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Educational material on the effects of climate-related matters on financial statements was published on 20 November 2020.

In Brief

IFRS® Standards and climate-related disclosures

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Climate-change is a topic on which investors and other stakeholders increasingly ask the International Accounting Standards Board (Board), why this is not mentioned explicitly in IFRS Standards.

In this update, Nick Anderson, a member of the Board, provides an overview intended to help investors understand what already exists in the current requirements and guidance on the application of materiality, and how it relates to climate and other emerging risks. While climate-change risks and other emerging risks are not covered explicitly by IFRS Standards, the Standards do address issues that relate to them.

This article has been inspired by work from the Australian Accounting Standards Board (AASB) and Audit and Assurance Board (AUASB).

What is this publication about?

The International Accounting Standards Board (Board) is often asked why IFRS Standards don't mention climate change. While the phrase 'climate-change' does not feature in our requirements, IFRS Standards do address issues that relate to climate-change risks and other emerging risks. The Board is also updating its non-mandatory guidance on management commentary, where it would expect companies to address material environmental and societal issues, complementing the information in financial statements.

In April 2019 the Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AUASB) issued a joint bulletin, 'Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2'[1]. The focus of that publication was to illustrate how qualitative external factors, such as the industry in which the company operates, and investor expectations may make such risks 'material' and warrant disclosures in the financial statements, regardless of their numerical impact.

Taking inspiration from the joint AASB-AUASB bulletin, we have prepared this publication to help analysts and investors better understand our requirements and our guidance on the application of materiality.

In the rest of this document we discuss:

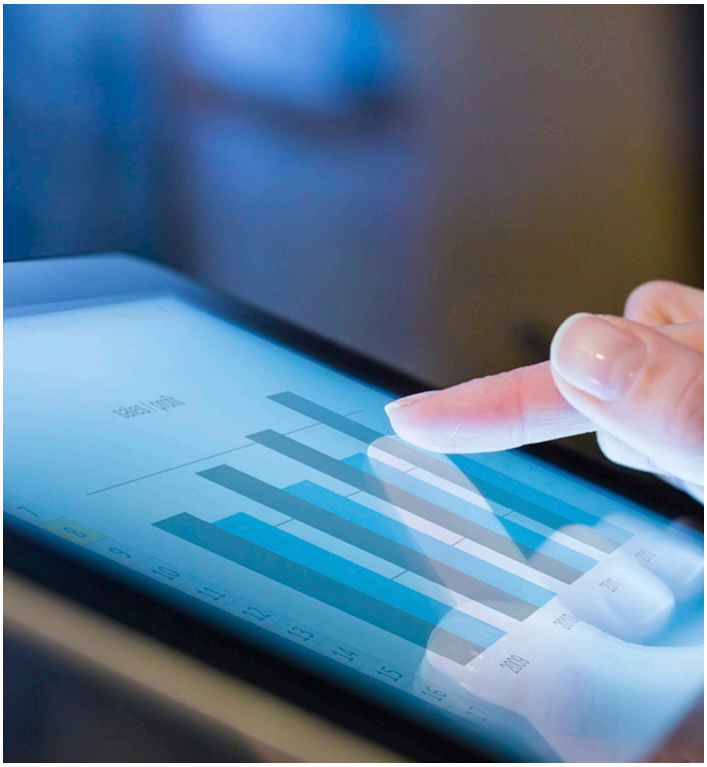
1. **Board guidance on how to make materiality judgements**
2. **applying IFRS Practice Statement 2 *Making Materiality Judgements* to climate-related and emerging risks**
3. **financial reporting considerations when applying IFRS Standards**
4. **disclosing climate-related and other emerging risks in the financial statements**
5. **management commentary: providing context to the financial statements**
6. **summary: materiality judgements should serve investors' information needs**

1 https://www.aasb.gov.au/admin/file/content102/c3/AASB_AUASBJointBulletin.pdf

IFRS®

1 Making materiality judgements

Primary users[2] need companies to make materiality judgements when they prepare their financial statements. IFRS Standards require companies to make materiality judgements in decisions about recognition, measurement, presentation and disclosure. However, rather than using judgement to decide what information to provide in financial statements, sometimes the disclosure requirements in IFRS Standards are used as if they were items on a checklist. Using the requirements in this way contributes to what many have described as a disclosure problem—namely, too much irrelevant information and not enough relevant information in financial statements. This publication illustrates how companies can use the Practice Statement when they make materiality judgements relating to disclosures about climate-related and other emerging risks.



IFRS Practice Statement 2 *Making Materiality Judgements*

The Practice Statement provides companies with guidance on how to make materiality judgements when preparing their general purpose financial statements in accordance with IFRS Standards.

The Practice Statement:

- provides an overview of the general characteristics of materiality;
- presents a four-step process companies may follow in making materiality judgements; and
- provides guidance on how to make materiality judgements in specific circumstances—namely, how to make materiality judgements about prior-period information, errors and covenants; and how to make such judgements when preparing interim reports.

All companies are required to make materiality judgements in preparing financial statements in accordance with IFRS Standards. However, the Practice Statement, which provides guidance on making materiality judgements, does not change or introduce any requirements in IFRS Standards; companies are not required to comply with it to state that they are complying with IFRS Standards.

2 Primary users are existing and potential investors, lenders and other creditors. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently

2 Applying *Making Materiality Judgements* to climate-related risks and other emerging risks

Climate-related risks and other emerging risks are predominantly discussed outside the financial statements. However, as set out in *Making Materiality Judgements*, qualitative external factors, such as the industry in which the company operates, and investor expectations may make some risks 'material' and may warrant disclosures in financial statements, regardless of their numerical impact.

Given investor statements on the importance of climate-related risks to their decision-making, the implication of the materiality definition and the Practice Statement is that companies may need to consider such risks in the context of their financial statements rather than solely as a matter of corporate-social-responsibility reporting.

For example, suppose that a company in an industry likely to be affected 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 recoverable amount of the company's assets could be affected by such risks, when applying the Practice Statement, the company may conclude that it needs to disclose information that explains clearly why the carrying amounts of its assets are not exposed to climate-related risks. Such an explanation may provide material information to investors even though the carrying amounts in the financial statements are not exposed to those risks. Example K in the Practice Statement, which illustrates a similar scenario in relation to a bank's exposure to credit risk, is reproduced on page 8.

The Practice Statement provides the Board's guidance on making materiality judgements. Although it is voluntary, investors may have reason to expect that directors, preparers and auditors will consider the Practice Statement when preparing and auditing financial statements.

Companies applying IFRS Standards when preparing financial statements would consider:

- whether investors could reasonably expect that emerging risks, including climate-related risks, could affect the amounts and disclosures reported in the financial statements. Investors have indicated the importance of information about such risks to their decision-making; and
- what information about the effect of emerging risks, including climate-related risks, on the assumptions made in preparing the financial statements is material, and thus should be disclosed.

The comments in this paper relate to requirements concerning the preparation of financial statements; they do not negate the need to consider other reporting obligations. Equally, disclosures made in other documents will not compensate for the omission of required disclosures in the financial statements and are therefore subject to audit in most jurisdictions.

3 Financial reporting considerations

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

- asset impairment, including goodwill;
- changes in the useful life of assets;
- changes in the fair valuation of assets;
- effects on impairment calculations because of increased costs or reduced demand;
- changes in provisions for onerous contracts because of increased costs or reduced demand;
- changes in provisions and contingent liabilities arising from fines and penalties; and
- changes in expected credit losses for loans and other financial assets.

The following table sets out some requirements in IFRS Standards that could require companies to consider climate-related and other emerging risks when making materiality judgements about what to recognise in the financial statements, about measuring recognised assets and liabilities and about what to disclose.

IFRS Standards	Effect on financial reporting arising from climate-related or other emerging risks
IAS 1 *Presentation of Financial Statements*	IAS 1 requires disclosure in the notes of information that is not presented elsewhere in the financial statements but is relevant to an understanding of them. Information will be relevant if it could reasonably be expected to influence decisions made by investors. For example, a company may need to explain whether and how it has considered climate-related risks in its impairment calculations even though IAS 36 makes no requirement for such a disclosure. Where other companies in a similar industry have recognised significant write-downs and investors have publicly demanded such information, a company may need to disclose whether climate-related risks have affected the carrying amount of the assets recognised in the financial statements.

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IFRS Standards	Effect on financial reporting arising from climate-related or other emerging risks
IAS 36 *Impairment of Assets*	The carrying amount 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 account for the effect of climate-related risks. A company's exposure to climate-related risks could be an indicator that an asset or a group of assets is impaired; that exposure could also affect future estimated cash inflows and outflows used for recoverable amount calculations. 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 significantly affect the recoverable amount of a company's assets, information about how the effect has been factored into recoverable amount calculations would be relevant for the users of the financial statements. Such information about long-lived assets and assets recognised in relation to mineral resources would be particularly relevant to users. In the extractive industries, investors may look for explanations as to whether a company has considered the effect of climate-related risks in determining whether exploration, or the evaluation of certain areas of interest, should continue.
IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*	Other than impairment, climate-related risks may also affect: • whether some expenses relate to items that satisfy the definition of an asset and can be recognised (for example, 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.
IFRS 13 *Fair Value Measurement*	IFRS 13 requires companies to disclose key assumptions used where assets are recognised at fair value. Fair value measurements may incorporate a number of possible scenarios. When the fair value of an asset is affected by climate-related risks including the effect of and potential changes to laws and regulations with respect to managing such risks, a company may need to disclose how it factors climate-related risk into the calculations. Companies in sectors particularly affected by climate-related risks would need to consider disclosing their assumptions regarding such risks, even if they cannot quantify any effects on the financial statements.

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IFRS Standards	Effect on financial reporting arising from climate-related or other emerging risks
IFRS 9 *Financial Instruments* and / IFRS 7 *Financial Instruments: Disclosures*	IFRS 9 impairment requirements use forward-looking information to recognise expected credit losses. For companies applying these requirements, such as banks, determining whether credit risk has increased significantly since initial recognition is a critical step in estimating expected credit losses. Such a determination requires lenders to consider whether any actual or expected adverse changes in a borrower's regulatory, economic or technological environment have changed significantly the borrower's ability to meet its debt obligations. When banks invest in projects or lend money to businesses affected by climate-related risks, 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 a bank's loan portfolio has significant exposure to fossil-fuel-intensive projects, it would identify the extent of this exposure and how climate-related risks could affect the amounts recognised in its financial statements. Investment funds and insurance companies could also hold investments in industries that may be affected by climate-related risk; and they would therefore be exposed to price risk in relation to these investments. IFRS 7 requires disclosure of such a company's exposure to market 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 or sector, could specifically identify sectors exposed to climate-related risks and explain the company's policy of managing its exposure to those sectors.
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Companies 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 for settling the obligation. Climate-related risks and uncertainties may also affect the best estimate of a provision. Companies must disclose their major assumptions about future events, which may need to include an explanation of how climate-related risks have been factored into the best estimate of the provision. Climate-related risks could have the following effects: • recognition of an onerous contract provision for the potential loss of revenues or increased costs postulated in climate-related risk scenarios considered in the best estimate; • 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 or penalties because of environmental and other regulations, where the company may have broken a regulation, but the probability that it will have to make a payment is lower than 50%.

4 Disclosing climate-related and other emerging risks

Even though the Practice Statement is not mandatory, it provides the Board's guidance on making the materiality judgements required when applying IFRS Standards to prepare financial statements.

However, the Practice Statement only applies to the financial statements and not to the other information published by the company. Other forms of corporate communications typically vary by country.

What information is material to financial statements?

According to IFRS Standards, 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 reporting entity.

Primary users are existing and potential investors, lenders and other creditors. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who diligently review and analyse the information.

The discussion of material information in IAS 1 emphasises that an assessment of materiality must be made on the basis of size (quantitative) and nature (qualitative factors), or a combination of both. The Practice Statement further emphasises that an item of information could influence primary users' decisions regardless of its size. A quantitative threshold could even reduce to zero, such as when primary users closely scrutinise information about a transaction, other event or condition.

An example from the Practice Statement illustrates that external qualitative factors such as the industry in which the company operates and investor expectations should be considered when making materiality judgements about required disclosures in the financial statements.

Example illustrating—influence of external qualitative factors on materiality judgements

Background

An international bank holds a very small amount of debt originating from a country whose national economy is currently experiencing severe financial difficulties. Other international banks that operate in the same sector as the entity hold significant amounts of debt originating from that country and, hence, are significantly affected by the financial difficulties in that country.

Application

Paragraph 31 of IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risk arising from financial instruments to which the entity is exposed at the end of the reporting period.

When preparing its financial statements, the bank assessed whether the fact that it holds a very small amount of debt originating from that country was material information.

In making that assessment, the bank considered the exposure to that particular debt faced by other international banks operating in the same sector (external qualitative factor).

In these circumstances, the fact that the bank is holding a very small amount of debt (or even no debt at all) originating from that country, while other international banks operating in the same sector have significant holdings, provides the entity's primary users with useful information about how effective management has been at protecting the bank's resources from unfavourable effects of the economic conditions in that country.

The bank assessed the information about the lack of exposure to that particular debt as material and disclosed that information in its financial statements.

Source: Example K from Practice Statement 2: *Making Materiality Judgements*

In the example about assessing external qualitative factors, the company is operating in an industry that is exposed to debt originating from a country whose national economy is 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 small exposure to this risk is material for the reporting bank.

Although the example relates to a bank's exposure to debt risk, it is also relevant to companies exposed to climate-related risks. **Similar external qualitative factors now exist for climate-related risks and may also exist for particular companies in relation to other emerging risks**.

The Task Force on Climate-related Financial Disclosures identifies the following types of company that are likely to be affected by climate-related risks:

- companies in the financial sector—banks, insurance groups, asset owners (investment companies), and asset managers; and
- companies in non-financial industries, such as—energy, transportation, material and buildings and agriculture, foods and forest products.

Task Force on Climate-related Financial Disclosures

The Financial Stability Board Task Force on Climate-related Financial Disclosures will develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.

The Task Force will consider the physical, liability and transition risks associated with climate change and what constitutes effective financial disclosures across industries.

The work and recommendations of the Task Force will help companies understand what financial markets want from disclosure in order to measure and respond to climate-change risks, and encourage firms to align their disclosures with investors' needs.

Learn more about the Task Force

Other Resources

Corporate Reporting Dialogue – Driving Alignment in Climate Related Reporting

Given that investors have specifically identified climate-related risks as being used in their decision-making, when companies in the above industries are determining if information is material they are likely to judge 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 judgements made in relation to the recognition or measurement of items in the financial statements (see section 3). As Example K implies, a company may need to disclose information about climate-related risks even if the company did not recognise any material impairment or other impact in the financial statements, or, in the extreme, even if a company was not exposed to these risks, but investors would reasonably expect that it was.

The majority of climate-related information is currently disclosed within management commentary and not in the financial statements. For some companies, applying the materiality definition and the principles in the materiality practice statement[3] would result in some of this information being reflected within the financial statements.

For example, a company 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 companies may need to 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 The Board has issued two practice statements, the first in 2010 on management commentary and the second in 2017 on making materiality judgements. Practice statements provide non-mandatory guidance to preparers of financial statements prepared using IFRS Standards.

The disclosures in the notes will be most helpful to users of financial statements if the disclosures focus on specific issues and assumptions made that are relevant to the amounts recognised in the financial statements; and if they are not of a boilerplate nature. Section 3 above identifies areas that may be particularly affected. Comments about the company's overall approach to climate-related and other business risks belong in the 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 IFRS Standards. As explained in IAS 1 and illustrated in Example C of the Practice Statement, a company is required to consider whether to provide information not specified by IFRS Standards if primary users need that information to understand the effect of transactions, other events and conditions on the company's financial position, financial performance and cash flows.

Example illustrating—materiality judgements that lead to the disclosure of information in addition to the specific disclosure requirements in IFRS Standards

Background

An entity has its main operations in a country that, as part of an international agreement, is committed to introducing regulations to reduce the use of carbon based energy. The regulations had not yet been enacted in the national legislation of that country at the end of the reporting period.

The entity owns a coal fired power station in that country. During the reporting period, the entity recorded an impairment loss on its coal fired power station, reducing the carrying amount of the power station to its recoverable amount. No goodwill or intangible assets with an indefinite useful life were included in the cash generating unit.

Application

Paragraph 132 of IAS 36 *Impairment of Assets* does not require an entity to disclose the assumptions used to determine the recoverable amount of a tangible asset, unless goodwill or intangible assets with an indefinite useful life are included in the carrying amount of the cash generating unit.

Nevertheless, the entity has concluded that the assumptions about the likelihood of national enactment of regulations to reduce the use of carbon based energy, as well as about the enactment plan, it considered in measuring the recoverable amount of its coal fired power station could reasonably be expected to influence decisions primary users make on the basis of the entity's financial statements. Hence, information about those assumptions is necessary for primary users to understand the impact of the impairment on the entity's financial position, financial performance and cash flows. Therefore, even though not specifically required by IAS 36, the entity concludes that its assumptions about the likelihood of national enactment of regulations to reduce the use of carbon based energy, as well as about the enactment plan, constitute material information and discloses those assumptions in its financial statements.

Source: Example C from Practice Statement 2: *Making Materiality Judgements*

Information that users need to understand to make decisions 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 IAS 36 because no impairment has been recognised or the impairment recognition was not affected by an assumption about climate risk. Similarly, companies may disclose the significant estimates or judgements they have made about climate-related risks even if they currently face no financial impact or significant risk of materially adjusting the carrying amounts of assets and liabilities in the next financial year and, hence, are not required by IAS 1 to make such disclosures.

As has already been noted, financial reports are prepared for users of financial statements who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. However, the information needs of each primary user may differ and we recognise that we cannot meet the information needs of all primary users. Other parties may also find financial reports useful; however, those reports are not intended to inform all users on all matters that may be of interest to them.

5 Management commentary—providing context to the financial statements

The materiality practice statement notes that financial statements do not, and cannot, provide all the information that primary users need. Narrative reporting, often known as management commentary or management discussion and analysis, can help to fill some information gaps, complementing the financial statements.

The Board is currently updating its *Management Commentary* Practice Statement to set out a rigorous, principle-based approach for explaining a company's purpose, business model, strategy and performance, incorporating the long-term drivers of its success. The Practice Statement is not a mandatory part of IFRS Standards, but companies that choose to follow it, or are required to do so by their regulators, will need to consider both the risks and opportunities facing a company. We would expect management to report on environmental and societal issues to the extent necessary for primary users of financial statements to form their own assessment of the company's longer-term prospects and management's stewardship of the business.

The need to focus disclosures on material issues and to avoid mere boilerplate is a critical consideration in the preparation of management commentary, just as it is in the financial statements.

Management Commentary Project

Read about the Board's project.

6 Summary: Materiality judgements should serve investors' information needs

While climate-change risks and other emerging risks are not covered explicitly by IFRS Standards, the Standards do address issues that relate to them. The potential financial implications arising from climate-related and other emerging risks may include, but are not limited to, requirements set out in: IAS 1 *Presentation of Financial Statements*; IAS 36 *Impairment of Assets*; IAS 16 *Property, Plant and Equipment*; IAS 38 *Intangible Assets*; IFRS 13 *Fair Value Measurement*; IFRS 9 *Financial Instruments*; IFRS 7 *Financial Instruments: Disclosures*; and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The need for materiality judgements is pervasive in the preparation of financial statements. As set out in IAS 1, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Materiality depends on the nature or magnitude of information, or both. Building on this concept, *Making Materiality Judgements* 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 closely scrutinised by the primary users.

Disclosures in other documents (including presentations, management commentary and sustainability reports) will not compensate for the omission of disclosures that are required to be made in the financial statements and are therefore subject to audit in most jurisdictions.

The Board acknowledges that financial statements do not and cannot satisfy the needs of each primary user and all interested parties. Financial statements focus on common investor needs and are not intended to report to all users on all matters that may be of interest to them.

Management commentary or management discussion and analysis complement the financial statements. We would expect management to report on environmental and societal issues to the extent necessary for primary users of financial statements to form their own assessment of the company's longer-term prospects and management's stewardship of the business.

4 Primary users are existing and potential investors, lenders and other creditors. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.

Find out more

For an overview of the Materiality Practice Statement, read our Project Summary and Feedback Statement or watch our video on the project page.

Send us your views

The Management Commentary project aims to publish an Exposure Draft in 2H 2020. To follow the project, visit the project page.

Get in touch

If you would like to discuss this topic or other areas of accounting, please contact Fred Nieto, Technical Staff – Investor Engagement, at fnieto@ifrs.org.

Follow @IFRSInvestors on Twitter to keep up to speed on changes in the world of IFRS Standards and how these changes may affect investors.

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