CHAPTER 1

# Effects of climate-related matters on financial statements

**This article aims to:**

- Highlight requirements in accounting frameworks (Ind AS/IFRS) to report on the effects of climate-related matters on the financial statements.

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# Introduction

Climate-related risks and opportunities are faced by all companies. Some are affected more than others. As the impact of climate change increases investors and regulators are increasingly looking for greater transparency in relation to climate change and detailed information in the financial statements. Considering the growing implications of climate risk for the preparation of financial statements and lack of sufficient disclosure of climate-related information in financial statements, regulators and standard setting bodies around the globe are working on developing the climate-related disclosure requirements.

However, IFRS Accounting Standards or Ind AS do not refer explicitly to sustainability or climate-related matters. In this regard, in June 2023 the International Sustainability Standards Board (ISSB) issued the final version of the first two IFRS Sustainability Disclosure Standards:

- IFRS S1, *General Requirements for Disclosure of Sustainability-related Financial Information* (IFRS S1)
- IFRS S2, *Climate-related Disclosures* (IFRS S2).

The standards aim to put sustainability reporting on an equal footing with financial reporting and facilitate the much needed connectivity between sustainability-related financial information and the financial statements. The IFRS S2, the standard on climate-related disclosures specifically requires an entity to disclose information about its climate-related risks and opportunities that is useful to primary users of general purpose financial reports in making decisions relating to providing resources to the entity.

Considering the recent sustainbility framework related developments, the IFRS Foundation republished its educational material on climate-related disclosures to reiterate requirements in IFRS Accounting Standards to report on the effects of climate-related matters in the financial statements when those effects are material.

The education material also highlights that information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that primary users of financial statements (hereafter, investors) make on the basis of those financial statements, which provide financial information about a specific company. For example, information about how management has considered climate-related matters in preparing a company's financial statements may be material with respect to the most significant judgements and estimates that management has made.

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# Overview of the disclosure requirements

IAS 1, *Presentation of Financial Statements* deals with the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. While preparing financial statements, companies should consider overarching requirements under IAS 1 that could be relevant when considering climate-related matters. As per IAS 1 companies are also expected to provide additional disclosures when compliance with the specific requirements in IFRS Accounting Standards is insufficient to enable investors to understand the impact of climate-related matters on the company's financial position and financial performance.These overarching requirements in IAS 1 may be especially relevant for companies whose financial position or financial performance is particularly affected by climate-related matters.

The following section contains relevant disclosure considerations for certain key areas under IFRS Accounting Standards related to effects of climate-related matters that companies should consider in applying the principles of IFRS Standards.

## IAS 1, *Presentation of Financial Statements*

### Significant judgements and estimation uncertainty

IAS 1 requires specific disclosures on key judgements and estimates made by the management in preparing the financial statements. This includes the disclosure of:

- Judgements that management has made in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements; and
- Information about the assumptions that management has made about the future, and other major sources of estimation uncertainty as at the reporting date, that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year.

Therefore, disclosure of such judgements and assumptions about climate-related matters would be required to be made.

### Going concern

The provisions of IAS 1 requires management to assess a company's ability to continue as a going concern when preparing financial statements. In assessing whether the going concern basis of preparation is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, 12 months from the end of the reporting period.

It is important to note that climate-related risks may result in:

- Material uncertainties affecting a company's ability to continue as a going concern or
- May involve significant judgements in concluding that there is no material uncertainty (commonly referred as a 'close call' scenario).

IAS 1 requires disclosure of those uncertainties and significant judgements involved.

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- **IAS 16, *Property, Plant and Equipment***
- **IAS 38, *Intangible Assets***

On an annual basis, companies should review the estimated residual values and expected useful lives of Plant, Property and Equipment (PPE) and intangible assets as per IAS 16 and IAS 38. Further, companies should also reflect changes in the amount of depreciation or amortisation recognised in the current and subsequent periods.

Climate-related matters may significantly affect the useful lives and the residual values of PPE and intangible assets. If management re-estimates an asset's useful life and/or residual value, then it discloses the nature and amount of the change in that estimate.

**IAS 12, *Income Taxes***

IAS 12 requires companies to recognise deferred tax assets for deductible temporary differences and unused tax losses and credits, to the extent it is probable that future taxable profit will be available against which those amounts can be utilised.

Climate related factors could increase the level of uncertainty with respect to the future tax profits. As a result, a company would not be able to recognise deferred tax assets or would be required to derecognise deferred tax assets previously recognised.

**IAS 2, *Inventories***

As per IAS 2, inventory is measured at the lower of cost and Net Realisable Value (NRV). Further, if the cost of inventories is not recoverable then the company should write down those inventories to their NRV. The NRV estimates are based on the most reliable evidence available, at the time that estimates are made, of the amount the inventories are expected to realise.

Climate-related matters could impact both the selling price and the cost of an inventory item, such as climate-related matters could cause a company's inventories to become obsolete, their selling prices to decline or their costs of completion to increase. Therefore, management needs to consider these carefully when determining the NRV of its inventories.

**IAS 36, *Impairment of Assets***

Under IAS 36, companies are required to assess at each reporting date whether there is an indication that an asset or Cash-Generating Unit (CGU) may be impaired. One such impairment indicator could be external information such as significant changes in the environment (including for example changes in regulation) in which a company operates having an adverse effect on the company.

Climate-related matters may give rise to indications that an asset (or a group of assets) is impaired. For example, a decline in demand for products that emit greenhouse gases could indicate that a manufacturing plant may be impaired, requiring the asset to be tested for impairment.

The Discounted Cash Flow (DCF) technique is used to calculate the recoverable amounts of assets or CGUs for the purpose of testing impairment. While estimating the recoverable amount using the value in use, the calculation should reflect an estimate of the future cash flows it expects to derive from an asset and expectations about possible variations in the amount or timing of those future cash flows. For this purpose, the cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the range of future economic conditions. This requires companies to consider whether climate-related matters affect those reasonable and supportable assumptions.

IAS 36 requires disclosure of the events and circumstances that led to the recognition of the impairment loss. Disclosure of key assumptions used to estimate the asset's recoverable amount, as well as information related to reasonably possible changes in those assumptions, is also required in specified circumstances.

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## • IAS 37, Provisions, *Contingent Liabilities and Contingent Assets*
## • IFRIC 21, *Levies*

IAS 37 ensures that a company applies appropriate recognition criteria and measurement bases to provisions, contingent liabilities and contingent assets. IAS 37 requires a company to disclose the nature of a provision or contingent liability and an indication of the uncertainties about the amount or timing of any related outflows of economic benefits.

Climate-related matters could affect the recognition, measurement and disclosure of liabilities in the financial statements. For instance levies imposed by governments for failure to meet climate-related targets or to discourage or encourage specified activities could impact the determination of provisions and contingent liabilities and appropriate disclosures should be made as per the provisions of IAS 37.

## IFRS 7, *Financial Instruments: Disclosures*

As per IFRS 7, companies are required to disclose information about its financial instruments, including information about the nature and extent of risks arising from financial instruments and how the company manages those risks.

Climate-related matters may expose a company to risks in relation to financial instruments, and disclosure of such risk should be provided.

For instance,

- For lenders: Information about the effect of climate-related matters on the measurement of expected credit losses or on concentrations of credit risk should be provided.
- For holders of equity investments: Information about investments by industry or sector, identifying sectors exposed to climate-related risks, when disclosing concentrations of market risk, should be provided.

## IFRS 9, *Financial Instruments*

The objective of IFRS 9 is to establish principles for the financial reporting of financial assets and financial liabilities. Climate-related matters could impact the accounting for financial instruments. For instance, borrower's ability to meet its debt obligations could be negatively impacted due to wildfires, floods, or policy and regulatory changes which would have a consequential impact on the expected cash flows to be received from such a loan and the lender's exposure to credit losses.

Thus, climate-related matters could affect the range of potential future economic scenarios, the lender's assessment of significant increases in credit risk, whether a financial asset is credit impaired and/or the measurement of expected credit losses.

## IFRS 13, *Fair Value Measurement*

IFRS 13 provides guidance for measurement of fair value. Climate-related matters could affect the fair value measurement of assets and liabilities in the financial statements e.g. the market participants' views of potential climate-related legislation could affect the fair value of an asset or liability.

Climate-related matters could also impact the disclosures about fair value measurement. More specifically, for fair value measurements categorised within Level 3, IFRS 13 requires that unobservable inputs should reflect the assumptions that market participants would use when pricing, including assumptions about risk which may include climate-related risk. Further, a comprehensive disclosure should be provided as per the requirements of IFRS.

## Conclusion

Climate-related information is a key area of focus for many regulators and users of the financial staements. Therefore, companies are expected to improve the clarity and transparency of climate-related disclosures. To meet these expectations, companies need to consider the specific disclosure requirements in individual standards as well as the overarching requirements of IAS 1 when providng climate-related disclosures.

*Source: IFRS Foundation, Educational material - Effects of climate-related matters on financial statements, published July 2023*

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