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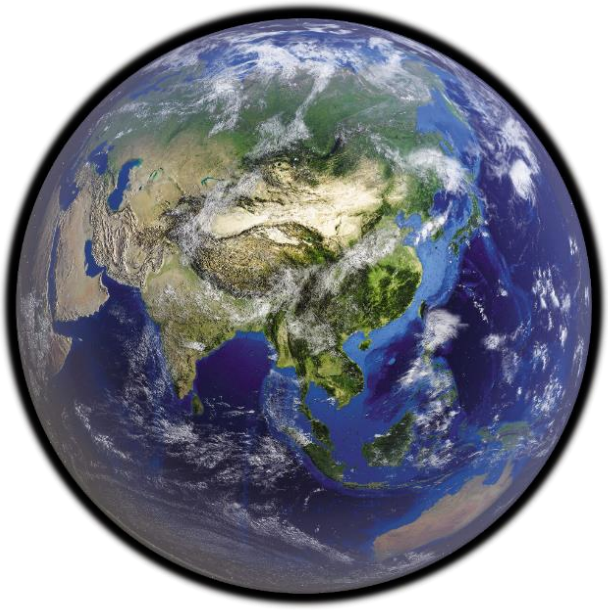

A closer look
Climate change

Introduction

Climate change is likely to drive some of the most profound changes to business in our lifetimes. Impacts on products and services, supply chains, loss of asset values and market dislocation are already being caused by more frequent and severe climate-related events. These effects are now compounded by the accelerating pace of policy and regulatory change as humanity recognises the challenge we face and the drastic and rapid actions we must all take in order to protect our planet and our own livelihoods.

A growing number of scientific projections detail not only potential average increases in global temperatures, but also the consequences, such as rising sea levels and more frequent extreme weather events. Economic forecasts are also increasingly reflecting these impacts, including related factors such as carbon pricing initiatives and changing demand for fossil fuels and renewable energy. It is critical to recognise that the past is no longer a predictor of the future.

For more information please see our website:

http://www.deloitte.co.uk/climatechange

Investors, regulators and other business stakeholders are increasingly demanding better disclosures on climate change matters and challenging companies that are not factoring the effects of climate change into their critical accounting judgements.

Revenues, costs and asset lives could be impacted, and companies will need to reassess their future cash flow forecasts and related management judgements relating to impairment, asset retirement obligations, provisions, going concern and viability statements.

In July 2019, the UK Government announced its Green Finance Strategy, including its commitment to achieve net zero GHG emissions by 2050.

The Green Finance Strategy was welcomed by financial regulators, including the Financial Reporting Council (FRC), the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA) and The Pensions Regulator (TPR) in a joint statement of support, which said that companies should consider the likely consequence of climate change on their business decisions.

In its October 2019 Feedback Statement *Climate Change and Green Finance*, the FCA set out its intention to issue a Consultation Paper in early 2020 proposing new disclosure rules for certain listed issuers aligned with the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations, initially on a 'comply or explain' basis. It further proposed to clarify that existing disclosure obligations already capture climate change impacts where they are financially material to a company's prospects.

Investors are challenging companies that are not factoring the effects of the Paris Climate Agreement into their critical accounting judgements and are not disclosing comprehensively these judgements, assumptions, sensitivities and uncertainties.

For example:

- Climate Action 100+, a global investor initiative, is actively targeting the world's largest corporate greenhouse gas emitters to ensure that they take necessary action on climate change. Climate Action 100+ involves over 370 investors collectively representing $35 trillion in assets.
- The Institutional Investors Group on Climate Change (IIGCC) published a discussion paper, *Voting for better climate risk reporting: the role of auditors and audit committees*, which emphasises the powerful levers that shareholders have to hold boards and auditors to account for inadequate climate risk reporting.

What should companies do?

Governance

Bring climate change onto the board agenda

Develop processes for considering the impact of climate change

Risk assessment and strategy

Assess climate change risk and opportunities and their implications on the business model

Metrics and targets

Set metrics and targets to address climate change effectively

Financial statements

Reassess assumptions used in cash flow projections that underpin recognition and measurement

Provide transparent disclosures of the underlying assumptions used in the preparation of the financial statements

Narrative reporting

Ensure that climate change disclosures in narrative reports are clear, balanced and meaningful

TCFD adoption

Assess readiness to make disclosures in line with those recommended by TCFD

Financial Reporting Council (FRC) expectations

In response to the Green Finance Strategy, the FRC stated:

> *"The Boards of UK companies have a responsibility to consider their impact on the environment and the likely consequences of any business decisions in the long-term. They should therefore address, and where relevant report on, the effects of climate change (both direct and indirect)."*

The FRC went on to say that they expect companies to disclose:

- how climate change has been taken into account in assessing the resilience of the business model, its risks, uncertainties and viability in the immediate and longer term; and
- the current or future impacts of climate change on their financial position, for example in the valuation of assets, assumptions used in impairment testing, depreciation rates, decommissioning, restoration and other similar liabilities and financial risk disclosures.

The FRC reminded companies of their existing reporting obligations:

- The strategic report requires companies to report on their principal risks and environmental matters when material. The FRC's *Guidance on the Strategic Report* has been updated to encourage better reporting on non-financial matters, including environmental matters.

- The updated UK Corporate Governance Code requires boards to discuss and report how the matters (including risks and opportunities arising from environmental matters) set out in section 172 of the Companies Act 2006 have been considered and addressed.

The FRC have also stated that they will monitor how companies and their advisers fulfil their responsibilities by continuing to review whether companies are complying with the statutory disclosure requirements of the strategic report (which includes reporting on principal risks and uncertainties) as well as any financial statement implications of climate change.

The FRC's Financial Reporting Lab (the Lab) published a report in October 2019, *Climate-related corporate reporting*, which aims to reflect the views of investors on existing reporting by companies and to help companies move towards more effective and comprehensive reporting. Structured around the TCFD framework, the Lab's report sets out challenging questions for boards to ask themselves and examples of good practice.

In its *Annual Review of Corporate Reporting*, and in an *open letter* to all Audit Committee Chairs and Finance Directors, the FRC has further emphasised their expectation that boards address and report on the effects of climate change. The FRC has stated:

> *"In times of uncertainty, investors and other stakeholders expect greater transparency of the risks to which companies are exposed and the actions they are taking to mitigate the impact of those uncertainties. The FRC expects companies to think beyond the period covered by their viability statement and identify those keys risks that challenge their business models in the medium to longer term and have a particular focus on environmental issues."*

Taskforce on Climate-related Financial Disclosures (TCFD) recommendations

The TCFD was established by the Financial Stability Board to identify the information needed by investors, lenders, and credit and insurance underwriters to assess and price appropriately climate-related risks and opportunities. It developed a framework to facilitate voluntary, consistent climate-related financial disclosures, building on existing disclosure regimes.

The TCFD's core recommendations are universally applicable to organisations across sectors and jurisdictions. They are structured around core elements of how organisations operate: Governance; Strategy; Risk Management; and Metrics and Targets, and include 11 detailed recommended disclosures. The TCFD has also produced general and sector-specific guidance, and a technical supplement on scenario analysis.

The TCFD recommendations are gaining momentum and have become the generally accepted framework for businesses to explain their approach to climate change-related risk. Since their release in June 2017, the recommendations have received public support from over 800 organisations. They include investors, banks and other financial institutions that are responsible for more than US$100 trillion in assets. The recommendations have been galvanising conversations about the impact of climate change on business.

In its Green Finance Strategy, the UK Government has proposed mandatory TCFD disclosures by 2022. The European Commission (EC) has published new guidelines on reporting climate change-related information integrating the recommendations of TCFD. ESMA, in its Common Enforcement Priorities 2019, has drawn issuers' attention to these guidelines, noting that they are useful in helping companies provide relevant information to explain the financial consequences of climate change.

The FRC, in its annual letter to Audit Committee Chairs and Chief Financial Officers, repeated the Government's expectation that listed companies are to report in accordance with the requirements of the TCFD by 2022. The FRC is an active member of a regulatory group established to consider how that expectation might be implemented. However, in the meantime, consistent with the UK Corporate Governance Code's focus on emerging risks, and after considering the likely consequences, companies should, where relevant, report on the effects of climate change on their business, as described above.

The Lab report on climate change sets out the questions boards should ask themselves when considering the adequacy of their reporting in relation to TCFD.

In early 2020, the FCA will publish a Consultation Paper proposing new disclosure rules for certain listed issuers aligned with the TCFD's recommendations, initially on a 'comply or explain' basis.

For further information please refer to the *IFRS in Focus — Task Force on Climate-related Financial Disclosures issues its final report*.

Governance

> The TCFD recommends that companies disclose the organisation's governance around climate-related risks and opportunities by describing:
>
> - the board's oversight of climate-related risks and opportunities; and
> - management's role in assessing and managing climate-related risks and opportunities.

At its 2019 annual meeting, the World Economic Forum (WEF) published guidance for boards: *How to Set Up Effective Climate Governance on Corporate Boards: Guiding principles and questions*.

Chapter Zero is the UK chapter of WEF's Climate Governance Initiative and their work supports non-executive directors (NEDs) in putting these Principles into practice. To help drive conversations in the boardroom, Chapter Zero have developed a NED Toolkit. Click here to access the Chapter Zero website and request the Toolkit.

Types of climate change risk

The TCFD recommendations divided climate change risks into two categories: physical risks and transition risks.

Physical risks

Physical risks are associated with disruption to business activities from climate change. Physical risks can be acute, one-off disruptions such as from extreme weather events and they can also be chronic – gradual changes that have a more lasting impact e.g. due to changing rain patterns, rising mean temperatures and sea levels, or prolonged periods of heat or drought.

Impacts from climate change-related events can be widespread across a company's operations, with significant financial consequences. Climate change can affect a business's facilities, operations, supply and distribution chains, employees and customers.

Risks to businesses include:

- Reduced revenue and/or increased operating costs arising from supply chain interruptions, reduced production capacity or impact on the workforce.
- Increased capital expenditure to protect operations and supply chains, or repair damage caused by climate change-related events.
- Increased financial risk through higher cost of capital or cost of insurance in high-risk locations.
- Write-offs and early retirement of existing assets.

Transition risks

Transition risks arise from moving to a low-carbon economy i.e. how governments and business stakeholders respond to the global commitment to limit the global temperature increase to 1.5-2°C.

Transition risks consist of policy and legal risks, technology risks, market risks and reputation risks as a result of transitioning to a lower-carbon economy.

Policy and legal risks – Policy actions by governments may tighten regulation, cap the use of resources, or introduce carbon taxes. These can all reduce demand for products and services, or increase operating costs. An increase in climate-related litigation claims heightens legal risks.

Technology risks – New technologies that support the transition to a lower-carbon economy can impact the demand for existing products. Furthermore, the cost of researching and developing alternative technologies can be high. Unsuccessful innovations may have to be written off.

Market risks – Consumers are increasingly looking for low-carbon products and services, such as food, clothing, energy and travel. This can lead to reduced demand for existing products and services as 'green' products become more attractive. Changing markets and availability of resources can also lead to increased costs of raw materials and production.

Reputation risks - Risks connected to society's trust in business are increasing. Stakeholders have higher expectations of how businesses are responding to climate change issues.

Risk management and strategy

TCFD recommends that companies disclose how the organisation identifies, assesses, and manages climate-related risks, by describing:

- the organisation's processes for identifying and assessing climate-related risks;
- the organisation's processes for managing climate-related risks; and
- how processes for identifying and assessing, and managing climate-related risks are integrated into the organisation's overall risk management.

TCFD recommends that companies disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material, by describing:

- the climate-related risks and opportunities the organisation has identified over the short, medium, and long term;
- the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning; and
- the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

When assessing climate change risk, it is important to appreciate that no company is immune. Every company will be affected. Risks may lie outside of the immediately consolidated boundary and it is necessary to consider a company's supply/value chain and its business model. It is also necessary to consider multiple layers of uncertainty and long-term horizons. This starts from understanding the scientific facts and the impacts that physical risks could have on the business, and how these might translate into policy or regulatory changes.

Factors that may significantly affect a company's specific exposure to climate change risk include:

- Geography and jurisdiction of operations.
- Life cycle of operations, including life of infrastructure etc.
- Specific business model and business practices.
- Societal/Political instability arising from the cumulative impact of multiple physical risk impacts.
- Macroeconomic impacts arising from the cumulative impact of multiple physical and transition risk impacts.

The following resources may be helpful when assessing your company's climate change risk:

- UK Climate Change Risk Assessment 2017
- European Environment Agency, Climate Change, Impacts And Vulnerability in Europe 2016 (2017)
- Taskforce for Climate-related Financial Disclosures, Final Report (2017) and 2019 Status Report (2019)
- World Economic Forum Strategic Intelligence

Metrics and targets

TCFD recommends that companies disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material, by:

- disclosing the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process;
- disclosing Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks; and
- describing the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

In order to address climate change effectively, companies should adopt metrics and targets as part of their wider risk management and strategy development. They provide a common language for articulating the threats that exist to the business arising from climate change.

While many frameworks and metrics are used to report climate-related financial information, two are widely accepted and broadly aligned with the TCFD recommendations, as follows.

- The Carbon Disclosure Standards Board (CDSB) Framework provides guidance, principles and content elements (i.e. requirements) on reporting to investors in a mainstream filing about climate, natural capital and other environmental issues. Although it takes a less prescriptive approach to the disclosure of indicators and other metrics, the CDSB Framework achieves nearly full alignment across the TCFD's 11 recommended disclosures, and signposts the TCFD's recommended disclosures.
- The Sustainability Accounting Standards Board (SASB) Standards are designed for reporting to investors on financially material environmental, social and governance issues through metrics and disclosures for 77 industries. The SASB Standards are well-aligned overall with the TCFD recommendations. They are also complementary with the TCFD's Governance, Strategy and Risk Management core elements.

SASB and CDSB have produced the *TCFD Implementation Guide* demonstrating how the two bodies' guidance can be used to make the 11 recommended disclosures of the TCFD.

The level of vulnerability and existing capability to deal with climate change will vary from business to business. Each company needs to focus on the most important risks for its circumstances. Where practical, seeking subject matter expertise in relation to a specific risk can help companies to determine the correct metrics and targets and also challenge underlying assumptions.

Companies may also set targets that are aligned to the goals of the Paris Agreement – through the Science Based Targets initiative. Its website includes helpful guidance on how to go about setting climate-based targets to drive change.

Energy and Carbon Regulations (periods beginning on or after 1 April 2019)

Quoted companies, large unquoted companies and large limited liability partnerships (LLPs) are in scope of the Energy and Carbon Regulations. These regulations extend disclosure of information on Green House Gas (GHG) emissions to unquoted, large companies and LLPs and require all in scope to disclose additional information on energy consumption and any steps taken to increase energy efficiency. There is a slightly broader scope of information required for quoted companies. There is an exemption for some subsidiaries or those with low energy consumption. The extended requirements apply for periods beginning on or after 1 April 2019.

For further information please refer to the Need to Know - Energy and carbon reporting requirements enacted.

Impact on the financial statements

To a greater or lesser extent, the risks and uncertainties arising from climate change are likely to have an impact on the financial statements of all companies.

Dealing with uncertainty

There is significant uncertainty around by how much the global temperature will increase, what the impact of different climate change scenarios on a company's business might be, and how these factors may result in changes to cash flow projections or to the level of risk associated with achieving those cash flows.

It is therefore necessary for companies to make assumptions about the impact of climate change when preparing cash flow projections that underpin measurement and recognition in the financial statements, including in the following areas:

- Cash flow forecasts for determining value-in-use to assess impairments of assets, cash-generating units (CGUs) and goodwill.
- Forecasts of future availability of taxable profits in assessing recoverability of deferred tax assets.
- Going concern assessment over a period of at least 12 months from the date of signing the financial statements.
- Viability statement over a longer period, typically 3-5 years.

The assumptions should be consistent with:

- risk management, strategy and business model disclosure;
- commitments made by the company to investors and other stakeholders; and
- commitments made by governments of jurisdictions in which the company operates, e.g., the 2016 Paris Agreement, or more specific commitments like the UK Government's commitment to 'net zero by 2050'.

In line with investor and regulatory demand for transparency, disclosures of assumptions made in the preparation of the financial statements should be clear, balanced and meaningful.

Going concern assessment

All companies are required to make a rigorous assessment of whether a company is a going concern when preparing financial statements. The period of assessment will be determined by the directors. Whilst this should cover a period of at least 12 months from the approval of the financial statements, it could be significantly longer. This is because in making their assessment, directors should consider all available information about the future at the date they approve the financial statements, such as the information from budgets and forecasts.

Impairment of non-financial assets

The uncertainties in relation to climate change may result in changes to management's cash flow projections or to the level of risk associated with achieving those cash flows, in which case they form part of a value-in-use assessment. For instance:

- Revenue streams and growth forecasts may need to change to reflect changing customer preferences, technology and market trends.
- Increased cost of resources and production, costs of compliance with new policies or legislation or rising cost of insurance may need to be factored in.
- Availability of finance and net impact of availability of insurance on cost of finance should be considered.

A company should consider the following with regard to value-in-use calculations:

Incorporation of changes expected to occur beyond the period covered by financial budgets and forecasts	If management's best estimate is that a climate change-related event will affect cash flows beyond the forecast or budget period, it would be inappropriate to exclude this from a value-in-use calculation by simply extrapolating budgeted or forecast cash flows using an expected rate of general economic growth. Instead, the extrapolation of budgeted or forecast cash flows should be modified to incorporate the anticipated timing, profile and magnitude of the effect of climate change.
Incorporation of expected changes in consumer behaviour into estimates of future cash flows	Management's best estimate of any forecast changes in consumer behaviour expected to result in (positive or negative) changes in either the volume or price of future sales should be included in a value-in-use calculation (e.g., a decreased demand for products with an environmental impact). The same approach should be applied to expected changes in the behaviour of a company's suppliers, who may themselves react to changing expectations of society, resulting in changes to a company's cost base.
Incorporation of expected government action into estimates of future cash flows	Judgement will be required in determining when expected government action, such as a levy on greenhouse gas emissions, should be factored into cash flow forecasts. However, it is not appropriate to wait for the enactment of a change before it is incorporated into an estimate of future cash flows. If management's best estimate is that, whilst the exact nature or form of the government legislative or regulatory action is not certain, there will nonetheless be an effect on the company's cash flows, then the expected changes in cash flows should be included in a value-in-use calculation.
Consideration of restructuring or capital expenditure plans	Determining whether a change in the scope or manner of operations due to climate-related factors meets the definition of a restructuring to be excluded from a value-in-use calculation will require judgement. In applying that judgement it will often be necessary to consider whether either the output or the process of producing that output will change significantly (indicating a material change that is excluded until the company is committed), or whether the change is a refinement to that output or process (indicating that the change does not meet the definition of a restructuring) and should be included.
Expenditure on maintaining and improving assets	If an asset is expected to be replaced due to climate-related factors by an asset that does not significantly change the manner of operations, but instead is a technological upgrade fulfilling the same function then the expenditure on the replacement (and resultant continuation of cash inflows) should be included in a value-in-use calculation. Conversely, if the replacement asset enhances the economic output of the asset or cash-generating unit, the expenditure on the replacement (and resultant continuation of cash inflows) should not be included in a value-in-use calculation.
Disclosure of climate as a key assumption	When climate change is a significant factor in a value-in-use calculation, the key assumptions applied together with a description of management's approach to determining the value assigned to each key assumption should be disclosed. When relevant, this disclosure should provide an explanation of not only the key assumption, but also of its forecast effects on the company's future cash flows.

The FRC's Thematic Review on Impairment of Non-Financial Assets, published October 2019, stated that:

> *"... when preparing impairment related disclosures in 2019 accounts... companies for whom climate change and environmental impact are significant will explain how such factors, specific to the company's industry and value chain, have been taken into account in assessing medium and long term growth potential, costs and licence to operate."*

Log into or subscribe to the Deloitte Accounting Research Tool (DART) for further guidance and examples of climate change-related impairment considerations.

Useful lives of assets

Climate change-related factors may indicate that an asset could become physically unavailable or commercially obsolete earlier than previously expected. Furthermore, the expected timing of the replacement of existing assets may be accelerated. Such factors should be incorporated into a review of an asset's useful economic life.

Provisions, contingencies and onerous contracts

The pace and severity of climate change, as well as accompanying government policy and regulatory measures, may impact the recognition, measurement and disclosure of provisions, contingencies and onerous contracts.

- New provisions may need to be recognised due to new obligations (for example, fines levied for polluting activities or for failing to meet climate-related targets), or due to existing obligations now being considered probable.
- The timing of when an asset may need to be decommissioned may change, accelerating the required cash outflows for asset retirement obligations.
- New contingencies may need to be disclosed for possible obligations, or due to existing contingencies previously considered remote becoming possible.
- Cash flows and discount rates used in measuring provisions need to take into account the risks and uncertainties of climate change and accompanying regulations.
- Existing contracts may become onerous contracts due to the cost of fulfilling a contract increasing - for example, due to an increase in the cost of energy or water - or due to the benefits from fulfilling the contract decreasing.

Assumptions underlying asset retirement obligations is a particular area of investor focus. Transparent disclosures of the key assumptions applied should be included in the financial statements. In addition, sufficient information should be disclosed to help users understand the level of sensitivity of asset retirement obligations to changes in the key assumptions used. For example, such disclosures might include sensitivity analysis as to the timing of the asset retirement obligations.

Key judgements and estimates disclosures

If assumptions related to the impact of climate change have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, then disclosures about the nature of the assumptions should be provided.

In addition, sufficient information should be disclosed to help users understand the level of sensitivity of assets and liabilities to changes in the assumptions used. Sensitivity analysis provides an important insight when the level of uncertainty is high and factors affecting it are complex. A wider range of reasonably possible outcomes may be relevant in some cases when performing sensitivity analysis and those need to be disclosed and explained. One approach to explaining the possible impact of uncertainty would be to disclose the results of scenario testing, including qualitative and quantitative information about the potential effects of different scenarios, if possible. Alternatively, the disclosures could be provided in narrative form, explaining the potential impact of a different outcome occurring.

Estimates where the risk of material adjustment is not significant within the next year should not be included in the IAS 1 key estimates disclosure to avoid obscuring key messages about those items that are in scope. However, disclosure may nevertheless be necessary for an understanding of the financial statements (see below).

For further guidance refer to our IFRS in Focus *Spotlight on key judgements and estimates disclosures*.

Information that is relevant to understanding the financial statements

If investors could reasonably expect that climate change-related risks will have significant impact on the company and this would qualitatively influence investors' decisions, then management should clearly disclose information about the climate change assumptions that they have made (if not disclosed elsewhere), including disclosures around the sensitivity of those assumptions. This is to enable users to understand the basis of forecasts on which the financial statements are prepared. This may mean that disclosure is provided even if the effects of climate change on the company may only be experienced in the medium to longer term.

Impairment of financial assets

Climate-related events, such as floods and hurricanes, can impact the creditworthiness of borrowers due to business interruption, impacts on economic strength, asset values and unemployment. Policy and regulatory changes put in place to combat climate change could also result in a rapid deterioration of credit quality in sectors and/or countries affected, particularly if policy changes are radical or quickly implemented. In addition, lenders could also suffer increased credit losses through exposure to assets that become stranded or uninsurable, as such assets will no longer offer suitable collateral to lenders.

This means that when it comes to determining expected credit losses, there is a variety of possible adverse future economic scenarios that could impact the probability of borrowers defaulting and the extent of losses that the lender may incur in the event of default.

The long-term nature of some financial assets held by lending organisations such as banks and building societies may mean that assets held at the current balance sheet date could be exposed to these potentially severe adverse economic conditions for a portion of the period over which they are outstanding. The PRA has issued guidance to help banks and insurers consider climate change risk.

The impact on receivables in companies operating in non-financial industries is likely to be less severe. The short-term nature of trade receivables means that economic conditions are less likely to change during the collection period of the debtors. However, where a significant climate-related event has occurred, the effect of this event on trade receivables at balance sheet date should be assessed.

Assets measured on a fair value basis
Climate change risk may impact the measurement of fair value in respect of assets measured at fair value or tested for impairment on a fair value less costs of disposal basis.

For assets measured at fair value using the income approach, IFRS 13 illustrates a number of methods of incorporating risk into forecast cash flows and/or discount rate. However, unlike IAS 36, IFRS 13 makes no distinction between forecasts in a 'detailed forecast' or later periods. Furthermore, future capex and resultant changes to subsequent cash flows would be included in the measurement of fair value if a market participant would make that investment.

For assets measured at fair value using the market approach, it is necessary to consider whether any adjustment to comparator quoted prices or transactions is needed to reflect higher or lower climate change risk associated with the asset being measured.

Defined benefit pension balances
Pension trustees are required to consider all material financial risks, including the exposure of pension assets to climate change risk. This could include how the funding level of a scheme changes due to climate change risk, with a consequential impact on the level of employer contributions payable.

Demographic assumptions and investment performance can vary significantly under different climate change scenarios, impacting the measurement of pension asset and liability balances at the balance sheet date.

In the light of increased volatility, it is more likely that trustees of pension schemes may seek to rebalance their portfolios, change their investment and hedging strategies to de-risk the schemes and/or seek to make changes to the methodologies used to determine key assumptions underpinning the valuation of liabilities.

The disclosures in the financial statements should explain the risks associated with the defined benefit plans. Guidance on climate change and pensions has been issued by the TPR (updated July 2019).

Recoverability of deferred tax assets
Assumptions underlying the forecast of future taxable profits that supports the recoverability of deferred tax assets should be consistent with assumptions underlying other profit forecasts used in the preparation of the financial statements or disclosed in the narrative reports.

New levies or taxes
New levies or taxes may be introduced to encourage decarbonisation. Any levy liabilities should be recognised as the obligation is triggered under law (per IFRIC 21) and any income tax effects should be incorporated into normal IAS 12 accounting. Care should be taken when distinguishing between a levy and income tax and the application of IFRIC 21 or IAS 12 as this has proven to be a challenging area as new taxes/levies have been introduced in the past.

Carbon trading schemes
There are currently different acceptable approaches to accounting for carbon trading schemes. Log into or subscribe to DART for further information. This is an area that may evolve as such arrangements become more common, their terms change and they apply to more companies. It will also be necessary to consider whether the acceptable approaches will be equally acceptable for any new schemes when implemented.

Incentive schemes
Companies may introduce incentive schemes to incentivise management to decarbonise. Such schemes may either fall in the scope of IAS 19 or IFRS 2 depending on the nature of the awards. Decarbonisation targets should be treated as any other uncertainties or actuarial assumptions for IAS 19 benefits and should be treated as performance conditions for share-based payments under IFRS 2.

Impact on narrative reporting

Requirement	Type of disclosure	Mandatory for
Strategic report	Risks and uncertainties, KPIs	All companies except small companies
	Business model, information including policies and impact on environment	Quoted companies
s172 statement	How directors have regard to impact on the environment	Large companies
Non-financial reporting regulations	Business model, policies, risks and impact on environment	Public Interest Entities (PIEs) with >500 employees
UK Corporate Governance Code	Long-term viability statement and emerging risks	Premium listed companies
Energy and carbon regulations (effective periods commencing 1st Apr 2019)	GHG emissions, steps to address energy efficiency and total energy usage	Quoted companies, large companies and large LLPs

Strategic report

All companies that prepare a strategic report are required to disclose their principal risks and uncertainties arising in connection with the company's operations. These include climate-related issues when they are material.

For companies in scope of s414CB of the Companies Act (i.e. those in scope of the Non-Financial Reporting Directive) these disclosures are likely to be reported under that section's requirement to consider the principal risks that the company poses to the outside world, and how it manages those risks.

For quoted companies, to the extent necessary for an understanding of the development, performance or position of the company's business, the strategic report must also include the main trends and factors likely to affect the future development, performance and position of the company's business. Disclosure should be linked to the disclosures relating to business model and longer-term viability.

The Lab report, *Climate-related corporate reporting*, highlights examples of current best practice and is structured using the TCFD's core elements.

The FRC's statement on the UK Government's Green Finance Strategy states that reporting should set out:

> *"How the company has taken climate into account in assessing the resilience of the business model, its risks, uncertainties and viability both in the immediate and longer terms."*

Coming soon:
Deloitte Strategic Report Guide which includes 'Spotlights on climate change' sections.

Section 172 reporting obligations

Section 172 – Duty to promote the success of the company	HAVE REGARD TO	Section 172 matters
A director of a company must act in the way [s]he considers, in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole, and in doing so have regard (amongst other matters) to factors (a) to (f).		(a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

In addition to the strategic report requirements, all large UK companies (private as well as public) must include a section 172(1) statement in their strategic report which describes how their directors have complied with their duty to promote the success of the company for the benefit of its members whilst having regard to the matters set out in section 172(1) (a)-(f). The matters in section 172(1) include the impact of the company's operations on the community and the environment.

The section 172(1) statement is intended to provide greater transparency of the board's decision-making process, drawing out the key considerations which were taken into account. The expectation is that boards will make it clear how consideration of the section 172(1) factors impacted the company's decisions and strategies during the year.

In relation to the impact of climate change specifically, to demonstrate that they have fulfilled their duty under section 172(1), boards will need to explain the mechanisms they have in place to make informed assessments of the environmental impacts of their decisions. These impacts will be many and varied depending on the nature of the decisions, but, where relevant, boards should seek to articulate how the aim of reducing or minimising environmental impact led them to a particular course of action.

Failure to reduce or minimise the environmental impact of the company's operations could result in significant reputational damage. Boards must take care not to provide 'greenwashing' disclosures in the section 172(1) statement.

Further information on the section 172(1) statement is available in our *Board briefing on the new section 172(1) statement* which is intended to provide boards with practical support in developing a meaningful description of their section 172 activities by:

- looking at what relevant information is likely already to exist in the annual report and how that can be enhanced;
- providing a suggested structure for the content of the statement which highlights the board's approach to section 172, how the licence to operate is maintained and examples of section 172 in action through descriptions of key decisions made in the year; and
- suggesting some key matters to consider in relation to each stakeholder group.

Non-financial reporting regulations (EU member states)

The Non-financial reporting regulations require PIEs with more than 500 employees within all EU member states to disclose information relating to environmental matters, including the impact of the company's business on the environment. The information required should be disclosed to the extent necessary for an understanding of the company's development, performance and position. This information should include:

- a description of the principal risks relating to environmental matters (including business relationships likely to cause adverse impacts in those areas of risk and how those risks are mitigated); and
- policies on environmental matters, due diligence over those policies and outcomes of the policies. If there is no policy on the environment more broadly then the company must provide a reasoned explanation why not.

As referred to earlier, the EC has updated its non-binding guidelines on non-financial reporting to cover more comprehensively climate change-related information. The new guidelines integrate the TCFD recommendations.

UK Corporate Governance Code

The updated UK Corporate Governance Code requires boards to discuss and report how the matters (including risks and opportunities arising from environment matters) have been considered and addressed. This includes what the board has been doing in respect of identifying and mitigating risks and uncertainties.

Business model

Quoted companies and private company PIEs that fall in the scope of the Non-financial reporting regulations are required by s414C(8)(b) of the Companies Act to disclose the company's business model in the strategic report. In addition, the UK Corporate Governance Code specifically refers to the sustainability of the business model in the context of the board assessing the basis on which the company generates and preserves value over the long-term (Provision 1).

Linked with these requirements to provide information on the company's business model, companies will need to consider what changes in disclosure are needed in the light of climate change. Additionally, if companies expect to make changes to the business model in the future as a result of climate change, there should be appropriate disclosure.

Viability statement

Companies that are required to apply the UK Corporate Governance Code are required to prepare a long-term viability statement. In preparing a viability statement, directors are required to explain in the annual report, taking into account the company's current position and principal risks, how they have assessed the prospects of the company, over what period they have done so and why they consider that to be appropriate. In general, companies have used viability statement lookout periods of 3 – 5 years. One of the key focus areas for the FRC and for investors is the disclosure of prospects as well as viability. The FRC anticipates that the period over which directors assess the prospects of the company will be longer than the period for the viability assessment. The directors' statement on the future prospects of the business and the sustainability of the business model might extend over 10-20 years, and therefore directors should consider the potential sensitivity of a company's viability to different climate change assumptions.

Where to find examples of good disclosures

For examples of good climate change disclosures refer to our Annual report insights 2019: Surveying FTSE reporting, the TCFD 2019 Status Report, the TCFD Good Practice Handbook published by CDSB and SASB, and the FRC Financial Reporting Lab report: Climate-related corporate reporting.

Appendix – Climate Change FAQs

What is climate change?

Climate change is not new. The planet's climate has changed throughout history. However, what is new is that the current period of warming is occurring more rapidly than in the past and scientists believe that human-induced warming has serious implications for the climate and life on Earth.

What is the cause?

Man-made burning of fossil fuels through industry and agriculture is releasing greenhouse gases such as Carbon Dioxide (CO_2) and Methane into the atmosphere – these gases are trapping heat, preventing it from escaping our planet.

What is the impact?

The Intergovernmental Panel on Climate Change (IPCC) *Fifth Assessment Report* details a range of forecasts for warming and climate impacts with different emission scenarios. The IPCC *Special Report on Global Warming of 1.5 °C* explains that climate change and warming by just 1.5°C could result in increased risks to health, livelihoods, food security, water supply and economic growth, due to more extreme weather-related events. This could include droughts, heat waves, wild fires, flooding and hurricanes, and more gradual changes such as sea level rise and loss of biodiversity. Global temperatures are 1°C warmer now than before the industrial revolution and are on track for a 3-4°C rise by 2100 if no action is taken.

What are 'climate change scenarios'?

The term 'climate change scenarios' is used to describe by how much global temperatures may increase above pre-industrial levels. When considering different climate scenarios the following are often referred to:

- 3°C or above (if no or limited action is taken)
- 2°C
- 1.5°C

2°C and 1.5°C climate scenarios are known as 'transition scenarios'. Limiting the global temperature increase to 2°C or 1.5°C will depend on the action that is taken and how quickly it is taken.

What is the Paris Agreement?

The Paris Agreement is an agreement within the United Nations Framework Convention on Climate Change (UNFCCC), dealing with greenhouse gas emissions mitigation, adaptation, and finance, signed in 2016. The agreement was negotiated by representatives of 196 state parties. The Paris Agreement's principal goal is to keep the increase in global average temperature to well below 2°C above pre-industrial levels; and to aspire to limit the increase to 1.5°C, since this would substantially reduce the risks and effects of climate change.

The IPCC *Special Report on Global Warming of 1.5 °C* states that for global warming to be limited to 1.5 °C, "Global net human-caused emissions of carbon dioxide (CO_2) would need to fall by about 45 percent from 2010 levels by 2030, reaching 'net zero' around 2050."

The UK is a signatory to the Paris Agreement. In July 2019, the UK Government announced in its Green Finance Strategy its commitment to achieve net zero GHG emissions by 2050.

What is CDP?

CDP issues an annual questionnaire-based framework that collects information on climate change, water security and forest commodities, which may have been reported in sustainability, annual or integrated reports. The main users of the information collected and scores given by CDP are institutional investors, purchasing organisations and policymakers.

What is CDSB?

The Climate Disclosure Standards Board (CDSB) works to provide decision-useful environmental information to markets via mainstream corporate reports. The CDSB Framework provides a basis for reporting material climate change and natural capital information with the same rigour as financial information, helping preparer companies provide investors with decision-useful environmental information via the mainstream corporate report.

What is GRI?

The Global Reporting Initiative (GRI) develops GRI Standards that outline how and what to report regarding the material economic, social and environmental impacts of an organisation on sustainable development. GRI Standards address and provide disclosures for 33 potentially material sustainability topics. The GRI Standards are used in sustainability reports, as well as annual or integrated reports. GRI Standards are oriented at a broad range of stakeholders.

What is IIRC?

The International Integrated Reporting Council (IIRC) developed the International <IR> Framework, which explains how an organisation can report on the value it creates for itself and others over time. The <IR> Framework includes the concept of six capitals: financial, manufactured, intellectual, human, social and relationship, and natural.

What is ISO?
The International Organization for Standardization (ISO) brings together experts from 164 national standards bodies and develops voluntary, consensus-based, market relevant International Standards. ISO 26000 on social responsibility provides a conceptual framework and guidance to address seven core subjects of organisational sustainability. It can be used in both sustainability reports and annual or integrated reports, addressing a broad range of stakeholders.

What is SASB?
The Sustainability Accounting Standards Board (SASB) Standards guide reporting on financially material environmental, social and governance issues by means of metrics and disclosures for 77 industries. SASB Standards are intended to be used in communications to investors, such as the annual report.

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