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Accounting

Staff paper

Agenda reference: 3

Accounting Standards Advisory Forum meeting

Date	**December 2023**
Project	**Climate-related and Other Uncertainties in the Financial Statements**
Topic	**Project direction**
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Purpose of this session

- To provide an update on the project.

- To seek feedback from ASAF members about the development of:
  - materiality examples; and
  - other examples.

Contents

Project background

Project overview

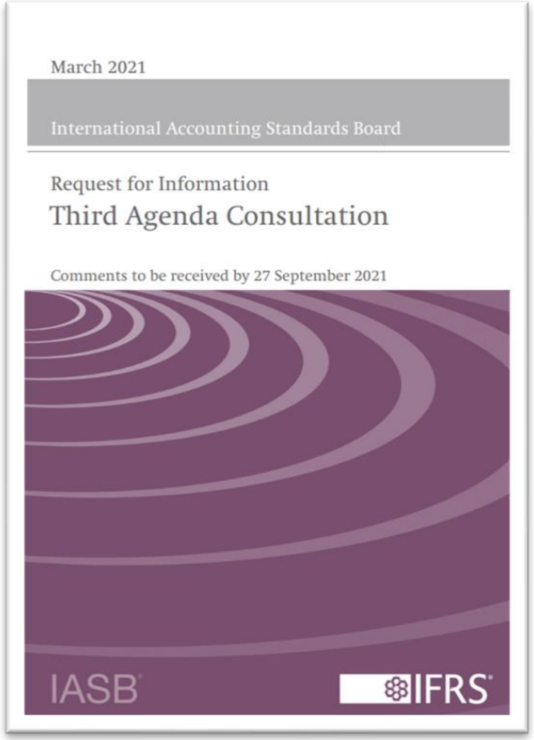
Project objective

Explore **targeted** actions to improve the reporting of **climate-related and other uncertainties** in the **financial statements**

Link to project page

March 2023	April–August 2023	September 2023	TBD
Project starts	**Research, outreach and analysis**	**Decisions**	**Next steps**
(slides 6–7)	(slides 8–9)	(slide 10)	

Origins of the project


March 2021
International Accounting Standards Board
Request for Information
Third Agenda Consultation
Comments to be received by 27 September 2021
IASB
IFRS

- In the IASB's Third Agenda Consultation, respondents attributed **high-priority** to a project on climate-related risks in the financial statements

- Concerns that information about climate-related risks in financial statements is:
  - **insufficient**
  - **inconsistent** with information reported elsewhere by the company

Focus of the project

- **Targeted actions** such as:
  - examples and educational materials.
  - targeted amendments to IFRS Accounting Standards.

- This project will **not** seek to:
  - develop an Accounting Standard on climate-related risks;
  - broaden the objective of financial statements;
  - change the definitions of assets and liabilities; or
  - develop accounting requirements for pollutant pricing mechanisms.[1]

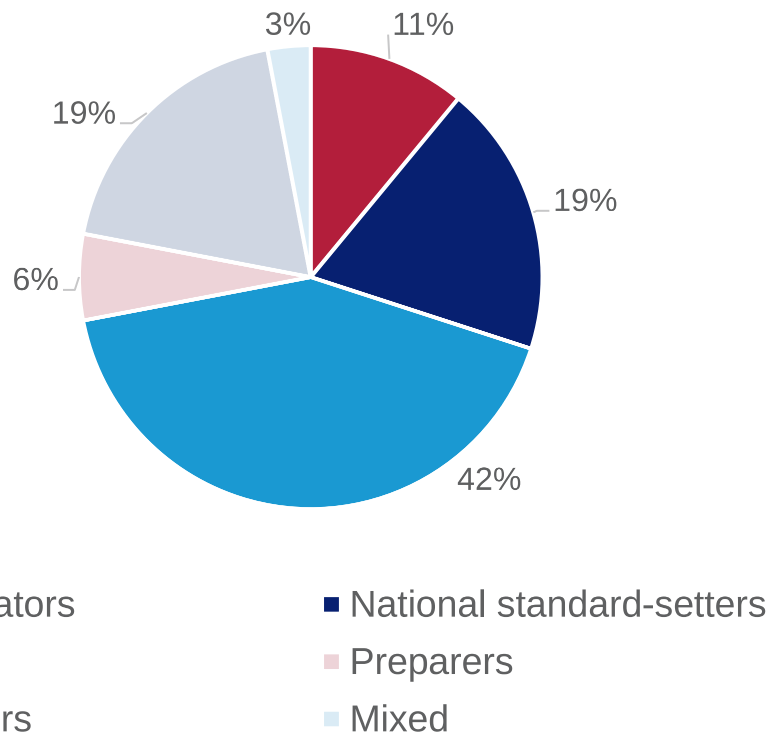
[1] *Pollutant Pricing Mechanisms* is on a reserve list of projects that may be added to the IASB's work plan if stakeholders and the IASB have sufficient capacity.

Summary of work

- **Engaged** with the IASB's consultative bodies and other stakeholders to understand the nature and causes of concerns.
- **Reviewed** academic research and other publications to identify the nature and causes of concerns.
- **Analysed** IFRS Accounting Standards for:
  - potential gaps;
  - unclear requirements; or
  - limitations

  that may impede reporting on the effects of climate-related risks in the financial statements.

Outreach by type of stakeholder



Summary of findings

Concerns

- **Insufficient** information about the effects of climate-related risks in the financial statements
- **Inconsistencies** between the information about climate-related risks reported in the financial statements and elsewhere

Standards generally sufficient

- Investor information needs might go beyond objective of financial statements
  - **Some information needs may be satisfied by sustainability-related financial disclosures**
- IFRS Accounting Standards generally sufficient in requiring useful information about effects of climate-related and other risks
  - However, there may be **challenges in application**

Evolving area

- Some **improvements** in recent years
- As sustainability-related financial disclosures evolve, they may better inform and improve compliance with IFRS Accounting Standards

Decisions

Discuss today

Examples

Explore development of **examples** to help improve application of IFRS Accounting Standards

Other actions

Article about the role of financial statements

✓ **Translate** and make more **visible** existing educational material

Standard-setting

Explore **possible targeted amendments** to improve disclosures about estimates in financial statements

- estimates require significant judgment
- IASB to assess whether standard-setting is feasible and helpful
- any amendments about uncertainties generally—not specific to climate[1]

Other ongoing IASB projects may also help address concerns about accounting for climate-related matters[2]

IFRS Interpretations Committee

- Respond to submission about the recognition of **liabilities** for climate-related commitments
- Provide feedback to the IASB about the measurement of certain non-financial assets when testing for **impairment**
- **An update of November IFRS Interpretations Committee discussions will be shared at the ASAF meeting**

IASB will continue to monitor developments

[1] Project objective has therefore been generalised to cover other uncertainties in addition to climate.
[2] Other projects include Primary Financial Statements, Power Purchase Agreements and Amendment to the Classification and Measurement of Financial Instruments

Materiality examples

Background

Concerns

- Extensive discussion about climate-related strategy, risks and targets outside the financial statements. However:
- Concern #1: Financial statements appear **inconsistent (not connected)** with disclosures made elsewhere. Financial statements might make no reference to climate-related matters.
- Concern #2: Information in financial statements appears **insufficient**. Financial statements might only state that the effect of climate-related uncertainties on the financial position and financial performance is immaterial. This raises a question about the reason for that conclusion.

Staff analysis

- An item of information might be qualitatively material, even when the quantitative effect is zero if it could reasonably be expected to influence primary users' decisions.
- In making materiality judgements, an entity considers the nature and magnitude of an item of information—both qualitative and quantitative factors are considered.
- At its July 2023 meeting, some ASAF members suggested that different interpretations of materiality, including a focus on quantitative rather than qualitative factors, might be a cause of the concerns.
- Therefore, examples about applying materiality could help address concerns, including promoting **connections** between the financial statements and sustainability-related financial disclosures.

Content of the examples

- Findings (slide 9) noted that requirements are generally sufficient but some targeted actions might help application of IFRS Accounting Standards.
- The IASB is exploring whether new examples about the application of the definition of materiality might help address concerns that information about climate-related and other uncertainties in the financial statements is insufficient or inconsistent (not connected) with information reported elsewhere.
- These examples would not add to or change the requirements in the Standards.
- However, these examples could build on Examples C and K in IFRS Practice Statement 2 *Making Materiality Judgments* (see slides 14–15) and be tailored to a climate-related scenario. They could cover:
    - The need for disclosure even when there is no quantitative impact on the financial statements (building on Example K), considering, for example:
        - common information needs of primary users when making investment decisions
        - user expectations created from an entity's financial disclosures outside financial statements, market developments and peer company comparisons.
    - Examples of possible disclosures if material (building on Example C)

IFRS Accounting

IFRS Practice Statement 2—Example C

Extract—paragraph 10 of IFRS Practice Statement 2 *Making Materiality Judgements:*

> …the entity must consider whether to provide information not specified by IFRS 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.

Example C—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.

IFRS Practice Statement 2—Example K

Extract—paragraph 55 of IFRS Practice Statement 2 *Making Materiality Judgements:*

> In some other circumstances, an item of information could reasonably be expected to influence primary users' decisions regardless of its size—a quantitative threshold could even reduce to zero. This might happen when information about a transaction, other event or condition is highly scrutinised by the primary users of an entity's financial statements.

Examples of events for which information might be qualitatively material:

- Climate change
- Covid-19
- Geopolitical events

Example K—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.

Vehicle for the examples

Low — IMPACT — High

Materiality examples included in:

Educational material

- Least visible
- Most difficult to enforce
- May not improve reporting significantly (educational material already exists)
- Limited opportunity to involve stakeholders before publication (no exposure draft or endorsement)
- Allows for more informal explanation

Illustrative examples accompanying Accounting Standards

- More visible than educational materials
- Easier to enforce than educational materials
- Some improvement to reporting expected
- Some opportunity to involve stakeholders before issuance (exposure draft for illustrative examples—may not receive same amount of interest as amendments to Accounting Standards)
- Some explanation, but less than in educational material

Accounting Standards

- Most visible
- Easiest to enforce
- Most likely to improve reporting
- Most opportunity to involve stakeholders before issuance (exposure draft and endorsement)
- More formal explanation

Fastest (H1 2024) — TIMING — Slowest (Finalised in 2025)

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Questions to ASAF members

1	Would materiality examples significantly improve how entities apply IFRS Accounting Standards in reporting the effects of climate-related and other uncertainties?
2	What is your experience of the application of Examples C and K by preparers in practice? What are the challenges in applying the concepts illustrated in Examples C and K in your jurisdiction?
3	What recommendations do you have about the possible content of the example, as described on slide 13?

Question to ASAF members

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If the IASB decides to develop new examples on materiality (as described in slide 13), should those examples be included in:

- educational material;
- illustrative examples accompanying Accounting Standards; or
- Accounting Standards?

Other examples

Background

- Some stakeholders asked for more examples to illustrate the reporting of climate-related risks in the financial statements.
- These stakeholders observed that IFRS Accounting Standards do not explicitly refer to ‘climate’ so stakeholders need to draw analogies to apply the existing requirements and examples.
- Furthermore, the requirements that apply to the reporting of climate-related risks cut across multiple IFRS Accounting Standards.

IFRS Accounting

Content of the examples

- The IASB is exploring developing examples to illustrate how an entity would apply the requirements in IFRS Accounting Standards in reporting the effects of climate-related and other uncertainties in its financial statements.
- The examples would not add to or change the requirements in the Standards.
- We are exploring the following aspects of possible examples:
  - **a) scope**—whether examples should focus only on climate-related uncertainties or also cover other types of uncertainties
  - **b) fact patterns and areas of accounting**—which fact patterns and areas of accounting to illustrate. Slide 22 includes a few examples.
  - **c) type of examples**—whether to:
    - i. illustrate the application of specific requirements (*stand-alone examples*); or
    - ii. use a fact pattern to walk through the application of requirements across multiple IFRS Accounting Standards (*walk-through examples*).

Examples of possible fact patterns and illustrations

Fact patterns	Effects that could be illustrated include:
Entity A plans to phase-out the production of one of its products in connection with its plans to transition to net zero	• Assessment of impairment indicators • Calculation of the value-in-use of the affected CGU • Disclosures of key assumptions used in estimating the CGU's recoverable amount • Review of the expected useful lives and residual values of items of PP&E, including disclosure of changes in estimates
Entity B is a bank with credit risk exposures through its lending activities. Climate-related matters affect Entity B's lending customers	• Reflecting climate-related and other uncertainties in the measurement of expected credit losses (ECL) • Disclosure about how climate-related matters affect risks arising from financial instruments, including disclosures about credit risk management practices and the measurement of ECL

Vehicle for the examples

The examples could be:

a) **published as educational materials**—for example, as an appendix to the educational material *Effects of climate-related matters on financial statements*. In this case, we could aim to:

   i. *publish in 2024*—the examples could reflect new requirements in the forthcoming IFRS 18 and the outcome of the discussions on matters the IASB decided to refer to or consult with the IFRS Interpretations Committee.

   ii. *publish in 2025*—in addition to the above, the examples could reflect any changes to disclosure requirements about accounting estimates if the IASB decides to proceed with standard-setting (see slide 10).

   The educational materials could include either stand-alone or walk-through examples.

Continues on the following slide…

Vehicle for the examples *continued…*

The examples could be:

b) added to IFRS Accounting literature—in this case, the examples could either be:

i. included as illustrative examples accompanying Accounting Standards[1], or
ii. incorporated into the applicable IFRS Accounting Standards.

The examples would be stand-alone (not walk-through) and expected to be finalised in 2025, after exposure.

Similar trade-offs to those discussed in slide 16 would apply to the options (a) and (b) discussed above.

[1] *For example, the Illustrative Examples and Implementation Guidance that accompany some Standards and are included in Part B of our Bound Volumes.*

Questions to ASAF members

1	Would examples (other than on materiality) significantly improve how entities apply IFRS Accounting Standards in reporting the effects of climate-related and other uncertainties?
2	What areas of IFRS Accounting Standards and fact patterns do you think should be illustrated through examples? Should the examples illustrate the application of specific requirements (stand-alone examples) or walk through requirements across multiple Standards (walk-through examples)?
3	What are your views regarding the best vehicle and timing for the examples?

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