Are your climate disclosures revealing the true risks of your business?

Insights for the CFO on the release of *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures*.

September 2017

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Key points

The Task Force on Climate-related Financial Disclosures (TCFD) Recommendations were developed because the Financial Stability Board (FSB) considers climate change to represent a **systemic financial risk to the economy** that is not being adequately addressed by business.

Companies who adopt the TCFD Recommendations are asked that climate-related disclosures be reported in their **financial filings**.

It is likely that the TCFD Recommendations will motivate **investor demands, increase shareholder resolutions** and even **potential legal and regulatory change**.

Implementation of or alignment to the TCFD Recommendations potentially requires changes to existing **financial** risk process and disclosures.

CFOs should be better informed on how their company is managing its climate-related financial risk, and the time period over which the impacts are anticipated.

Early movers will likely be better positioned to effectively measure and evaluate their own risks and be ready to address growing demands from their investors.

On 30 June 2017, the industry-led Task Force on Climate-related Financial Disclosures (TCFD) set up by the Financial Stability Board (FSB) released its ***Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures***[1] (the Report).

The Report sets out the TCFD's Climate-related Financial Risk Disclosure Recommendations (the TCFD Recommendations) for use by companies in providing information to investors, lenders, insurers, and other stakeholders. These disclosures include the **financial impact** that climate risks have, or could have, on their organizations.

The recommended disclosures include how boards and management govern the impacts of climate change, and how they integrate governance into their strategy, businesses, financial plans and risk management processes. The Report also recommends that companies disclose various metrics and targets relating to climate change, ranging from greenhouse gas (GHG) emissions to executive remuneration. The most complex of the Recommendations asks organizations to model a range of climate scenarios (including a two degree aligned scenario[2]) over the short-, medium- and long-term and quantify the financial impacts from climate change.

This is a milestone for climate risk reporting. For the first time, there is a framework for companies to deliver information that is consistent, comparable, reliable, clear and efficient. It also solicits decisions that are useful, forward looking and informative for financial markets.

While the adoption of the recommended disclosures is voluntary, more than 100 companies globally, across sectors, with a combined market capitalisation of around US$3.5t, together with financial institutions with assets under management of about US$25t, have already publicly committed to support the Recommendations. These include ANZ, CBUS, Singapore Exchange, Tata Steel, Unilever, Swiss Re, Jet Blue, Acciona, HSBC and EDF Group.

Highlights of the TCFD Recommendations

- Applicable to all organizations
- Disclosures to be included in financial filings
- Designed to solicit decision-useful, forward-looking information for financial markets
- Strong focus on risks and opportunities related to the transition to lower carbon economy
- Voluntary

1. The Report builds on the TCFD's Draft Recommendations that were issued in December 2016 and feedback collected from a rigorous consultation period.

2. The UN's Conference of the Parties (COP) Paris Agreement limits climate change to less than two-degrees.

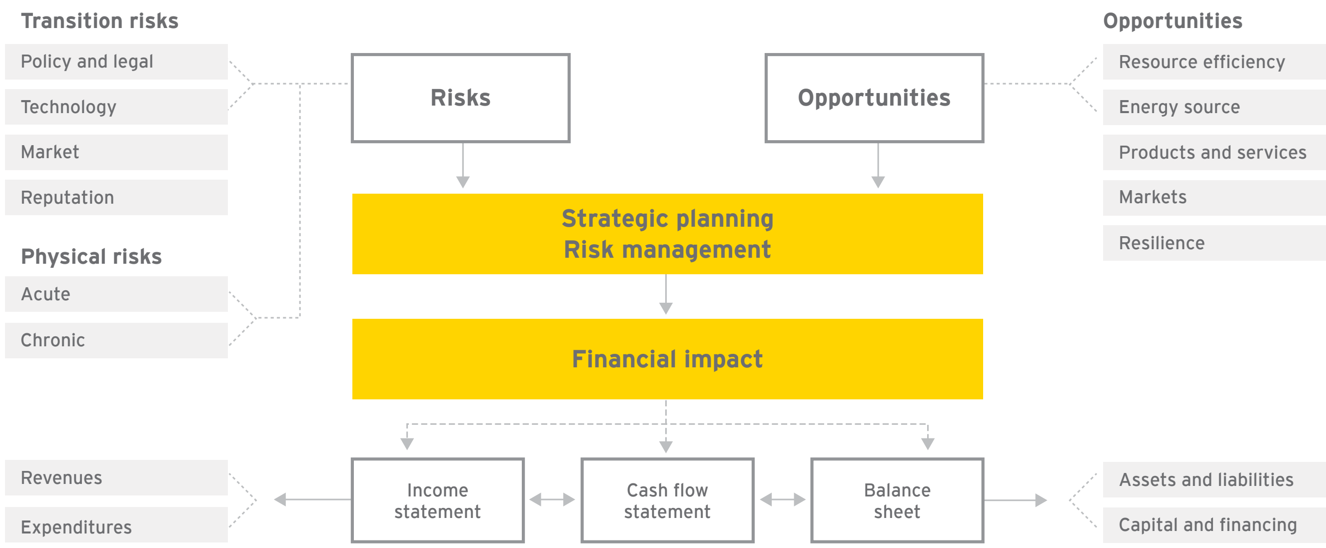
What is the potential impact for you as CFO?

While the TCFD Recommendations are voluntary, companies who adopt to the Recommendations are asked that disclosures be reported in **financial filings**, or for asset managers and owners that don't prepare standard corporate financial reporting, in existing financial reporting to investors. Specifically, the Report recommends all companies report on governance and risk management processes relating to climate risk, due to the systemic (non-diversifiable) nature of the risk. These governance processes should undergo the same review procedures as other financial reporting processes by the CFO and audit committee. Those companies that assess climate risk to be material to their activities, and companies in certain sectors[3] and where annual revenue exceeds US$1b, should also include recommended disclosures relating to strategy, targets and metrics, including the results of climate scenario modeling.

The TCFD Recommendations were developed because the FSB considers climate change to represent a systemic financial risk to the economy that is not being adequately addressed by business.

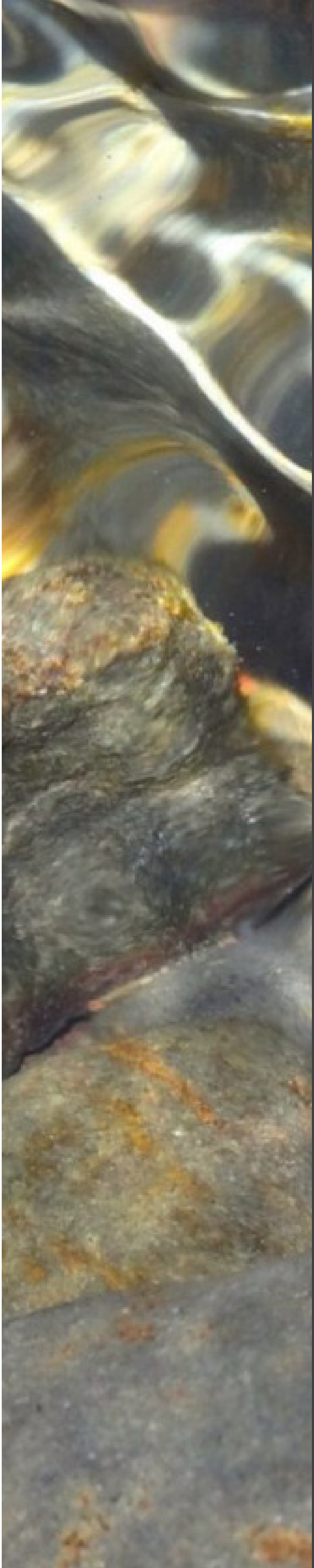
Climate risks are more complex and longer-term in nature than most traditional businesses risks, and this has contributed to a lack of understanding and measurement on their potential impacts. Climate risks are further categorized as **transition risks** and **physical risks**, both of which have the potential to impact financial statements (as shown in Figure 1). Where an organization does not have a clear understanding of the range and magnitude of potential financial impacts from climate change, this may be increasingly detrimental to its financial performance.

Fig. 1. Climate-related risks, opportunities and financial impact



Source: *Financial Stability Board, Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures*, FSB, 2017.

3. For example, energy, transportation, buildings; materials and agriculture, food and forestry products.



The adoption of the Recommendations will potentially require changes to existing financial risk processes and disclosures. For example, CFOs may need to be better informed regarding the climate risks that the company may be exposed to, and the time period over which their impacts are anticipated.

Due to the forward looking nature of this analysis, risk assessments should be updated regularly to assess technology, regulation, consumer and physical changes that may impact the materiality of the risk. For example, solar electricity generation falling below the cost of grid (or other stand-alone options) in certain regions and countries, will likely have an impact on growth of other electricity sources such as coal-fired generation. Depending on the materiality and the timeframe, climate risks should be considered in terms of future revenue and cost expectations, provisioning and liability, and asset depreciation.

There may be broader implications

In addition to the financial risk implications set out above, companies may be impacted by the TCFD Recommendations via **investor demands, increase shareholder resolutions** and even **potential legal and regulatory change**. As a result, it is important for CFOs, together with directors and management, to understand the risks and potential repercussions to their company should the Recommendations not be adopted, adopted but applied inappropriately, or if their company has publicly welcomed the Recommendations but not acted on them.

Influencing factors leading to better disclosure, and potentially the transition from voluntary disclosure to mandatory reporting include:

France has already introduced a legal requirement which mandates listed companies and financial institutions to make certain climate related disclosures including financial disclosures via "Article 173, the French Energy Transition Law." The Australian Prudential Regulation Authority stated, in February 2017, that they see climate change as a material financial risk to the economy and that it may become a parameter of their system-wide stress testing processes.

BlackRock has issued a statement that they expect companies most exposed to climate risk to consider these Recommendations and expect the whole board to have a good understanding of how the risks may affect the business and management's approach to adapting and mitigating the risks.

ExxonMobil, faced shareholder resolutions in 2016 and 2017 requesting the company to report on the portfolio risks under a two degree aligned scenario – the key Recommendation on the TCFD Report. This gained 38.1% in 2016 and 62.3% in 2017. The resolution was passed at the 2017 AGM.

Standard & Poor's and Moody's are now considering climate change risks as part of sovereign credit ratings and on a sectoral basis. Improving climate risk disclosures and providing evidence of risk management is seen as a way to show the market you have no increased credit risk and may address the concerns of credit ratings. If sectoral risks are not managed this may lead to future credit rating reductions and potentially an increased capital cost.

Accounting bodies are already exploring the question: Can existing accounting, reporting and assurance standards accommodate the FSB TCFD Recommendations? Not all the TCFD Recommendations can sit within financial data of companies but strategic and other qualitative disclosure may well fit within management commentary within existing accounting standards.

Millennials are highly engaged with environmental and social issues and often require an organization to share similar concerns to remain as a customer. This trend has seen a rise in socially minded enterprises and pressure from customers may compel companies to implement the TCFD Recommendations.

Given the breadth of potential interaction between climate risk and business operations, the adoption of the TCFD Recommendations could require changes to the governance structure, risk assessment process and disclosures. The earlier the supporting business processes are reviewed and implemented, the better positioned businesses will likely be from both the financial reporting and business strategy perspectives.

For CFOs in particular, they will likely be expected to report back confidently to the Board on how the company is managing its climate-related financial risk. **To do this, CFOs should be ready to answer the following key questions:**

- What are your governance and risk management processes for assessing the financial implications of climate change risk?
- In what ways will climate change risk impact the organization?
- What could the financial impacts of climate-related risk be under a business-as-usual and a two-degree scenario? Are these financial impacts material and if so how are they disclosed in financial filings? If no, are governance and risk management processes disclosed to show these risks have been assessed?

If these questions cannot be answered confidently, flags should be raised and you should consider taking immediate action within your business to address concerns.

EY can assist businesses seeking to build a strategy to respond to climate-related financial risk. Our Climate Change and Sustainability Services (CCaSS) professionals work alongside our risk, governance and financial reporting teams, and can provide you with company-specific climate risk analysis and implementation advice that meets the TCFD disclosure Recommendations.

Our climate change scenario risk analysis services can be tailored to meet the requirements of the TCFD Recommendations, which requires organizations to model the transition and physical impacts of at least one two degree scenario. This results of these risk assessments are designed to meet the requirements of the organization and can be qualitative or quantitative in nature.

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The quality of our audits starts with our 60,000 assurance professionals, who have the breadth of experience and ongoing professional development that come from auditing many of the world's leading companies.

For every client, we assemble the right multidisciplinary team with the sector knowledge and subject matter knowledge to address your specific issues. All teams use our Global Audit Methodology and latest audit tools to deliver consistent audits worldwide.

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Governments and organizations around the world are increasingly focusing on the environmental, social and economic impacts of climate change and the drive for sustainability.

Your business may face new regulatory requirements and rising stakeholder concerns. There may be opportunities for cost reduction and revenue generation. Embedding a sustainable approach into core business activities could be a complex transformation to create long-term shareholder value.

The industry and countries in which you operate as well as your extended business relationships introduce specific challenges, responsibilities and opportunities.

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