Climate-related and other emerging risks disclosures:
assessing financial statement materiality using AASB/IASB Practice Statement 2

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1 Overview and objectives

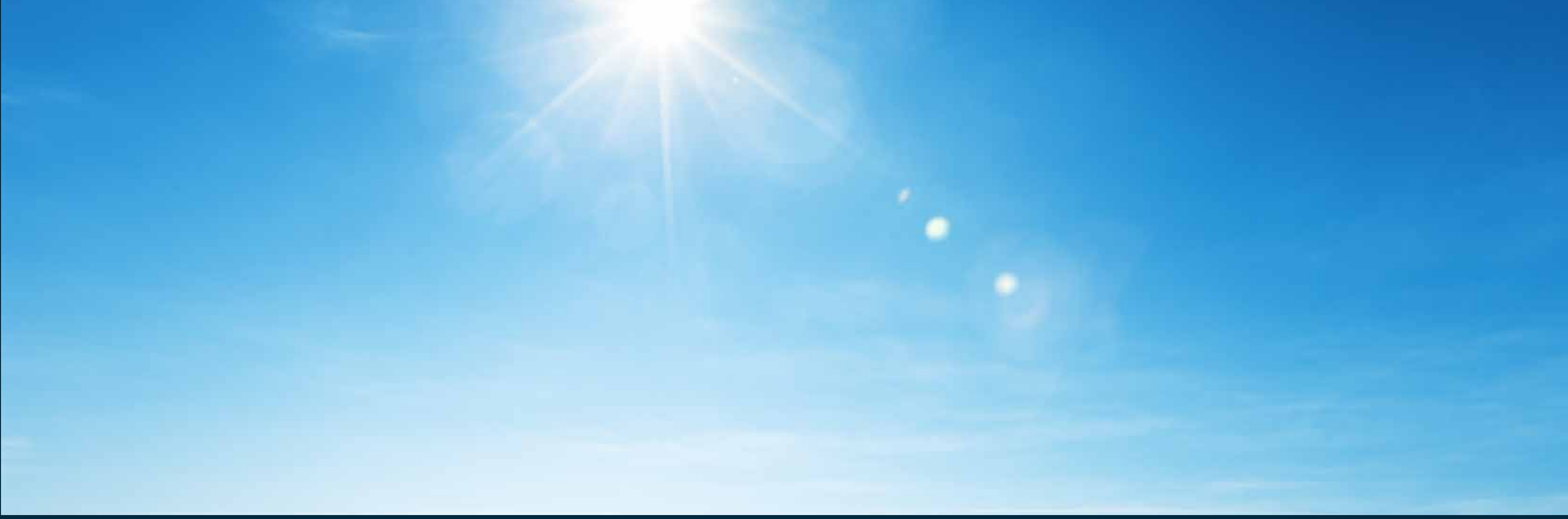
Climate-related risks and other emerging risks are currently predominantly discussed outside the financial statements, if at all[1]. However, as set out in AASB/IASB Practice Statement 2 *Making Materiality Judgements* (APS/PS 2), qualitative external factors such as the industry in which the entity operates, and investor expectations may make such risks 'material' and warrant disclosures when preparing financial statements, regardless of their numerical impact.

Given investor statements on the importance of climate-related risks to their **decision making**, the impact of the materiality definition and APS/PS 2 is that entities can no longer treat climate-related risks as merely a matter of corporate social responsibility and may need to consider them also in the context of their financial statements.

For example, an entity in an industry likely to be impacted by climate-related risks determines that its impairment testing does not need to include a specific assumption regarding such risks. However, taking into account investor comments on the importance of climate-related risks to their investment decisions and reasonable expectations that the entity could be impacted by such risks, applying APS/PS 2, the entity assesses that its assumptions regarding climate-related risks are material and need to be specifically disclosed, even though there is no impact on amounts recognised in the financial statements.

The Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AUASB) expect that directors, preparers and auditors will be considering APS/PS 2, when preparing and auditing financial statements for their next half and full year ends. Even though the guidance is not mandatory, it represents the IASB's best practice interpretation of materiality and entities in Australia are already being subject to law suits regarding lack of disclosure.

1 A high-level review of "climate" related content in annual reports of listed entities indicates climate-related risks disclosures are included in the annual report. However, this is predominantly residing outside the financial statements. Only 8% of ASX100 entities and 2% of ASX101-200 entities have disclosed some form of climate-related contents within the financial statements.



2 Key recommendations

Entities preparing financial statements in accordance with Australian Accounting Standards should consider:

- whether investors could reasonably expect that emerging risks, including climate-related risks, could affect the amounts and disclosures reported in the financial statements and have indicated the importance of such information to their decision making; and
- what disclosures about the impact of climate-related risks and other emerging risks on the assumptions made in preparing the financial statements are **material** to the financial statements in light of the guidance in APS/PS 2, as summarised in the decision tree on the following page.

These recommendations relate to financial statement requirements and do not negate the need to consider reporting obligations in other parts of the annual report such as the operating and financial review/management commentary or the corporate governance statement. Conversely, disclosures made in other documents will not compensate for disclosures that should be in the financial statements, and are therefore subject to audit.

Auditors of the financial statements may consider:

- climate-related risk and other emerging risks as part of their risk assessment applying ASA 315 *Identifying and Assessing Risks of Material Misstatement through Understanding the Entity and its Environment.* If there is an assessed risk of material misstatement in the financial statements, the auditor responds appropriately to the risks of material misstatement applying ASA 330 *The Auditor's Responses to Assessed Risks;*
- whether climate-related risk and other emerging risks are relevant for accounting estimates including assumptions used to arrive at a fair value estimate and potential impairment, under ASA 540 *Auditing Accounting Estimates and Related Disclosures.*

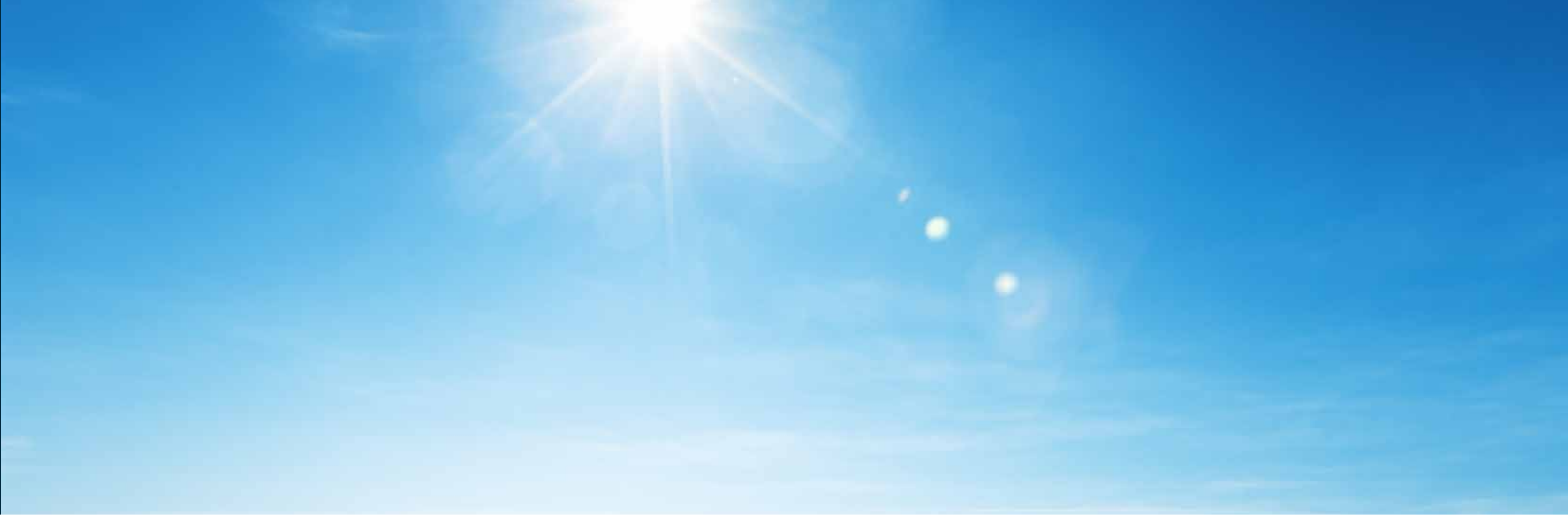
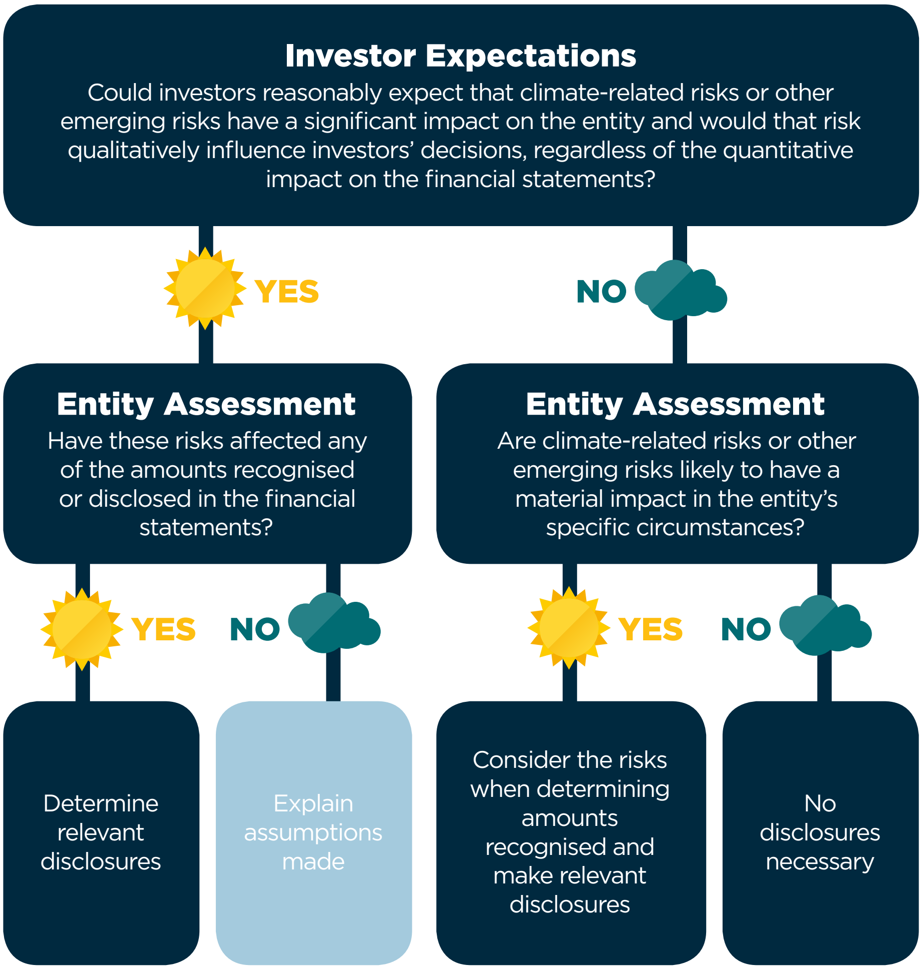


Figure 1 **Considerations in Assessing Materiality**



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3 What are climate-related risks and why are they different to other emerging risks?

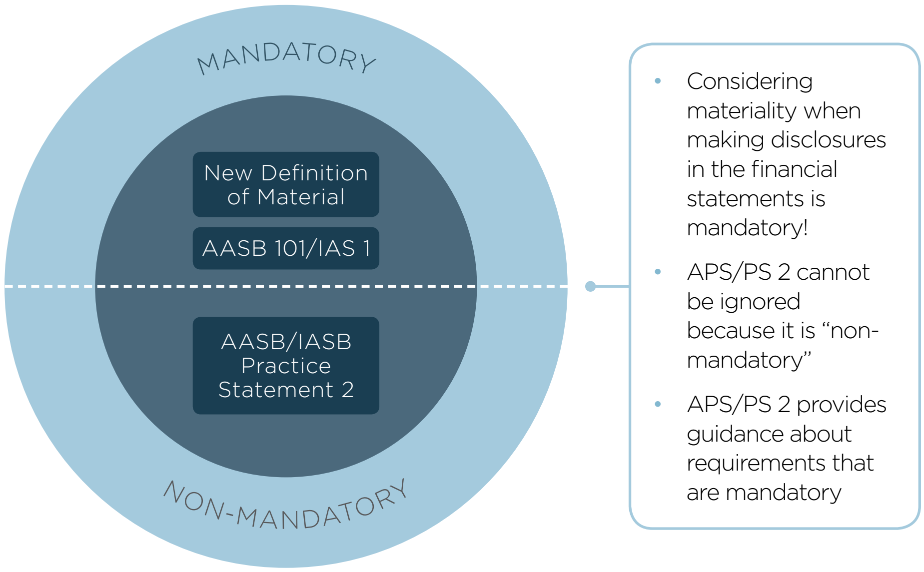
Climate-related risks include those from potential acute or chronic natural disasters, change in climate patterns and the related technology, market, legal and changes in government policies risks.

While there are also other emerging risks such as data breach and cyber-security risks and broader technological and regulatory risks that could be significant for entities, **investors have specifically identified climate-related risks as being used in their decision making,** but not being adequately addressed in annual reports. Existing and potential investors, creditors, insurers and customers are increasingly demanding more specific information about an entity's exposure to, and management of, climate-related risks. This is evident from the following recent initiatives by investors:

- A briefing paper on the Global Investor Statement on Governments in Climate Change was issued early this year by seven investor organisations including The Investor Group on Climate Change (IGCC, Australia/New Zealand), Principles for Responsible Investors (PRI) and UN Environmental Program Finance Initiative (UNEP FI);
- Blackrock published their Investment Stewardship's approach to engagement on climate-related risk;
- Vanguard, Black Rock and HSBC call for climate-related disclosures and called for investors to factor climate-related risk into investment decisions;
- A group of shareholders of Whitehaven attempted to pass an ordinary resolution requesting information about the company's exposure to climate-related risks in the AGM notice for the year ended 30 June 2018;
- Super funds demand climate reporting as one of their own faces court action; and
- A legal claim was filed against Commonwealth Bank of Australia (CBA) on August 8, 2017 by advocacy group Environmental Justice Australia on behalf of two Commonwealth Bank shareholders. The case argued that climate-related risks create material financial risks to the bank, its business and customers, and that the bank breached the *Corporations Act 2001* by failing to give a true and fair view of its financial position and performance because of the inadequate disclosure of this risk. The case was withdrawn after CBA included several pages of discussions in their annual report that are based on the TCFD recommendations.

4 What is AASB Practice Statement 2 *Making Materiality Judgements* and how does it apply to disclosing climate-related and other emerging risks in financial statements?

Even though APS/PS 2 is not mandatory, it represents the AASB's and IASB's best practice guidance for making the materiality judgements required by Australian Accounting Standards when preparing general purpose financial statements in accordance with Australian Accounting Standards.



However, APS/PS 2 only applies to the financial statements and not to the other information contained in the annual report.

As defined in AASB 101/IAS 1 *Presentation of Financial Statements* and explained further in APS/PS 2, information is material[2] if omitting it or misstating it could **influence decisions** that users make on the basis of financial information about a specific reporting entity.

The AASB 101/IAS 1 materiality definition also highlights that an assessment is made on the basis of size (quantitative) and nature (qualitative factors), or a combination of both. APS/PS 2 further emphasises that an item of information could influence primary users' decisions regardless of its size, and a quantitative threshold could even reduce to zero, such as when information about a transaction, other event or condition is highly scrutinised by the primary users.

Example K in APS/PS 2 illustrates that external qualitative factors such as the industry in which the entity operates, and investor expectations are considered when making materiality judgements about required disclosures in the financial statements.

Although the example relates to banks, it is equally relevant to entities exposed to climate-related risks. In the example, the entity is operating in an industry that is exposed to debt originating from a country whose national economy is currently experiencing severe financial difficulties. The fact that other international banks have exposure to such debt creates a reasonable expectation that the reporting bank may also be exposed to such risk. The reporting bank holds only a small amount of the debt. These external qualitative factors are considered in assessing whether disclosure about the lack of exposure to this risk is material for the reporting bank.

As noted in section 3, similar external qualitative factors now exist for climate-related risks, and may also exist for particular entities for other emerging risks.

2 The International Accounting Standards Board (IASB) recently amended IAS 1 and IAS 8 to clarify the definition of "material" and to align the definition used in the Conceptual Framework with that in the standards themselves. The corresponding amendments will be issued in Australia in December 2018. Specifically, the amendments define the term "material" as follows: 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. However, the substance of the definition has not changed.

The TCFD report[3] identifies the following entities that are likely to be affected by climate-related risks[4]:

- financial sector entities - banks, insurance groups, asset owners (investment entities), and asset managers, and
- non-financial sector entities - energy, transportation, material and buildings and agriculture, foods and forest products.

Given the external factors noted in section 3, entities in the above industries determining material disclosures are likely to assess that it is necessary to explain whether and how they have considered climate-related risk in their impairment assessments and how climate-related risks have affected other decisions made in relation to the recognition or measurement of items in the financial statements (see section 5). This could be the case even if the entity did not recognise any material impairment write-down or other impacts in the financial statements, consistent with the conclusions in Example K.

A high-level review of "climate" related content in 2018 annual reports[5] has shown that climate-related risk is being considered, however the financial statements do not reflect this. The majority of climate-related disclosures are currently made in the broader annual report, primarily in the director's report and corporate governance statement and not in the financial statements. For some entities, applying the materiality definition and the principles in APS/PS 2 would result in some of this information being reflected within the financial statements.

For example, an entity may need to explain its judgement that it was not necessary to factor climate change into the impairment assumptions, or how estimates of expected future cash flows, risk adjustments to discount rates or useful lives have, or have not, been affected by climate change. Financial sector entities may consider disclosing to what extent their investment or loan portfolios are exposed to climate risk and how this risk has been factored into the valuation of these assets.

3 Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) (June 2017)

4 Financial sector entities might be indirectly impacted by the effect of climate risk on their clients, such as through impaired loans, higher insurance claims or reduced value of equity holdings. Superannuation entities, asset managers and asset owners may be impacted through holding investments in affected entities. Non-financial sector entities are likely to be directly impacted by climate risks, for example through transition and physical risks around greenhouse gas emissions, energy, or water dependencies associated with their operations and products.

5 The AUASB undertook a high-level review of "climate" related content in annual reports for all listed entities for 2018. 966 annual reports were analysed and the results were aggregated across listed entities by industries and ASX indices. The review indicates that there is a consideration of climate-related disclosures in the annual report mainly in the industries which are expected to be impacted by climate-related risks such as energy and utility, material, consumer staples and real estate. However, there is a lack of disclosure in the financial statements as explained in footnote 1 above.

The disclosures in the notes to the financial statements should be focusing 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. Section 5 below identifies areas that may be particularly affected. Comments about the entity's overall approach to climate-related and other business risk belong in the narrative operating and financial review/management commentary or related documents outside the financial statements.

Materiality judgements may also lead to the disclosure of information that is not specifically required by the Accounting Standards. As explained in AASB 101/IAS 1 paragraph 31 and illustrated in Example C of the Practice Statement[6], an entity considers whether to provide information not specified by Australian Accounting Standards if that information is necessary for primary users to understand the impact of particular transactions, other events and conditions on the entity's financial position, financial performance and cash flows.

This may include the disclosure of assumptions made about climate change in the assessment of an impairment loss for an individual asset even though such disclosure is not required under AASB 136/IAS 36 as no impairment has been recognised (particularly if including an assumption would result in an impairment) or the impairment recognition was not impacted by a climate risk assumption. Similarly, entities may disclose their significant estimates or judgements made about climate related risks even if there is currently no financial impact or significant risk of materially adjusting the carrying amounts of assets and liabilities in the next financial year and hence no disclosure required under AASB 101/IAS 1.

However, APS/PS 2 also notes that general purpose financial statements do not, and cannot, provide all the information that primary users need. Entities should consider the common information needs of their primary users. They would not need to focus on climate risk, for example, if this was not commonly considered a significant issue in the context of the entity's business environment by the investor group at large, and had not already affected the entity's financial statements for other reasons.

6 Example C explains that an entity may need to disclose its assumptions made in the context of determining an impairment loss where this information is relevant for users to understand the impact of the impairment on the entity's financial position, financial performance and cash flows. This is even though AASB 136/IAS 36 does not require such disclosure.

5 Financial reporting considerations

The potential financial implications arising from climate-related and other emerging risks may include, but are not limited to:

- asset impairment;
- changes in the useful life of assets;
- changes in the fair valuation of assets due to climate-related and emerging risks;
- increased costs 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; and
- changes in expected credit losses for loans and other financial assets.

Using the decision tree above, the table below discusses how climate-related risks in particular, could affect the financial statements and which accounting standards may need to be considered.

Relevant Accounting Standard	Impact on financial reporting
AASB 101/IAS 1 *Presentation of Financial Statements*	Paragraph 112 of AASB 101/IAS 1 requires the notes to the financial statements to provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them. In the context of climate-related risks, information will be relevant if investors could reasonably expect that climate-related risks or other emerging risks have a significant impact on the entity and this would influence investors' decisions. For example, an entity may need to explain whether and how it has considered climate-related risks in their impairment calculations even though there is no specific requirement in AASB 136/IAS 36 for such disclosure. Where other entities in a similar industry have recognised significant write-downs and investors have publicly demanded such information disclosure of whether or not climate-related risks impacted the carrying value of the assets recognised in the financial statements should be provided.
AASB 136/IAS 36 *Impairment of Assets,*	The carrying value of assets such as property, plant and equipment, assets recognised in relation to mineral resources, intangible assets and goodwill could be overstated if the impairment calculations do not take the impact of climate-related risks into account. An entity's exposure to climate-related risks could be an indicator that an asset or a group of assets is impaired, and also affect future estimated cash in- and outflows used for the recoverable amount calculations. AASB 136/IAS 36 requires disclosure of the key assumptions on which cash flow projections have been based and management's approach to determining the value assigned to these key assumptions, in particular in relation to goodwill or indefinite-life intangible assets. Where climate-related risks could have a significant impact on the entity's operations, information about how this has been factored into the recoverable amount calculations would be relevant for the users of the financial statements. This would be particularly the case for long-lived assets and assets recognised in relation to mineral resources. In the extractive industries, investors may look for explanations as to whether an entity has considered the impact of climate-related risks in determining whether exploration or evaluation of certain areas of interests should continue.

Relevant Accounting Standard	Impact on financial reporting
AASB 116/IAS 16 *Property, Plant and Equipment* and AASB 138/IAS 38 *Intangible Assets*	Other than impairment, climate-related risks may also affect: • whether certain expenses satisfy the definition of an asset and thus can be recognised (e.g. as property, plant and equipment or an intangible asset); and • the estimated useful lives of assets, and therefore the amount of depreciation or amortisation recognised each year.
AASB/IFRS 13 *Fair Value Measurement*	AASB/IFRS 13 requires entities to disclose key assumptions used where assets are recognised at fair value. When the fair value of a particular asset is impacted by climate-related risks, the entity may need to disclose how climate-related risk is factored into the calculations. Entities in impacted sectors particularly impacted by climate-related risks should disclose their assumptions regarding climate-related risks, regardless of the quantitative impact.
AASB/IFRS 9 *Financial Instruments* and AASB/IFRS 7 *Financial Instruments: Disclosures*	AASB/IFRS 9 impairment requirements use forward-looking information to recognise expected credit losses. When determining whether credit risk has increased significantly since initial recognition, any actual or expected adverse changes in the regulatory, economic or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations must also be considered. When banks invest in projects or lend money to businesses impacted by climate-related risk, they will need to consider how the exposure to climate-related risk affects the expected credit losses of these loans and investments. For example, if an entity has significant exposure to fossil-fuel intensive projects, it should identify the extent of this exposure and how climate-related risks could affect the amounts recognised in their financial statements. Superannuation entities and insurance companies could also hold investments in industries that may be impacted by climate-related risk and would therefore be exposed to price risk in relation to these investments. AASB/IFRS 7 requires disclosure of the entity's exposure to risks arising from financial instruments, its objectives in managing these risks and changes from the previous period. Quantitative information such as an analysis of investments by industry/sector could specifically identify those sectors that are exposed to climate-related risks and explain the entity's policy of limiting its exposure to those sectors.

Relevant Accounting Standard	Impact on financial reporting
AASB 137/IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Entities are required to provide a brief description of the nature of any contingent liability, and where practicable an estimate of its financial effect and an indication of the uncertainties relating to the outflow of resources to settle the obligation. Potential climate-related risks and uncertainties may also be taken into account in determining the best estimate of a provision. Entities must disclose the major assumptions made about future events, which may need to include an explanation of how climate-related risks has been factored into the best estimate of the provision. Climate-related risk could have the following impacts: • recognition of an onerous contract provision driven by the potential loss of revenues or increased costs under different climate-related risk situations; • an increase of provisions recognised for decommissioning a plant or rehabilitating environmental damage in extractive industries due to regulatory changes or shortened project lives; and • disclosure of a contingent liability for potential litigation and fines/penalties due to stricter environmental and other regulations.

6 Assurance considerations

In accordance with the expectations of the application of APS/PS 2 to climate-related risks, auditors would be expected to consider and understand the implications of climate-related risk and how it affects their own work and procedures. If climate-related risk has a significant impact on the entity, the auditor is expected to consider whether the financial statements, appropriately reflect this in accordance with the applicable financial reporting framework. This information would then be audited under the Australian Auditing Standards (ASAs).

In order to address these issues confidently, auditors will need to understand how climate-related risk relates to their existing legal and professional duties. Auditors who do not consider climate-related risk may face increased risks of regulatory intervention and shareholder pressure. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Applying ASA 315 auditors consider the implications of climate-related risk when obtaining an understanding of the entity and its environment, in light of its objectives, strategies and other business risks and the adequacy of its internal controls and risk management systems. This may include having an understanding of:

- regulatory climate-related risk implications;
- climate-related market risk implications;
- climate-related risk implications for committed and proposed capital expenditure; and
- climate-related risk implications for the entity's objectives and strategies.

Applying ASA 330 the auditor would then respond appropriately to the risks of material misstatement.

Where the auditor identifies that climate-related risk may be relevant for accounting estimates including assumptions used to arrive at a fair value estimate and potential impairments, the auditor applies ASA 540 and is expected to:

- perform risk assessment procedures in order to obtain an understanding of the entity and its environment;
- identify and assess the risk of material misstatement in order to evaluate the degree of estimation uncertainty associated with the estimate;
- respond to the assessed risks of material misstatement by selecting an appropriate testing strategy;
- perform an overall evaluation including the reasonableness of the estimate;
- assess the adequacy of disclosures relating to estimates;
- obtain written representations from management;
- communicate with those charged with governance, management or other relevant parties about certain matters, as appropriate; and
- document the basis for their conclusion about the reasonableness of accounting estimates and indicators of possible management bias, if any.

If material disclosures are made in relation to climate-related risk and any financial impact is reflected in the financial statements this information would be audited as part of the annual audit under the Australian Auditing Standards. The auditor applying ASA 700 *Forming an Opinion and Reporting on a Financial Report* evaluates whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework.

Auditors read and consider other information presented in the annual report but outside the financial statements, including the operating financial review and corporate governance statements for material inconsistency with the financial report, or the auditor's knowledge obtained during the audit in accordance with ASA 720 *The Auditor's Responsibilities Relating to Other Information*. If the auditor identifies material inconsistencies or that other information appears materially misstated they need to respond appropriately.

If climate-related disclosures are made outside the annual report (e.g. in a sustainability report) and external assurance is sought on this information, ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* would usually be the applicable standard to use.