CLIMATE-RELATED RISKS IN THE FINANCIAL STATEMENTS

EFRAG SECRETARIAT BRIEFING

SUMMARY: EFRAG OUTREACH, LEARNINGS FROM REVIEWS OF EUROPEAN REPORTING TRENDS

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INTRODUCTION

1. Objective

This report summarises findings from EFRAG's outreach and engagement with stakeholders on the International Accounting Standards Board (IASB) project on Climate-related Risks in the Financial Statements ('CRFS project'). In this document, consistent with the IFRS Foundation's description of general purpose financial reporting[1], the term "financial statements" refers to the primary financial statements and accompanying notes to the accounts.

The findings in this report draw upon and integrate the following:

- findings from EFRAG's outreach that was carried out from June to July 2023. The feedback was obtained from the responses to a survey that was sent to EFRAG stakeholders (see Section 4 below and the Appendix for further details) and from input received during meetings with some of EFRAG's technical expert and advisory working groups;
- constituents' views expressed during the 2021 EFRAG agenda consultation;
- learnings from EFRAG's participation in stakeholder meetings addressing the topic; and
- a review of concerns flagged in publications related to European companies' reporting of climate-related risks in the financial statements.

These findings are pertinent for both the IASB CRFS project and the EFRAG research project on the connectivity between financial and sustainability reporting information.

2. Executive summary

The feedback EFRAG has received, and various reviews of annual reports of European companies point to an improving trend in the reporting of climate risk in financial statements albeit there are several areas of concern including the disconnect between the front end of the annual report and financial statements. Furthermore, the climate-related risks reported in the financial statements is sometimes too high-level and inadequate (see Section 5 for more detail).

Some stakeholders have observed that these concerns predate the adoption of mandatory sustainability reporting requirements (i.e., IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*, IFRS S2 *Climate-related Disclosures*, European Sustainability Reporting Standards-ESRS, and other mandatory jurisdictional requirements). Hence, there is an expectation[2] that the mandatory sustainability reporting requirements which include connectivity requirements will have a nudge effect on the identification of material sustainability risks for financial reporting purposes (i.e., greater coordination and communication across companies' sustainability and financial reporting departments will enhance the identification of material risks). As a result, the current reporting of climate-related risks in the financial statements is expected to further improve.

[1] As conveyed during several IFRS Foundation presentations including at the April 2023 IFRS Advisory Council meeting, general purpose financial reports consist of financial statements, management commentary and sustainability-related financial disclosures.
[2] Although there are differences in the respective objectives and audiences of sustainability reporting and financial statements information (see analysis in Section 6b), there are also overlapping objectives, characteristics, and audiences for these two information sets.

The observed concerns arise for various reasons including a perceived lack of full compliance with IFRS Accounting Standards by some reporting entities including on how materiality is applied in this context; limitations and interpretations of existing IFRS Accounting requirements (i.e., IAS 1 *Presentation of Financial Statements* and IAS 36 *Impairment of Assets*); limitations associated with the current IASB educational material; challenges in the quantification of climate risk; and expectation gaps related to financial statements information.

The suggested courses of action by the IASB include the issuance of illustrative examples; enhanced IASB educational material including material that is tailored for stakeholders outside the traditional financial reporting community; issuance of application guidance for some of the more challenging reporting areas; and limited amendments to the core of IFRS Accounting Standards requirements (i.e., IAS 1 requirements on time horizon, the impairment test requirements under IAS 36, and similar to sustainability reporting requirements, having explicit requirements for connectivity within IFRS Accounting requirements).

Finally, many stakeholders support expanding the scope of the IASB CRFS project to encompass long-term risks and to only consider the reporting on climate-related risks as an illustration of a principle or a concept within IFRS Accounting Standards. However, some stakeholders have expressed concerns that, if a change of scope occurs, the IASB may fail to come up with timely solutions to the concerns raised on the reporting of climate-related risks. These stakeholders have suggested a climate-risk-first approach.

3. Overview of the IASB project

Respondents to the 2021 IASB Third Agenda Consultation (including EFRAG) assigned a high-priority ranking to a project on climate-related risks in the financial statements. In response, the IASB added the CRFS project to its pipeline of projects in April 2022 and thereafter added it as a narrow-scope amendment project in the IASB maintenance project workplan in March 2023. The objectives of the CRFS project include:

- to explore whether and how companies can provide better information about climate-related risks;
- to explore the nature and causes of stakeholder concerns about the reporting of climate-related risks in the financial statements; and
- to consider the possible courses of action.

As depicted in Figure 1, since March 2023 when the CRFS project commenced, the IASB has been gathering feedback from stakeholders as a precursor to deciding the scope and direction of the CRFS project.

Figure 1: IASB tentative project plan

Source: IASB July ASAF meeting paper

The IASB has indicated that the CRFS 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; or
- develop accounting requirements for pollutant pricing mechanisms[3].

Following its outreach, the IASB is expected to decide on the project direction in September 2023 (see related IASB staff papers[4] on project scope, causes of concerns and proposed solutions) with results on the global outreach and IASB staff's suggested way forward.

4. Overview of EFRAG's outreach and engagement with stakeholders

EFRAG has obtained feedback on the IASB CRFS project during the June 2023 EFRAG Insurance Accounting Working Group (IAWG) meeting, the June 2023 EFRAG Financial Reporting Technical Expert Group and EFRAG Consultative Forum of Standard Setters joint meeting (EFRAG FR TEG-CFSS), and the July 2023 EFRAG User Panel meeting. In addition, in June 2023, EFRAG conducted a questionnaire-based survey that was sent to members of various EFRAG technical expert and advisory working groups across both the financial and sustainability reporting pillars. The survey elicited 18 responses including from preparers (i.e., from oil and gas, banking, insurance, chemical, and utility sectors), national standard setters, users, an environmental consultant, and a professional organisation (see Appendix for more details). The findings also include the perspectives of some EFRAG FR TEG members and some members of the EFRAG Connectivity Advisory Panel (EFRAG CAP) shared through written comments and interviews.

Insights on the topic have also been drawn from constituents' feedback to the 2021 EFRAG agenda consultation, and learnings from EFRAG's participation at the International Forum of Accounting Standard Setters (IFASS) meetings in January and April 2023, the European Accounting Association (EAA) symposium in May 2023, and at the European Systemic Risk Board (ESRB) exploratory accounting group meeting and the IASB's Accounting Standards Advisory Forum (ASAF) meeting in July 2023.

DETAILED FINDINGS

To align with the IASB outreach objectives, during its outreach, EFRAG sought feedback on the following aspects:

- Nature and prevalence of concerns related to the reporting of climate-related risks in the financial statements
- Causes of these concerns
- Suggested courses of action for the IASB

[3] Pollutant Pricing Mechanisms is on the reserve list of IASB research workplan.

[4]IASB staff papers a) project objective https://www.ifrs.org/content/dam/ifrs/meetings/2023/september/iasb/ap14a-project-objective.pdf
b) Nature and causes of concern https://www.ifrs.org/content/dam/ifrs/meetings/2023/september/iasb/ap14b-results-of-work-on-the-nature-and-causes-of-concern.pdf
c) Potential action https://www.ifrs.org/content/dam/ifrs/meetings/2023/september/iasb/ap14c-potential-actions.pdf

- Suggested scope of the IASB project

Correspondingly, our findings are broken down into the above categories.

5. Nature and prevalence of concerns

Several publications[5] that have reviewed the reporting of climate risks in the financial statements by European companies highlight an improving trend in the reporting of these risks. At the same time, both stakeholder feedback and the aforementioned publications also point to several current concerns associated with current reporting.

Despite differences in the respective objectives, characteristics, and audiences of IFRS Accounting Standards and mandatory sustainability reporting requirements (i.e., IFRS S1, IFRS S2, ESRS and other mandatory jurisdictional requirements), there are also overlapping[6] objectives, characteristics, and audiences. Hence, many stakeholders anticipate that the mandatory sustainability reporting requirements which include connectivity requirements will likely have a nudge effect on the identification of material sustainability risks for financial reporting purposes (i.e., greater coordination and communication across companies' sustainability and financial reporting departments will enhance the identification of material risks) and this will further enhance the current reporting of climate-related risks in the financial statements.

a) Stakeholder feedback on concerns

During EFRAG's outreach and engagement with several stakeholders, diverse perspectives have been shared on the reporting of climate-related risks in the financial statements. Some stakeholders (including a minority of respondents to the EFRAG survey- 22% as shown in Figure 2) had no concern on the current reporting and considered existing IFRS Accounting Standards to be adequate and some were concerned about a disproportionate focus on climate-related risk relative to other risk categories (see findings on the scope of IASB project).

[5]These studies include:

a) ESMA, March 2023, *Report- 2022 Corporate reporting enforcement and regulatory activities* https://www.esma.europa.eu/sites/default/files/2023-03/ESMA32-63-1385_2022_Corporate_Reporting_Enforcement_and_Regulatory_Activities_Report.pdf

b) Finanstilsynet, March 2023, *Report on Information on climate-related matters in annual financial reports*. https://www.finanstilsynet.no/contentassets/bb3c71bd8f414dc19790cbfe67ecbeb7/information-on-climate-related-matters-in-annual-financial-reports.pdf

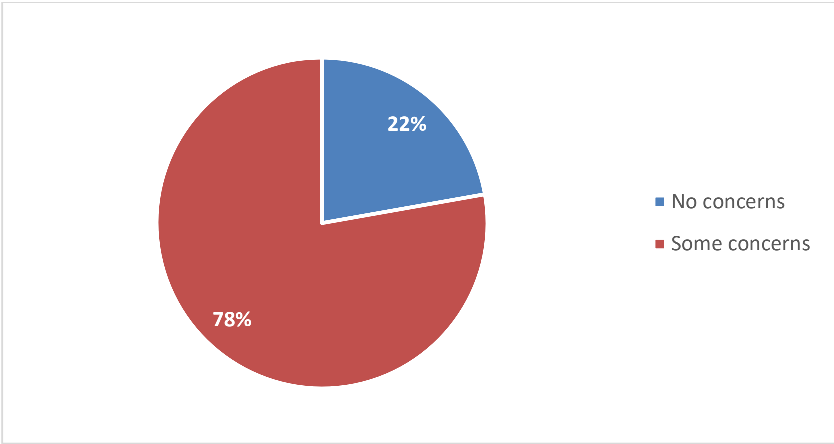
c) Autorité des Marchés Financiers -AMF, 2022, *Overview of the information provided in the 2021 financial statements on the effects of climate change and the commitments made by companies*. https://www.amf-france.org/sites/institutionnel/files/private/2022-11/AMF_Effects%20of%20climate%20change%202022_EN_0.pdf

d) Leo van der Tas, Yukti Aggarwal, and Danijela Maksimovic, September 2022, *Effects of climate change on financial statements of entities listed in the Netherlands*, MAB- Maandblad voor Accountancy en Bedrijfseconomie. https://mab-online.nl/article/94820/

e) Mazars, 2022, *Financial reporting of European companies on climate issues- Findings from 2021 financial statements*. https://www.mazars.com/content/download/1151119/58954530/version//file/Financial%20reporting%20of%20European%20companies%20on%20climate%20issues.pdf

[6] Sustainability disclosures include sustainability impacts, risks and opportunities that are financially material. Furthermore, both ESRS and IFRS Sustainability Disclosure Standards require the same reporting entity, and reporting period as IFRS Accounting Standards-based financial statements. The qualitative characteristics of information from the Conceptual Framework for Financial Reporting (Conceptual Framework) have been applied in respect of sustainability information. The IFRS Accounting requirements for errors in estimates and consolidation are also encompassed within ESRS and IFRS S1 requirements.

Figure 2: Concerns about reporting of climate-related risks in financial statements



On the other hand, many stakeholders (including 78% of EFRAG survey respondents) expressed concerns about the reporting of climate-related risks in the financial statements. These concerns included:

- The lack of connection between the information inside and outside the financial statements. This is evident in the following ways:
  - In several cases, companies disclose climate-related risks in the front part without any quantitative disclosures in the financial statements (e.g., an insurance analyst cited the case of the annual report of an insurance company whose front part (that includes sustainability disclosures) referred to climate risk 330 times but yet the financial statements had no quantitative disclosures on this risk).
  - Commitments and investments disclosed in management reports and sustainability reports are often not reflected in the financial statements.
  - The carrying value, remaining useful lives and residual values, impairment of assets, and information within the segment reporting are often not linked to the disclosures outside the financial statements related to the companies' investments and their transition-linked business model adaptations.
  - It is unclear when reporting entities' failure to meet their 'net zero' related commitments will either be recognised as provisions or disclosed as contingent liabilities.
  - It is often difficult to reconcile the information on climate-related risks and opportunities in the sustainability reports to the information in the financial statements (e.g., reconciling EU taxonomy-related investments to either the financial statements' line items or segment information). In some cases, the reconciliation difficulty could stem from differences in the unit of account applied across sustainability and financial reporting. For instance, whenever assets that are vulnerable to climate-related physical risk are disclosed at a site level in the sustainability disclosures, but are not reconcilable to the information in the financial statements line items or segment disclosures.

- The use of some terms (e.g., commitments, compensation, and neutrality) in sustainability reporting may not be consistent with their use in the financial statements. Furthermore, there are inconsistencies in the level of aggregation and disclosure of reported risks (e.g., gross risk versus net risk and whether it is an actual or potential risk).

- The climate-related information reported in the financial statements is sometimes too high-level and inadequate. The following shortcomings have been noted:
  - There is sometimes a lack of information on why an entity concluded there are no material climate risks reported in the financial statements. Some stakeholders pointed to the failure of entities to apply qualitative thresholds of materiality in the financial statements, and this is sometimes due to materiality being viewed as a purely quantitative concept.
  - The disclosures in the financial statements are mostly qualitative rather than quantitative. For example, an insurance analyst commented that this was usually the case for insurance entities. Some stakeholders have indicated that their review of climate risk reporting by a sample of EU banks (in France, Germany, Italy, Netherlands, and Spain) showed that, in many cases, these banks only qualitatively mentioned that climate risk is considered in the expected credit loss model.
  - Many times, financial statements do not include disclosures of the climate-related assumptions and estimates underpinning the future cash flow projections and valuation of financial statement line items. Also, there is usually an absence of sensitivity analysis of recoverable amounts due to a variation of key assumptions directly linked to climate-related risks.

b) Concerns noted in literature covering reporting by European companies

As noted earlier, several publications show an improving trend in the reporting of climate risks in the financial statements across a selection of European companies. However, some of the concerns raised by stakeholders have also been evident in these publications. The below summary highlights these concerns to contextualise the feedback EFRAG received from stakeholders. The positive findings flagged in these publications are not included. Consequently, the below summary should not be read as a summary of the state of play of reporting on climate-related risks in the financial statements of European companies.

European Securities and Markets Authority (ESMA) findings: A March 2023 ESMA report on enforcement activities highlights findings from enforcers' assessment of a sample of 98 issuers for their 2021 reporting on climate risk. This assessment was based on the aspects highlighted in the 2021 European Common Enforcement priorities-ECEP. Below are some of the key concerns (as noted above, the positive findings in the ESMA report are not summarised below).

Consistency between IFRS financial statements and non-financial information: 8% of issuers in the sample provided inconsistent or partially inconsistent climate-related information across their reporting (e.g., by providing climate-related information in accompanying sustainability reports or management commentaries, but not reflecting such information anywhere else in the financial statements).

33% of the issuer sample did not disclose information that would allow users of financial statements to assess the effect of climate-related matters on the issuer's financial position, financial performance or cash flows, including information such as impacts of climate-related physical risks, impacts of

transforming business lines due to climate-related matters, and compliance costs. In most cases, more information was requested by enforcers. Only 10% of the issuer sample disclosed sensitivity analyses for a range of climate-related scenarios, and only 6% of issuers also provided explanations of the related uncertainties in the estimates.

IAS 36 *Impairment of Assets*: A sub-sample of the assessed issuers (32%) disclosed they had material assets that should be tested for impairment under IAS 36 and identified climate risks as major sources of estimation uncertainty or causes for significant judgements required under IAS 1. 45% of this sub-sample of issuers had no or only insufficient explanations for these key assumptions in relation to climate-related matters. And 45% only provided boilerplate disclosures that did not specify in detail how assumptions related to climate-related matters were incorporated into the impairment assessment.

IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangibles:* A sub-sample of the assessed issuers (28%) disclosed they had material assets exposed to climate risks in the scope of IAS 16 and IAS 38 and identified climate risks as major sources of estimation uncertainty or causes for significant judgements required under IAS 1. 59% of this sub-sample of issuers did not provide sufficient explanations on these judgements or major sources of estimation uncertainty (e.g., technical characteristics of each asset, energy transition considerations, and where relevant, additional downward sensitivities related to growth rates, commodity prices). 52% of the sub-sample either explicitly indicated that they did not consider climate change when performing their annual assessment or did not provide any information as to whether they have considered climate change when assessing the need to revise the expected useful lives or the residual values of noncurrent assets. 37% of the sub-sample disclosed information including the accounting treatment of material expenditures to change or adapt business activities and operations.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*: A sub-sample of the assessed issuers (21%) disclosed climate-related matters as major sources of estimation uncertainty or causes for significant judgement with effect on the provisions and contingent liabilities in the scope of IAS 37. 43% of this sub-sample of issuers did not provide sufficient explanations for these judgements or major sources of estimation uncertainty (e.g., pointing to considerations such as provisions and/or obligations related to legislative or regulatory requirements, changes in the condition of a specific location or changes in technology). For two-thirds of such cases, enforcers have taken action or recommended improvements in relation to considerations of climate risk in financial statements. Of the issuers that recognised such material provisions or disclosed material amounts of contingent liabilities related to climate-related areas, 33% either did not provide or only provided insufficient accompanying explaining disclosures (e.g., expected timing or major assumptions concerning future events).

Furthermore, the ESMA 27th Extract from the EEC's database of enforcement highlights two cases where entities failed to comply with IFRS requirements that would have required their disclosure of climate-related risks in financial statements.

- ESMA Decision ref EECS/0123-07- Climate risk disclosures in impairment tests: In its non-financial information, an issuer detailed information on how climate change affects its business and provided information regarding its commitments to reduce CO_2 emissions by 2025. However, the issuer's financial statements did not refer to its CO_2 reduction commitments in the disclosures on impairment tests.

  The enforcer concluded that the issuer's disclosures related to impairment tests and its exposure to climate risk were insufficient to meet the requirements of IAS 36. The missing disclosures were

considered a material departure from IFRS requirements. The enforcer required the issuer to make additional disclosures[7].

- ESMA Decision ref EECS/0123-08- Climate risk disclosures in financial statements: In its non-financial information, an issuer presented 'Climate change related risks and opportunities' including future environmental regulations and directives, supply and demand disruptions for transported commodities, and re-routing risks. However, the issuer's financial statements did not provide any further information in relation to climate-related matters.

  The enforcer concluded that the issuer's disclosures in the financial statement were insufficient to meet the requirements of IAS 1 on significant accounting policies, judgements and sources of estimation uncertainty. The missing disclosures were considered a material departure from IFRS requirements. The enforcer accepted the issuer's explanations regarding the useful lives of the vessels, as well as the judgements and assumptions used when carrying out impairment tests. However, the enforcer concluded that climate risks were a major source of estimation uncertainty and required the issuer to make additional disclosures[8].

Other reports: Other publications (besides ESMA) have also reviewed the reporting of climate risks in the financial statements by European companies. The publications and their findings on concerns are summarised below:

- A March 2023 report by the Financial Supervisory Authority of Norway (Finanstilsynet) based on a review of the financial statements of 11 Norwegian entities. The report highlights the failure to disclose sources of estimation uncertainty (as required by IAS 1) by three of four companies that would have been expected to provide such information. Some entities had incomplete and generic disclosures on impairment testing. Furthermore, there were scant disclosures on research and development expenditures despite several of the reviewed entities describing emissions-reducing technological developments outside the financial statements. Also, there was information outside the financial statements showing green versus non-green revenues and major differences in climate exposure and future prospects for various parts of the reviewed entities' operations. However, none of the entities' IFRS 15 *Revenue from Contracts with Customers* disclosures presented revenue from low-emission activities separately from other activities and only one entity's segment disclosures separately identified its business segment with high climate-risk exposure.

- A November 2022 report by Autorité des Marchés Financiers (AMF) based on a review of the financial statements of 27 French entities (issuers) that had commitments to reduce their net emissions. This report notes that the way these commitments are reflected in the financial statements is not always clear or sufficiently detailed. Almost all issuers concluded there was no material financial impact on their business, but the information of no impact is stated in a general

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[7] To comply with the requirements of IAS 36.134 and IAS 1.125, 127 and 129, the enforcer required the issuer to
- Specify that the costs of the carbon emission commitments are considered in its free cash flow projections as they are not considered to be linked to future restructuring and will not improve or enhance the asset's performance (IAS 36.45)
- Explain the modification of the airport traffic hypothesis (one of the key assumptions considered by the issuer) and the external sources used with further explanations on the expected impacts of the environmental transition on the traffic
- Explain how the modification of the airport traffic affects the growth rate (IAS 36.134 (d) (iv)
- Include a sensitivity analysis of the recoverable amounts to a reasonable variation of the assumptions used which were related to climate change (mainly air traffic and growth rate).

[8] To comply with the requirements of IAS 1.122 and 125, the enforcer required the issuer to disclose:
- The consideration of any climate-related factors as either sources of estimation uncertainty or causes for significant judgements related to the assets in the scope of IAS 16
- Whether the issuer considered climate change when assessing whether the expected useful lives and estimated residual values of non-current assets should be revised, and why any such revisions were made.

way at the group level and no information is provided on the materiality analysis that, for instance, might have been carried out at the activity or geographical level. Furthermore, although the reviewed issuers were eligible to apply the EU taxonomy, except for one issuer, there was no impact on revenue disaggregation and the information provided on operating expense (OpEx) and capital expenditures (CapEx) for the rest of the issuers.

- A 2022 journal publication by van der Tas, Aggarwal, and Maksimovic based on the review of the 2021 reporting of 88 Dutch entities, of which 39 entities refer to climate change in their financial statements. This publication found that, overall, entities can significantly improve the usefulness of financial statements by explaining the link between the commitments expressed in the management report and the assumptions used in the financial statements. This can be done by describing scenarios and/or disclosing price (ranges) and expected volumes and/or including sensitivity analyses. Furthermore, the publication noted the limited reference made to whether assumptions and estimates are 'Paris-aligned', as requested by investors.

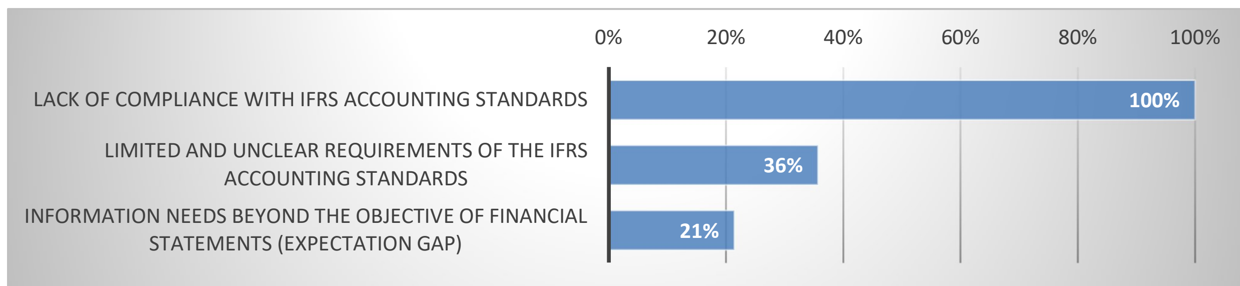
- A 2022 publication by Mazars based on the review of the 2021 reporting of approximately 80 French and European entities (excluding financial institutions), of which more than 80% of the sample mention climate issues (risks, commitments and, to a lesser extent, opportunities) in their accounts. This report highlights that the climate risks identified mainly concern transition risks, i.e., the risks for a company to adapt to changes (technological, regulatory, etc.) triggered by climate change. The physical risks and opportunities related to climate change are rarely mentioned. 40% of the sample gave details of climate risks, while the others either did not mention them or considered them not material without giving details. The publication notes that assessing the materiality of these risks over the long term is complex.

6. Causes of the concerns

This section summarises the feedback on a) the remediable causes of concerns, and b) justifiable causes for climate-related information not being reflected in the financial statement.

a) Remediable causes of concerns

Figure 3: EFRAG Survey results- Causes of the concerns[9]



As shown in Figure 3 above, all EFRAG survey respondents (100%) who expressed concerns[10] with the reporting of climate-related risks in the financial statements considered the lack of compliance with existing IFRS requirements to be the root cause of these concerns. This view is consistent with the earlier described two cases of enforcement whereby the affected entities excluded material information. However, some stakeholders from the audit profession have also noted that, in many

[9] Percentages reflect those that had concerns and the cumulative percentages are greater than 100% because respondents could pick multiple causes of the concerns.
[10] As noted in Figure 2, 22% of the respondents had no concerns and thus they did not provide causes of concerns.

cases, there is an expectation gap (between users versus preparers and their auditors) on what ought to be considered material information for reporting in the financial statements and this leads to a possibly overstated view on the lack of compliance.

Stakeholders have also highlighted other remediable causes of concerns in the reporting of climate-related risks in the financial statements. These include:

- **Application and explanation of materiality:** As seen in the earlier-noted two enforcement actions, material information on climate-related risks is sometimes excluded by reporting entities. Relatedly, users (i.e., EFRAG User Panel members) have indicated the difficulties they face in understanding entities' assessment of the materiality of long-term risks, and they have suggested the IASB consider requiring an entity to disclose how it has performed the materiality assessment.

- **Limitations of existing requirements of IFRS Accounting Standards:** several gaps in existing requirements of the IFRS Accounting Standards that contribute to the concerns. These gaps are in respect of the below:

  Time horizon: The description of the applicable time horizon under IAS 1 does not explicitly refer to long-term horizons. Thus, the Standard may be perceived by some stakeholders as prohibiting disclosures that affect carrying amounts of assets and liabilities for periods beyond the next 12 months.

  Impairment test and information on valuation of non-financial assets: IAS 36 requires detailed 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. Assumptions to be used to assess the value-in-use estimate of a cash-generating unit must be based upon the current use of assets and must be consistent with management's best estimate of future cash flows.

  Stakeholders (e.g., at the EFRAG FR TEG-CFSS meeting) indicated that it can be difficult to reflect climate risk within the impairment time horizons applied under IAS 36. They also noted that the consideration of enhancements (incremental capex) versus maintenance capex under IAS 36 is unclear. They noted that entities in many industries could expect high capex in the future, but whether that has to be reflected in the impairment testing or should be excluded was unclear. The difficulty in determining the treatment of capex was also noted in the earlier-referenced 2023 Finanstilsynet report.

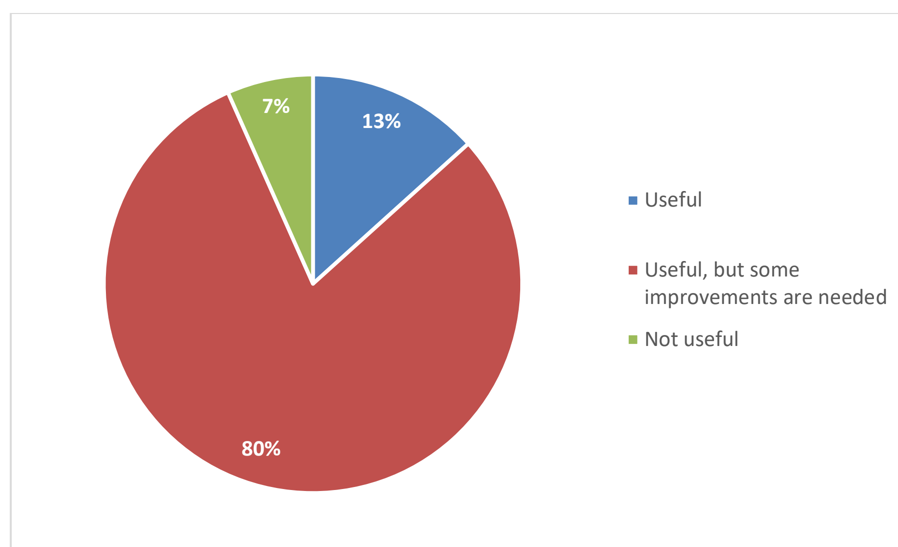
  The feedback received by EFRAG on impairment testing is corroborated by the findings of the review of Dutch entities by Van der Tas, Aggarwal, and Maksimovic (2022). These authors found that affected entities refer to the long-term nature of climate transition, which extends beyond the remaining useful lives of the current asset base, and this explains why there is no immediate effect on the residual useful lives of assets and the recoverability of their carrying amounts. The authors also found that other entities refer to significant headroom in the impairment test, which makes it unlikely that climate-related risks lead to impairment in the short term.

  More broadly, a user noted that reporting current IFRS standards often does not provide all the needed information on fixed assets. Vital statistics such as the average life of newly capitalized assets or the average remaining life of existing assets are often undisclosed. Preparers provide life expectancy ranges for these assets, but these ranges are usually so broad that they offer little informational value to investors.

Lack of connection requirements: Unlike sustainability reporting requirements, there are no connection requirements within IFRS Accounting Standards requirements.

- **High-level nature, non-authoritative stature, and limited awareness about the IASB educational material**: Overall, as can be seen in Figure 4 below, most EFRAG survey respondents (93%) considered the IASB educational material to be useful. However, the educational material was also considered to either have scope for improvement (by 80% of respondents) or not useful (by 7% of respondents). The high-level nature, non-authoritative stature, and limited stakeholder awareness of the existence of the educational material were noted. And, in the respondent's view, this contributes to the inconsistent application and non-compliance with IFRS requirements by some preparers.

Figure 4: Usefulness of IASB educational material on climate risk reporting[11]



- **Difficulties and constraints in assessing and measuring climate-related risks:** These difficulties arise for the following reasons:
    - Complex calculations and estimations are associated with climate-related risk. Illustratively, the study by Van der Tas, Aggarwal, and Maksimovic (2022) noted the challenges in applying IFRS 13 *Fair Value Measurement* guidance by entities with exposure to climate risk. When these entities assess fair value less cost of disposal for assets, a market participant perspective needs to be taken. In assessing the fair value, the market data of the potential effect of climate on energy demand and prices as well as emission rights and other regulations can differ significantly from one source to the other.
    - There is limited data availability for entities to assess and report on climate-related risks, particularly for physical risks.
    - There are inadequate risk management systems and inadequate skills to identify and manage climate-related risks.

[11] Percentages do not take into account the three respondents who did not answer the related question.

- The prevalence of siloed organisations limits the interdepartmental collaboration (e.g., between finance, sustainability, environment, and strategy departments) required for the effective identification, assessment and reporting of climate-related risks.

- **More practical application guidance is needed:** Related to the above-noted difficulties, some constituents indicated there is a need for application guidance on how to assess and measure climate-related risks.

- **An expectation gap on what information can be reflected in the financial statements**: As noted earlier there could be an expectation gap on what information is material for inclusion in financial statements. Another aspect of this expectation gap arises from a new category of users of financial statements (e.g., civil society). For instance, in some cases, for purposes of monitoring the stewardship of companies and facilitating engagement on companies' sustainability policies, some users have expectations of a greater disaggregation of financial information than is currently provided in financial statements (e.g., for the mining sector companies, they may expect a site-level disaggregation of provisions for the rehabilitation of closed mines).

  To address the expectation gap, as discussed in Section 7 below, stakeholders have expressed a need for educational material that can create a greater awareness of the financial reporting principles and requirements that may preclude the recognition or disclosure of sustainability impacts, risks, and opportunities in the financial statements.

b) Justifiable causes of climate-related information not being reflected in the financial statements

Stakeholders have also pointed to existing features of the current financial reporting requirements that, rather than necessarily being deemed to be deficiencies, can justify why climate-related information (impacts, risks, and opportunities) may not be reflected in the financial statements line items and disclosures. An awareness of these features can reduce the noted expectation gap:

- **Differing materiality thresholds**: Sustainability information is based on an impact materiality perspective under the Global Reporting Initiative (GRI) Standards and will be reported under the double materiality perspective (impact materiality[12] and financial materiality[13]) under the ESRS requirements. There can be information items disclosed under an impact materiality lens that would not be disclosed from a financial materiality perspective.

- **Constraints in reflecting climate-related "inside-out" impacts within the financial statements**: Some sustainability reporting stakeholders have expressed an expectation that, at least in the long run, financial statements ought to reflect climate-related "inside-out" impacts (e.g., an adjustment of the statements of financial position and financial performance for a company's negative impacts including its GHG emissions).

[12] ESRS 1.43 states that a sustainability matter is material from an impact perspective when it pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- or long-term. Impacts include those connected with the undertaking's own operations and upstream and downstream value chain, including through its products and services, as well as through its business relationships. Business relationships include those in the undertaking's upstream and downstream value chain and are not limited to direct contractual relationships.

[13] ESRS 1. 49 states that a sustainability matter is material from a financial perspective if it triggers or could reasonably be expected to trigger material financial effects on the undertaking. This is the case when a sustainability matter generates risks or opportunities that have a material influence, or could reasonably be expected to have a material influence, on the undertaking's development, financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium- or long-term. Risks and opportunities may derive from past events or future events. The financial materiality of a sustainability matter is not constrained to matters that are within the control of the undertaking but includes information on material risks and opportunities attributable to business relationships beyond the scope of consolidation used in the preparation of financial statements.

These stakeholders have pointed to the nascent initiatives[14] conceptualising the monetisation and internalisation of these impacts/externalities into financial reporting. However, many stakeholders support retaining the current distinctive purposes of financial reporting and sustainability reporting. Based on the current objectives of financial reporting, the determinant for inclusion in the IFRS Accounting Standards-based financial statements is whether an item is material as defined in IAS 1[15]. This precludes the reporting of "inside-out" impacts in the financial statements unless these have "outside-in" effects (i.e., effects on an entity's financial position, financial performance, or cash flows) and these latter effects may only crystallise in the primary financial statements in future reporting periods.

- **Constraints in reporting climate-related economic opportunities**: Stakeholders have noted that many firms are adapting their business models to capitalise on the profit-generating activities arising from the climate-change-driven transition to a low-carbon economy (i.e., opportunities). As shown in Section 8b, a slight majority of the EFRAG survey respondents expect opportunities to be in the scope of the IASB CRFS project. However, under current IFRS Accounting Standards' recognition and measurement requirements, these opportunities (that could be deemed potential assets) cannot be recognised[16] as line items in the primary financial statements. However, as indicated by an EFRAG survey respondent who is a preparer from the energy utilities sector, opportunities are incorporated into the sensitivity analysis disclosures.
- **Differing reporting boundaries**: Financial reporting is limited to information related to the reporting entity, but sustainability reporting encompasses impacts, risks, and opportunities across the value chain. For example, sustainability disclosures may include investments in opportunities across the value chain related to the transition to net-zero emission targets. Such investments may not be reconcilable to the investments reported in the financial statements.

[14]Cohen,R and Serafeim,G. 2020, How to Measure a Company's Real Impact, Harvard Business Review https://hbr.org/2020/09/how-to-measure-a-companys-real-impact. Stakeholders have shared examples of initiatives in certain jurisdictions on how to monetise and incorporate CO2 into financial reporting standards (e.g., expenses and carbon liabilities).

[15] IAS 1.7 states that information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

[16] Paragraph 5.7 of the Conceptual Framework for Financial Reporting conveys that an asset or liability is recognised only if such recognition provides users of financial statements with information that is useful (**relevant** and **a faithful representation**). Paragraph 5.12 conveys that recognition of relevant information may not provide relevant information if, for example: a) it is **uncertain whether an asset or liability exists; b) an asset or liability exists, but the probability of an inflow of economic benefits is low**. Paragraph 5.18 conveys that whether a faithful representation can be provided may be affected by the level of **measurement uncertainty** associated with the asset or liability or by **other factors** (e.g., to avoid a misleading depiction of income, expenses and changes in equity; and whether related assets and liabilities are recognised).

- **Differences in the time horizons typically**[17] **applied to sustainability disclosures and financial statements information**: Climate-related risks may be reflected in sustainability disclosures earlier than can be reflected in the financial statements. As mentioned before, this could be due to how some stakeholders interpret the applicable time horizon under IAS 1. It could also be due to the limitations imposed on the applicable time horizon for impairment testing under IAS 36. In addition, low-probability long-term risks may not be reflected as liabilities or provisions due to recognition criteria as stated below. Some stakeholders have also noted that due to the typical long-term nature of climate-related risks, the effect of discounting these risks is that their impact on the values reported in the financial statements is often immaterial.

- **Climate-related risks may not meet the criteria for recognition of provisions and liabilities**: IAS 37 recognition requirements do not cover potential liabilities from low probability and/or high uncertainty risks.

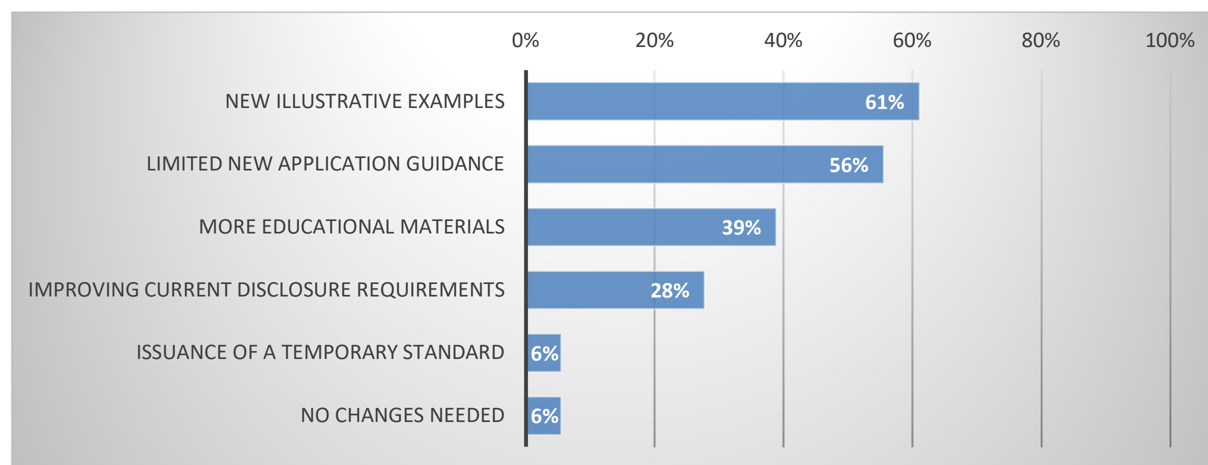
- **Climate-related risk may be implicit and embedded within reported line items:** For example, this risk would be part of the risk adjustment under IFRS 17 *Insurance Contracts*. The best estimate in accordance with IFRS 17 requirements should include all risks and opportunities. As required under IFRS 13, this risk should also be part of either the observable market prices or internal fair value estimate of assets held by entities subject to climate-related risks.

  It is also difficult to separately identify climate risk effects from other macroeconomic effects when determining the expected credit loss-ECL under IFRS 9 *Financial Instruments*. In effect, in some situations, while disclosing a sensitivity analysis related to changes in measurement, it can be difficult to attribute the effects of climate risk separately from other measurement inputs.

7. Suggested courses of action

As shown in Figure 5 below, respondents to the EFRAG survey suggested several courses of action to be taken by the IASB.

Figure 5: Suggested actions[18]



[17] Financial reporting information ought to be able to reflect all time horizons. In practice, one of the reasons provided for climate-related risks not being reflected is the long-time horizon associated with these risks.

[18] The cumulative percentages are greater than 100% because respondents could pick multiple courses of action that could be undertaken by the IASB to help entities properly consider climate-related risks.

As described below, the survey respondents and the stakeholders consulted during EFRAG's outreach elaborated on the suggested actions by the IASB to address the noted concerns :

- More **illustrative examples** including industry-specific examples and there should be a balance between examples that show connectivity and those that show why a connection cannot be attained.

- **Enhancing educational material as follows**:

    - Its content should be tailored for stakeholders from outside the traditional financial reporting community (e.g., on reasons why some sustainability risks may not be reflected as provisions or liabilities, sustainability opportunities are not reflected as assets, and why asset impairments may not occur). There is also a need for education tailored for financial reporting professionals, particularly on how sustainability impacts, risks and opportunities could be reviewed when assessing material items to be included in the financial statements.

    - It should be structured by IFRS Accounting Standards and sustainability topics (e.g., net-zero commitment), and through the use of practical case studies. It should indicate how each sustainability topic could impact the current IFRS Accounting Standards requirements and illustrate an assessment of the materiality of sustainability risks for purposes of their inclusion in the financial statements.

    - It should clarify terminology and concepts used that may be inconsistently applied across sustainability and financial reporting (e.g., commitments/goals/target, financial impact, gross versus net risk, regulatory risk).

  Of note, in July 2023, the IASB issued updated educational material[19] to reflect an IFRS IC agenda decision made in July 2022 on 'Negative Low Emission Vehicle Credits'[20]. The IFRS Accounting Standards covered in the education material are IAS 1, IAS 2 *Inventories*, IAS 12 *Income Taxes*, IAS 16, IAS 38, IAS 36, IAS 37, IFRIC 21 *Levies*, IFRS 7 *Financial Instruments: Disclosures*, IFRS 9, IFRS 13 and IFRS 17.

- **Issuance of application guidance:** Application guidance is considered to have a more authoritative stature than illustrative examples and educational materials. For instance, such guidance can be issued to a) support entities' quantification of climate risk; b) support entities' incorporation of climate-related risk when determining the fair value of assets; and b) guide entities' assessment of whether climate-related risk is material.

- **Limited amendments of the core accounting Standards requirements:** The potential amendments as suggested by stakeholders should focus on the following:

    - IAS 1 requirements should be amended to explicitly address time horizons that are longer than 12 months.

[19] IFRS Accounting, July 2023, Effects of climate-related matters on financial statements. https://www.ifrs.org/content/dam/ifrs/supporting-implementation/documents/effects-of-climate-related-matters-on-financial-statements.pdf

[20] Negative Low Emission Vehicle Credits (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) https://www.ifrs.org/content/dam/ifrs/supporting-implementation/agenda-decisions/2022/negative-low-emission-vehicle-credits-jul-2022.pdf

- IAS 36 requirements should be amended to consider all the relevant risks that could impact the future cash flows used to perform the impairment test (e.g., how to reflect risks beyond the five-year time limits).
- Various disclosure enhancements have been suggested by users and other stakeholders. These include explicit disclosure requirements for the materiality assessment related to climate risk; the long-term assets subject to sustainability risks; improvements in current disclosures of remaining useful lives of capex and current asset base (e.g., requiring average remaining useful lives instead of ranges); and disclosures requirements for constructive obligations arising from sustainability matters (e.g., maturity table of expected cash outflows).
- As is the case for the mandatory sustainability reporting requirements, there should be connection requirements within the requirements of IFRS Accounting Standards.

Of note, to clarify stakeholder questions on the recognition of provisions for constructive obligations arising from net-zero commitments, the IASB is considering amendments to the IAS 37 illustrative examples on the provisions recognition criterion[21] of there being a **present obligation to transfer an economic resource as a result of a past event**. A net-zero commitment example is proposed to be included as one of the illustrative examples. Specifically, the April 2023 IASB staff paper (Agenda reference: 22-Appendix B)[22] has an example of a manufacturer that has announced its commitment to becoming 'net zero' at a designated future date (20X5) and thereafter to offset the remaining emissions. The IASB staff concludes that the manufacturer should recognise a provision as a result of its net zero commitment: (a) when it has emitted[23] the greenhouse gases it has committed to offset; and (b) if at that time, management judges that its announcement has given rise to a constructive obligation to meet the net zero commitments.

8. Suggested scope of the IASB project

As elaborated below, stakeholders expressed mixed views on whether the scope of the CRFS project should be expanded to encompass other long-term risks and whether to include opportunities.

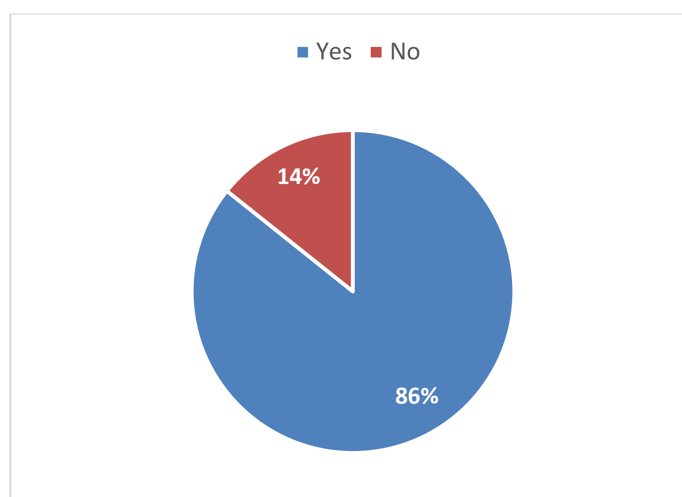
a) Extending the scope to encompass all long-term risks

[21] A *provision* shall be recognised when: (a) an entity has a present obligation (legal or constructive) to transfer an economic resource as a result of a past event; (b) it is probable that an outflow of resources embodying economic benefits the entity will be required to transfer an economic resource to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision shall be recognised.

[22] https://www.ifrs.org/content/dam/ifrs/meetings/2023/april/iasb/ap22-appendix-b-provisions-drafting-suggestions-for-illustrative-examples.pdf

[23] For this fact pattern, the IASB staff note that an announcement that fulfils the criteria for creating a constructive obligation is not sufficient in itself to create a *present* constructive obligation, which is necessary for the recognition of provisions and liabilities. A present constructive obligation arises only when the reporting entity has taken actions that will require its transfer an economic resource—that is, when it has emitted greenhouse gases it has committed to offset. It then has an obligation to pay for the amount of tree planting required to offset the past emissions.

Figure 6: Whether to extend the scope to other long-term risks?[24]



As shown in Figure 6 above, most (86%) respondents to the related survey question and many members of the consulted EFRAG technical expert and advisory working groups (e.g., EFRAG User Panel) supported extending the scope of the project to encompass other long-term risks. For instance, the scope should include sustainability risks (not only climate-related risks), geopolitical risks, technology-related risks (e.g., cybersecurity and artificial intelligence), reputational risks, and supply chain risks. The following reasons were provided for this view:

- The principles-based IFRS Accounting Standards should allow entities to capture all current and emerging relevant risks in their financial statements;
- A project focused on long-term risks will help to avoid overemphasising the reporting of climate-related risks in the financial statements relative to other relevant long-term risks; and
- As noted earlier, it is often difficult to disentangle climate-related risks from other risks.

However, there were also concerns about extending the scope of the project from a minority (14%) of respondents to the survey question and several members of the consulted EFRAG technical expert and advisory working groups. The following reasons were provided:

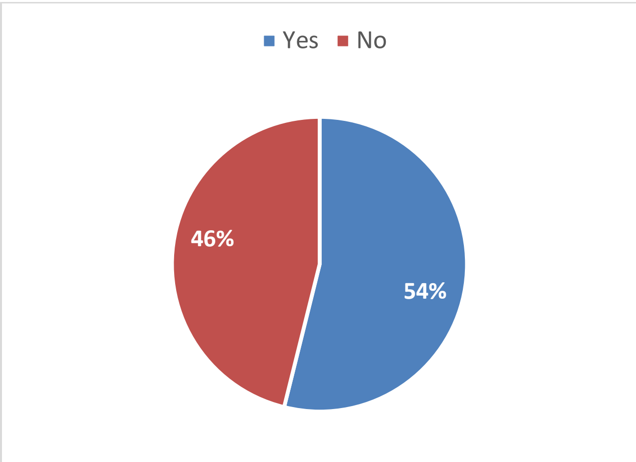
- A broader scope might delay the action by the IASB to address stakeholders' concerns about the current reporting of climate-related risks in the financial statements. A few stakeholders suggested a climate-first approach similar to the approach taken by the ISSB in its mandate to develop sustainability reporting requirements.
- Including information on all kinds of risks in the financial statements may not be aligned with the (current) purpose of the financial statements. There is a need for a clear conceptual distinction between the information that is respectively relevant for the management report/commentary, sustainability disclosures/statements, and the financial statements.

b) Should opportunities be in scope?

As shown in Figure 7 below, respondents to the survey had mixed views on whether to include opportunities in the scope of the project.

[24] Percentages exclude four respondents who did not answer the related question.

Figure 7: Whether to include opportunities in scope?[25]



A slight majority (54%) of survey respondents and some members of the consulted EFRAG technical expert and advisory working groups (e.g., EFRAG IAWG) supported the inclusion of opportunities in the scope of the project. Their justification was that for many firms the transition to a low-carbon economy is predominantly an opportunity (rather than a risk) to capitalise on profit-generating activities. Accordingly, climate-related opportunities information that allows users of financial statements to assess the effect of business model changes on the issuer's financial position, financial performance or cash flows ought to be relevant.

Conversely, a sizeable minority (33%) of the survey respondents and some members of the consulted EFRAG technical expert and advisory working groups (e.g., EFRAG User Panel) were against including opportunities in the scope of the project. The reasons provided included the need to restrict the recognition of sustainability matters in the financial statements line items based on the existing criteria for recognising assets and liabilities. It was also noted that, in some jurisdictions, the reporting opportunities would be problematic due to the high litigation risk associated with optimistic forward-looking information.

Furthermore, there was a concern that, for many companies that are adjusting their business models and products as part of the transition to a low-carbon economy (e.g., via new green technologies and low-carbon production methods), detailed quantitative reporting on opportunities would entail disclosing commercially sensitive information. Finally, as noted above, some stakeholders have called for a clear conceptual distinction between the information that is respectively relevant for the management report/commentary, sustainability disclosures/statements, and the financial statements. In their view, it suffices if information on opportunities is disclosed outside the financial statements as users can still apply such information in a complementary way to the information in the financial statements.

[25] Percentages exclude five respondents who did not answer the related question.

Appendix – Overview of the EFRAG CRFS survey

A questionnaire-based survey was sent to members of EFRAG technical expert and advisory working groups across the financial reporting and sustainability reporting pillars to gather their feedback on the reporting of climate-related risks in the financial statements. This survey consulted on the concerns, their causes, the suggestions for the IASB's possible actions, and the scope of the IASB project.

EFRAG received 18 complete responses. A breakdown of respondents is summarised in Figures 8 and 9:

Figure 8: Breakdown by type of respondent

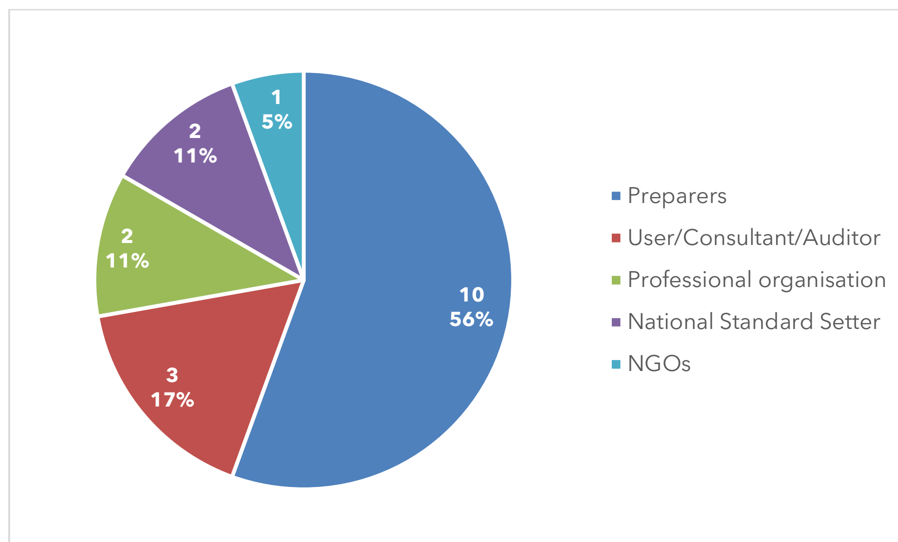


Figure 9: Breakdown of preparers by industry