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IFRS Developments

Effects of climate-related matters on financial statements

What you need to know

- On 20 November 2020, the IASB released a document for education purposes, highlighting what entities should consider in relation to climate-related matters.
- The document does not change, remove, nor add to, the requirements in IFRS Standards.

Background

On 20 November 2020, the International Accounting Standards Board (the IASB or the Board) released a document, prepared for educational purposes, highlighting the requirements within IFRS Standards that are relevant for entities' financial statements on climate-related matters. The document does not change, remove, or add to, the requirements in IFRS standards and the intention is to support robust climate-related disclosures.

Stakeholders are increasingly interested in the impact of climate change on entities' business models, cash flows, financial position and financial performance. While IFRS Standards do not explicitly refer to climate-related matters, entities must consider them in applying IFRS Standards when the effect of those matters is material.

The examples of IFRS Standards identified in the educational material are considered to be non-exhaustive as there could be other instances where climate-related matters are relevant to entities' financial statements.[1]

[1] Further discussion can also be found in an "in Brief" article entitled *IFRS Standards and climate-related disclosures*, written by IASB member Nick Anderson and published in November 2019.

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Key points in the material, which is organised by IFRS Standards, are summarised below.

IAS 1 *Presentation of Financial Statements*

The document underlines that IAS 1 requires entities to disclose information, for instance climate-related matters, not specifically required by IFRS Standards and not presented elsewhere, but relevant to an understanding of the financial statements.

Information pertaining to climate-related matters will be relevant if investors could reasonably expect that it will have a significant impact on the entity and, therefore, influence their investment decisions. Furthermore, IAS 1 requires an entity to consider whether any material information is missing from its financial statements.

IAS 1 requires disclosure of information about the assumptions an entity makes about the future that have a significant risk of resulting in a material adjustment within the next financial year.

The disclosure of judgements that have the most significant effect on the amounts recognised is also required by IAS 1. Many judgements will also be impacted by climate-related matters, so entities will need to consider disclosing these judgements.

IAS 1 requires disclosure of material uncertainties if they may cast significant doubt upon an entity's ability to continue as a going concern. Climate-related matters may create material uncertainties related to events or conditions that cast significant doubt upon an entity's ability to continue as a going concern. In assessing whether the going concern basis of preparation is appropriate, information regarding climate-related matters should be considered in conjunction with other uncertainties.

IAS 2 *Inventories*

Entities may find that climate-related matters cause inventories to become obsolete, selling prices to decline or costs to complete to increase and, thus, may need to be written down to net realisable value.

IAS 12 *Income Taxes*

Climate-related matters may affect an entity's estimate of future taxable profits and may result in the entity being unable to recognise deferred tax assets and/or being required to derecognise deferred tax assets that were previously recognised. An entity may find that climate-related matters affect their future taxable profits and, therefore, may result in it not being able to recognise deferred tax assets for any deductible temporary differences or unused tax losses.

IAS 16 *Property, Plant and Equipment and IAS 38 Intangible Assets*

Climate-related matters may lead to a change in expenditures to adapt business activities. An entity will need to determine whether these expenditures satisfy the definition of an asset and, thus, can be recognised as either property, plant and equipment or as an intangible asset.

Both IAS 16 and IAS 38 require entities to review the estimated residual values and expected useful lives of assets at least annually. Climate-related matters may impact both of these estimates due to, for example, obsolescence, legal restrictions or inaccessibility of the assets. Estimated residual values and expected useful lives, and changes to them, will also require disclosure.

IAS 36 *Impairment of Assets*

The carrying value of an entity's assets may be overstated if the impairment calculations do not take the impact of climate-related matters into account.

The carrying value of an entity's assets or cash generating units (CGUs) (including goodwill) may be overstated if the impairment calculations do not take into account the impact of climate-related matters. Entities are required to assess whether there is any indication of impairment in each reporting period. Exposure to climate-related matters could be an indicator that an asset (or a group of assets) is impaired. For example, a decline in demand for products that emit greenhouse gases could indicate that a manufacturing plant may be impaired. Changes in regulations relating to climate matters should also be considered. Similarly, these factors need to be considered when performing the annual goodwill impairment test.

IAS 36 requires the recoverable amount, if estimated using value in use, to be based on reasonable and supportable assumptions that represent management's best estimate of the range of future economic conditions. This requires entities to consider whether climate-related matters affect those assumptions.

For value-in-use calculations, IAS 36 also requires future cash flows to be estimated for an asset in its current condition, so entities will need to exclude any estimated cash flows expected to arise from enhancing the asset's performance. Judgement may be required as to whether expenses related to making the asset compliant with climate-related requirements should be excluded or not.

When recoverable amount is estimated based on fair value less costs of disposal, an entity will need to consider market participants' views of potential climate-related legislation that may affect the fair value measurement of the respective assets and CGUs.

Where climate-risks could have a significant impact on an entity, such as the introduction of emission-reduction legislation that increase manufacturing costs, information about how these risks have been factored into the recoverable amount calculations would be relevant for the users of the financial statements. Furthermore, disclosure of key assumptions used to measure recoverable amount, as well as information related to reasonably possible changes in those assumptions, is required in specific circumstances. Climate-related matters may impact what is considered to be reasonably possible changes.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets and IFRIC 21 Levies*

IAS 37 requires disclosure of the nature of a provision or contingent liability and an indication of the uncertainties about the amount or timing of any related outflows of economic benefits. Climate-related matters may impact provisions recognised under IAS 37 due to levies imposed for failing to meet climate-related targets, remediation of environment damage, contracts that may lose revenue or increase costs due to climate-related legislation becoming onerous, or restructurings required to achieve climate-related targets. Thus, disclosure of climate-related matters may be required.

IFRS 7 *Financial Instruments: Disclosures*

Climate-related matters may expose an entity to risks in relation to financial instruments. IFRS 7 requires entities to disclose the nature and extent of risks arising from financial instruments and how the company manages them. For lenders, it may be necessary to provide information about the effect of climate-related matters on the measurement of expected credit losses or on concentrations of credit risk. For holders of equity investments, it may be necessary to disclose their exposure to climate-related risks when disclosing concentrations of market risk.

IFRS 9 *Financial Instruments*

Climate-related matters may affect a lender's exposure to credit losses, such as environmental disasters or regulatory change, affecting a borrower's ability to meet its debt obligations to the lender. Climate-related matters may, therefore, be relevant in the calculation of expected credit losses if, for example, they impact the range of potential future economic scenarios or assessment of significant increases in credit risk.

Climate-related matters may affect the classification and measurement of loans as lenders may include terms linking contractual cash flows to an entity's achievement of climate-related targets. The lender would need to consider the loan terms in assessing whether the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. Additionally, those climate-related targets may affect whether there are embedded derivatives that need to be separated from the host contract.

IFRS 13 *Fair Value Measurement*

Market participants' views of potential climate-related matters, including legislation, may affect the fair value measurement of assets and liabilities in the financial statements.

Where relevant, climate-related matters may also affect the disclosure of fair value measurements, particularly those categorised within Level 3 of the fair value hierarchy. IFRS 13 requires disclosure of unobservable inputs used in fair value measurements. Those inputs should reflect the assumptions that market participants would use, including assumptions about climate-related risk.

IFRS 17 *Insurance Contracts*

As climate-related matters may increase the frequency or magnitude of insured events, there may be an impact on the assumptions used to measure insurance contract liabilities. Similar to other areas, disclosure of the judgements made in applying IFRS 17 and relevant risks is required.

How we see it

The IASB's document provides guidance to preparers of financial statements about the areas they need to consider in relation to climate-related matters. Although it does not introduce any new requirements, the document may help to remind preparers of the scope of the existing requirements in IFRS, and how climate-related developments may impact financial statements.

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ED None