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HOW SHOULD CLIMATE CHANGE BE CAPTURED IN FINANCIAL STATEMENTS?

As the focus on climate change intensifies, do you understand how it should be reflected in your financial statements under existing requirements?

With the increasing pressures of climate change, Regulators and investors now more than ever want to understand the impacts of climate change on your organisation and what you are doing to manage the risks that climate change poses. It is becoming evident that climate change will have a true economic impact on the value of an organisation.

Unlike other jurisdictions, Australia has minimal disclosure requirements that capture the impacts of climate change. Most disclosure is in the front half of a company's annual report with some disclosures being made in the Operating and Financial review as part of the Directors' report. Listed Australian organisations have to also provide disclosures under the *ASX Corporate Governance Principles and Recommendations (4th Edition)* on their environmental risks and how they manage them. Until now smaller unlisted organisations have not typically considered this in much depth.

However, climate change impacts should be reflected within the financial report itself. Whilst climate change is not explicitly mentioned, Australian Accounting Standards (AAS) do contain requirements which would require you to include the impacts of climate change in your financial statements if it is material. Accordingly, as climate change becomes a more significant issue, it may become more material for your organisation and be required to be incorporated into your financial statements.

TYPES OF CLIMATE RISKS FACED

Climate change can affect different organisations in different ways. The proposed International Sustainability Standards Board (ISSB) standard on climate-related disclosures and the Taskforce on Climate Related financial disclosures (TCFD) both consider climate risks faced by organisations to consist of two different elements:

- Physical risks
  These are the risks that arise from actual changes in climate, they can be acute (due to one off weather events) or chronic (impacts of long-term changes in climate patterns). These risks may cause damage to your assets, as well as implications on the way that you run your business due to changes in water availability, extreme temperature changes impacting your premises, operation, supply chain and employee safety etc.
- Transitional risks
  These are the risks associated with transitioning to a low carbon operation model. This may require extensive policy, legal, technological and market changes. Depending on the speed and nature of

these changes, they may pose significant financial and reputational risk to your organisation.

Whilst we typically consider the physical risks, it is important that we are also mindful of the transitional risks and how they may impact your organisation.

IMPACTED FINANCIAL STATEMENT CAPTIONS

The implications on the financial statements can be broad reaching. As climate change impacts every part of your organisation it may impact your financial statements due to:

- Changes in the costs of doing business
- Forecast future cashflows and customer expectations
- Management's intentions to address climate issues

Specifically, you will need to consider the following key areas

Useful life of property, plant & equipment, and intangible assets

The useful life of some assets may be shortened for two reasons

1. if you have carbon intensive assets, due to investor and market pressure you may cease using these assets earlier than previously intended.

   Examples of this include recent decisions to close coal fired power plants earlier than previously planned.

2. Due to the harsher climate conditions assets may no longer be useful for as long as previously expected. For example:

   - Airconditioning units that due to increased usage are expected to wear out sooner or will not be of sufficient strength
   - Harsher weather conditions means assets exposed to the elements need to be replaced more frequently
   - Bearer plants (such as grape vine) that will not survive in hotter temperatures and therefore may have to be replaced with different varieties.

Decreasing the useful lives of assets will increase the depreciation charge in the income statement each year.

Impairment of non-financial assets

Shifts in market demand for carbon intensive products or other exposures to climate risk (such as operating in a flood prone location) may be an indicator of impairment requiring you to do a full impairment test.

The impacts of climate risk should also be factored into the future cash flows used to determine the recoverable amount in an impairment test. The impacts could include factors such as:

- Increased operating costs to deal with the effects or consequences of physical impacts of climate change such as increased maintenance
- shifts in customer demands for greener products
- increased costs associated with scares resources including water etc
- cost of implementing any agreed climate transition plans

Provisions and contingent liabilities

The cost of restoration and make good provisions may increase due to increases in restoration obligations as a result of regulatory changes, or the shortened life of projects bringing the restoration forward. Alternatively, as technology improves to address climate issues, some costs may decline.

If you have long term contracts, you should also consider whether more contracts will be onerous due to higher costs flowing through your supply chain as a result of climate change.

If you operate in industries that pollute or have other significant environmental impacts, you may need to consider recognition of provisions or disclosure of contingent liabilities for fines or

litigation arising from stricter environmental regulations as well.

Fair value measurement

Some assets are going to be significantly impacted by physical climate change. This is likely to impact the market's view of the fair value of these assets and should be reflected in fair valuation calculations.

Due to the nature and uncertainty of climate change It may also involve using more unobservable inputs (level 3 inputs) that would require additional disclosures, or broader ranges of potential values to consider as well.

Financial instruments

If you have long term receivables, more common in the financial services industry, the climate risks faced by your customers may be a significant input into your expected credit loss (ECL) calculation. If your customers don't mitigate their climate risks, they may fail and your debt is no longer recoverable.

You may also find lenders offering your organisation sustainability-linked financing products, where the interest rates charged on borrowings are linked to your organisation's ability to reduce their carbon footprint or other sustainability measures. The accounting for such arrangements should be considered carefully including the appropriate disclosures.

Inventory

Change in customer demand for greener products or potential increases in the costs to complete inventory may mean you need to write inventories down to their net realisable value. This is more likely to be a significant issue if you have inventory that takes a significant length of time to produce such as wine or cheese.

Deferred taxes

The impacts of climate change may mean that future taxable profits become less probable, and you will need to consider the appropriateness of recognising deferred tax assets.

Going concern

If you operate in a carbon intensive industry you should consider your ability to continue as a going concern. Whilst you only need to consider your abilities over the next 12 months from year-end (or 12 months from the audit report date if you undergo an audit), cash flow forecasts should consider the change in customer preference and potentially increasing costs.

More significantly, many lenders are looking to reduce their exposure to carbon intensive industries. Therefore, if you have financing that is due for renegotiation, consideration may have to be given to the likelihood of being able to renew it, or whether a limitation in accessing funding creates significant uncertainty about your ability to continue as a going concern.

IS THE IMPACT MATERIAL ENOUGH TO WARRANT INCLUSION

Different organisations are going to be impacted differently by climate change and some are clearly more impacted than others. Therefore, this will also drive the extent to which it needs to be reflected in the financial statements. If you have not previously considered the impacts of climate change on your financial statements, you will need to do some analysis to determine how significant it is for your organisation.

Where the impacts of climate change are material to the amounts recognised in the financial statements it is essential that they are included, and that appropriate disclosures are also provided around the significant judgements and estimates associated with including it.

Even if climate change does not have a significant impact on the numbers in the financial statements, it may still be appropriate to make disclosures of the impact (or lack thereof), given the nature of the risks.

Information can still be material if it can influence the decisions of users of the financial statements. Therefore, in the current environment you should consider whether the

investors would expect there to be impacts or want to understand the impacts of climate change on the financial statements.

REGULATORY DEVELOPMENTS

There are no plans currently underway to increase sustainability related disclosures in the financial statements. However, the International Sustainability Standards Board (ISSB) has been set up as a sister board to the International Accounting Standards Board (IASB). The ISSB has issued two exposure drafts on sustainability reporting:

- Draft IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*
- Draft IFRS S2 *Climate-related Disclosures*

The finalised standards are expected to be issued by the end of 2022.

ASIC has indicated strong support for the proposed sustainability standards. However, they nor any other regulator, has yet to determine how they would be applied in Australia. However, it is safe to assume that there will be an increase in the level of sustainability disclosures that will be required to accompany the annual financial report in the near future.

FURTHER INFORMATION

No matter where you are on your climate change journey Moore Australia is here to help. Not only can our experts help you ensure that climate risks are appropriately reflected in your financial statements, we can help with a broad range of Environmental, Social and Governance (ESG) matters including

- Assessment
- Strategy & Implementation
- Measurement & Reporting
- Assurance & Attestation
- Optimisation

For more information please contact your local Moore Australia advisor.

www.moore-australia.com.au/ESG

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