 12 – Recognition of deferred tax assets;
- IAS 20 – Accounting for government grants;
- IFRS 15 – Climate-related risks may add a constraint on variable consideration or consideration payable to a customer for any climate-related incentives for purposes of revenue recognition;
- IFRS 8 *Operating Segments* – Operating segments may change to align with a new climate-related strategy; and
- IAS 34 *Interim Financial Reporting* – Disclosures on the seasonality or cyclicality of interim operations because of climate change (e.g., increased risks during certain months depending on the geographical location of an entity's operations).

The Group's Discussion

The Group agreed with this analysis and encouraged entities to consider how climate-rated risks affect insurance contracts and revenue contracts. A few Group members noted the importance of considering how climate-related risks affect investments in associates and joint ventures because they could affect the entity-investor's equity accounting for such investments. One Group member noted the importance of monitoring other jurisdictions' progress with new corporate reporting requirements in this area, such as the European Union. Canadian entities with global operations will need to determine the scope of their reporting requirements across all relevant jurisdictions.

One Group member indicated that Canadian stakeholders should monitor the development of the Canadian Sustainability Standards Board (CSSB) and consider the types of entities that will be impacted by its mandate. They also noted the Public Sector Accounting Discussion Group had an interesting discussion recently on the impact of climate-related risk on financial statements. The Group member said stakeholders might find this discussion helpful in developing their understanding of this topic, even though the discussion was in the context of another framework.

Overall, the Group's discussion raised awareness of the pervasive impact that climate-related risks may have on the application of various IFRS Accounting Standards. No further actions were

recommended to the AcSB.