Column

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NOT JUST A MATTER OF JUDGEMENT

Climate change-related disclosures have a number of facets when it comes to accounting standards.

Climate change is an important issue socially, politically and economically. More entities are applying the Task Force on Climate-related Financial Disclosures' (TCFD) recommendations, and discussing climate-related risks in their management commentary or broader corporate reporting. Listed businesses should also consider the impact of climate risk on financial statements, including disclosures regarding climate risk assumptions. In some cases, it may be necessary to disclose that directors' assumptions are that climate risk has not had an impact.

Accounting standards require disclosure of significant judgements made in preparation of financial statements, subject to materiality considerations. Information is material if omitting it or misstating it could influence investor decisions.

If investors have made it known climate-related risks could affect their decision-making, such information is deemed to be material. Relevant climate risk assumptions should be disclosed in financial statements. AASB 101/IAS1 also highlights an assessment of materiality is made on the basis of size (quantitative) or nature (qualitative), or a combination of both. APS/PS2 further emphasises qualitative external factors, for example, the industry in which the entity operates and that investor expectations warrant disclosure.

A high-level review undertaken by the AUASB of climate-related content in 2018 annual reports has shown climate-related risks are being reported in annual reports, but this trend does not extend to financial statements or notes. The majority of climate-related disclosures are made in the director's report and corporate governance statement.

Applying the materiality definition, and the principles in APS/PS2 and the AASB AUASB Bulletin is likely to result in entities in sectors identified in the TCFD having climate-related assumptions impacting financial statement amounts and disclosures. Entities should explain what areas of the financial statements could be impacted, and the basis for the assumptions on which they make the disclosure. Entities may need to explain why their financial statements are not affected by such risk.

Areas that could be impacted:

- Asset impairment.
- Changes in the useful life of assets.
- Changes in the fair valuation of assets due to climate-related and emerging risks.
- Increased cost and/or reduced demand for products and services affecting impairment calculations and/or requiring recognition of provisions for onerous contracts.
- Potential provisions and contingent liabilities arising from fines and penalties.
- Changes in expected credit losses for loans and other financial assets.

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An entity may need to explain why it was not necessary to factor climate-related risk into the impairment assumptions. It may need to justify how estimates of expected future cash flows, risk adjustments to discount rates or useful lives have or have not been affected by climate-related risks. Financial sector entities may consider disclosing to what extent their investment or loan portfolios are exposed to climate-related risk and how this risk has been factored into asset values.

The disclosures in the notes to the financial statements should focus on specific issues and assumptions made that are relevant to the amounts recognised in the financial statements, and should not be of a boilerplate nature.

Auditors need to consider and understand the implication of climate-related risk and how it affects their audit work and procedures. When they are gaining an understanding of the entity and its environment, auditors need to confirm with management, and those charged with governance, whether climate-related risks have a significant impact on the entity and if so, how these risks are being managed, mitigated and reported.

If climate-related risks have a material impact on the entity and have been adequately considered and reflected in the financial statements, auditors should consider any accounting estimates, including assumptions used to arrive at fair value estimates and potential impairments or provisions.

When an entity appropriately does not recognise or disclose climate-related risk in the financial statements, auditors can assess whether such a risk has been adequately disclosed in the broader annual report and whether there is an adequate explanation as to why there is no impact.

Such disclosures in the annual report but outside the financial report should be read and considered by the auditors under ASA 720 The Auditor's Responsibilities Relating to Other Information, to ensure it is not materially inconsistent with the financial report or the auditor's knowledge obtained as part of the audit.

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