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## SUBMISSION TO IASB EXPOSURE DRAFT "CLIMATE-RELATED AND OTHER UNCERTAINTIES IN THE FINANCIAL STATEMENTS – PROPOSED ILLUSTRATIVE EXAMPLES" (JULY 2024)

Dear Mr. Barckow,

## INTRODUCTION

Sarasin & Partners LLP was an early advocate for the inclusion of material climate-related factors in financial statements. In 2018, we published a report setting out our concerns that listed European energy companies were failing to provide transparency over how global decarbonisation was being reflected in critical forward-looking accounting assumptions[1].

This report attracted considerable public attention and has been followed by growing demands from investors globally for standard setters, regulators and companies to address this blind-spot in financial disclosures[2]. In 2022, we worked with the Institutional Investor Group on Climate Change (IIGCC) to publish clear investor expectations for company audit committees and auditors to ensure financial statements and the associated audits address investor concerns[3].

**Progress where investors have engaged**

We have been pleased to see the response to investor calls from regulators and companies[4]. We have particularly welcomed the steps taken by the International Accounting Standards Board (IASB) to provide guidance and educational materials setting out how climate factors, wherever material, would need to be captured under existing accounting rules. This was vital to respond to arguments by some companies that new accounting standards would be needed to address climate change.

Over time, we have seen some improvements in disclosures, especially where investors have targeted their engagement efforts, notably with European oil and gas companies. We now routinely see some reference to how climate is considered in financial statements in the UK and Europe. The UK's Financial

[1] https://sarasinandpartners.com/think/are-oil-and-gas-companies-overstating-their-position/

[2] See, for instance, the collective investor statement in 2020 that demonstrated widespread expectations for climate-aware accounting: https://www.unpri.org/accounting-for-climate-change/investor-groups-call-on-companies-to-reflect-climate-related-risks-in-financial-reporting/6432.article

[3] https://www.iigcc.org/resources/investor-expectations-for-paris-aligned-accounts

[4] This paper focuses on the IASB, but we have welcomed action taken by the UK's Financial Reporting Council and the European Securities and Market Authority, and more recently the US Securities and Exchange Commission.

Reporting Council and European Securities Market Authority have published thematic reviews pointing to examples of progress[5].

**Overall, however, climate consequences remain hidden**
Notwithstanding the progress made by certain companies, the broad picture remains one of either boiler-plate and superficial disclosure on the financial consequences of climate considerations. This is clear in regulatory reports[6]. Carbon Tracker's latest review of the largest carbon-emitters' 2022 financial statements also puts the spotlight on this problem. Based on a review of 140 high-carbon listed companies' financial statements and audit reports, Carbon Tracker found[7]:

- 60% failed to provide meaningful information about whether, and how, climate risk and the energy transition impact the financial statements, or the audits;
- 81% of companies continue to omit basic data on the relevant quantitative assumptions and estimates used in financial reporting;
- No company provided a fully consistent climate narrative across its financial statements and other reporting and auditors rarely called this out;
- 80% of auditors provided little to no evidence of consideration of climate factors in their audits; and
- net zero-aligned sensitivities were rarely provided by companies, despite over 100 of the assessed companies having net zero targets.

Crucially, even where disclosures are improving, few companies have actually changed critical accounting assumptions or estimates as a result of climate considerations. Examples where changes have been made leading to impairments include the oil and gas majors like Shell, BP, Total and Eni, where long-term oil and gas price and refining margin assumptions have been lowered in recent years to reflect decarbonisation trends[8]. These changes followed intensive engagement by ourselves and other investors with the companies and their auditors.

**IASB's proposed "Illustrative examples" are important for investor protection and market stability**
Given this inertia, the IASB's proposed "Illustrative Examples" set out in its July Exposure Draft are extremely important to drive more reliable reporting and, thus, investor protection and efficient markets going forward. The IASB is right not to seek to introduce new standards, which would take too long and is unnecessary as existing standards already effectively cover emerging risks like climate change and the energy transition. Instead, the eight examples do something that standards alone cannot; they bring to life the relevance and materiality of climate to key accounting standards and offer clarity on the types of disclosure that should follow. Importantly, the IASB's examples also underscore the relevance of climate factors beyond the usual suspects, such as oil and gas companies.

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[5] https://media.frc.org.uk/documents/Thematic_review_of_climate-related_metrics_and_targets_2023.pdf; https://www.esma.europa.eu/sites/default/files/2023-10/ESMA32-1283113657-1041_Report_-_Disclosures_of_Climate_Related_Matters_in_the_Financial_Statements.pdf

[6] See for instance ESMA's review of 2022 accounts in the EU (https://www.esma.europa.eu/sites/default/files/2023-03/ESMA32-63-1385_2022_Corporate_Reporting_Enforcement_and_Regulatory_Activities_Report.pdf)

[7] https://carbontracker.org/reports/flying-blind-in-a-holding-pattern/

[8] For instance, Shell and its auditor (EY) have shown leadership in this regard. In its 2020 financial statements it recognised a $6.4 billion impairment linked to a 30% lower refining margin assumptions due to energy transition; it also increased decommissioning and restoration provisions for its refining assets by $0.9 billion linked to a decision that it was no longer appropriate to assume these assets had indefinite lives, due to the energy transition. Also, it published for the first time, sensitivities to a change in commodity price assumptions of -10% or +10%, which would *ceteris paribus* result in $6.0-$8.0 billion impairment or $6.0-$9.0 billion impairment reversal respectively in Integrated Gas and Upstream. See https://reports.shell.com/annual-report/2020/servicepages/downloads/files/cons-financial-statements-shell-ar20.pdf
A change of -10% or +10% in long-term refining margins would ceteris paribus result in some $1.5-$2.5 billion impairment or some $1.7-$2.7 billion impairment reversal respectively in Oil Products

We are particularly pleased to see the example on credit risk (Example 6) and the need for financial institutions to consider climate in their forward-looking expected credit loss (ECL) assumptions. Banks are arguably amongst the most exposed to climate risks – both transition and physical – due to their financing of companies across the economy. A failure to reflect this in the accounting disclosures raises the risk of hidden losses/liabilities in their banking and trading books. Prudential and accounting authorities have been putting the spotlight on this issue through climate stress testing exercises and supervisory statements urging banks to review their ECL assumptions now for at least two years[9]. The danger of market instability is real.

In the attached addendum, we offer our perspectives on the consultation questions, with some detailed suggestions on specific examples.

Yours sincerely,

Natasha Landell-Mills, CFA
Partner, Head of Stewardship

[9] The European Securities Market Authority; European Banking Authority and the UK's Prudential Regulation Authority have flagged the importance of banks' ECL assumptions considering climate since 2021. Recent examples include: https://www.esma.europa.eu/sites/default/files/2023-03/ESMA32-63-1385_2022_Corporate_Reporting_Enforcement_and_Regulatory_Activities_Report.pdf; https://www.eba.europa.eu/sites/default/files/2023-11/25b12d35-9c28-4335-a589-166c77198920/Final%20Report%20on%20IFRS9%20implementation%20by%20EU%20institutions.pdf; https://www.bankofengland.co.uk/prudential-regulation/letter/2024/thematic-feedback-on-accounting-for-ifrs-9-ecl-and-climate-risk

## ADDENDUM - RESPONSES TO CONSULTATION QUESTIONS

***Question 1 (a) Do you agree that providing examples would help improve the reporting of the effects of climate-related and other uncertainties in the financial statements? Why or why not? If you disagree, please explain what you would suggest instead and why.***

Yes, we strongly agree that the proposed illustrative examples are likely to improve reporting of the effects of climate-related and other uncertainties in the financial statements.

It is clear to us that further action is required given evidence of widespread disregard for climate factors in companies' financial statements, despite the IASB publishing Educational Material on this matter and regulators issuing supervisory guidance[10]. This is true even for the most carbon-intensive entities or those most exposed to physical climate risks, as revealed in Carbon Tracker's latest review of financial statements[11].

In our own engagements on this matter, where companies state they do not plan to provide more disclosures the most common reasons provided are: 1) the accounting standards do not require it; 2) they do not see how climate would be relevant to them; and 3) there is not data that they can use to credibly link assumptions.

The proposed illustrative examples would help by making clearer and more concrete the relevance of climate to key accounting standards for specific types of companies. This helps make more tangible what might otherwise be seen as an esoteric/theoretical concept. They also underline the importance of a forward-looking approach in a period of structural change driven by both the physical and transition consequences of climate change.

Backward-looking accounting will ensure the system is ill-prepared for climate change, increase risks of a disorderly transition and, as a result, harm investors and the broader economy. Investors do not expect companies to have perfect foresight, but they do expect executives and Boards to protect capital from likely risks. The Illustrative Examples will help open the eyes of corporate leaders to these consequences.

***Question 1(b) Do you agree with including the examples and illustrative examples accompanying IFRS Accounting Standards? Why or why not? If you disagree, please explain what you would suggest instead and why.***

We agree with including the illustrative examples alongside accounting standards, rather than as separate Educational Guidance or indeed as new standards for the following key reasons:

- There is no need for new standards as climate and other uncertainties should all be covered under existing requirements – this has been well covered in work already undertaken by the IASB[12];
- This approach will enable faster implementation and thus impact on company reporting more quickly, which is vital given evidence of weak disclosure today; and

[10] Please see references in the Introduction for papers issued by ESMA, EBA and the UK PRA, for instance.
[11] https://carbontracker.org/reports/flying-blind-in-a-holding-pattern/
[12] As documented under the Basis for Conclusions on the Exposure Draft, p. 26.

- Educational Material has already been published and, while extremely helpful, has failed to catalyse a meaningful shift in accounting behaviour.

***Q2 Do you agree with the IASB's approach to developing the examples? In particular, do you agree with the selection of requirements and fact patterns illustrated in the examples and the technical content of the examples?***

We are extremely supportive of the IASB's eight illustrative examples. We do, however, have some suggestions for additional guidance to support the application in certain cases, which we outline below.

Two common themes from our suggestions worth flagging are:

- **Sensitivities to plausible assumptions** – against a backdrop of rising uncertainty associated with both the physical and transition consequences of climate change, having greater transparency over how alternative plausible assumptions would impact the reported accounts is particularly important. This would enable investors to better understand the potential range of outcomes and make decisions accordingly.

  We would encourage these scenarios to incorporate one that is aligned with the Paris Climate Agreement goals and one consistent with a faster warming scenario. Not only are both these scenarios plausible pathways but they also reflect the scenarios that investors are themselves being asked to report against under TCFD reporting requirements.

- **Physical risks deserve greater attention** – Physical risks are only touched on in Example 6. We would like to see greater emphasis on the financial consequences of physical risks, either as part of the existing examples, or through additional examples. Given the latest science, and evidence that we are likely to see temperatures rise well above 2C[13], it is vital the businesses start factoring this into their forward-looking estimates and assumptions.

<u>Example 1 – Materiality judgements leading to additional disclosures (IAS1/IFRS18)</u>
As outlined in the ED, paragraph 31 in IAS1 (Para 20 IFRS18) sets out where additional disclosures may be required beyond what is asked for in specific standards. This occurs where the lack of disclosures mean users are left unable to understand the impact of transactions or other events/conditions on the entity's financial position/performance.

Example 1 clearly sets out the case for additional disclosures in the case of a carbon-intensive manufacturer, even where management believes it will not have a significant quantitative impact on the financial performance. The example helpfully underlines that materiality is not just determined by crossing quantitative thresholds; the expectations of users and the plausibility of large and/or rising financial consequences also needs to be considered.

While we support this example, we would like to see the proposed disclosures reflect the dynamic nature of climate-related consequences. Based on the text, a company may conclude that they need simply add 1 to 2 sentences saying they consider the transition plan immaterial because the asset values have adequate headroom. However, this leaves users in the dark as to what analysis the

[13] https://wmo.int/publication-series/state-of-global-climate

company undertook to arrive at this conclusion, such as the assumptions used in examining materiality; which assets/liabilities they considered; and how much headroom they have.

The above is important because we know that climate impacts are expected to grow over time and potentially accelerate. Disclosures which state that they are not material today fails to reflect this uncertainty, and will be inadequate to satisfy investors' desire to understand the entity's resilience to plausible but more severe outcomes. We would therefore favour expanding this example to provide more detailed disclosures on steps being taken to ensure the company is resilient to climate-related economic headwinds supported by quantitative disclosures, for example, key trigger points in critical accounting assumptions for impairments.

These disclosures may more appropriately come under IAS36 (Impairment of assets), in which case, the company should be encouraged to cross-reference additional disclosures under asset impairments (please see comments under Example 3).

<u>Example 2 - Materiality judgements leading to no additional disclosures (IAS1/IFRS18)</u>

We are supportive of this Example, but would suggest that it would be helpful to explicitly add that the entity is not exposed to significant physical impacts.

<u>Example 3 - Disclosure of assumptions related to asset impairment (IAS36)</u>

We support the proposed disclosures for where a carbon-intensive company concludes that a plausible change in key assumptions would lead to potential impairment loss. It is important for investors to have visibility on the level of headroom, current assumptions and what changes to these assumptions would lead to an impairment.

We believe, however, that there is a strong case for an issuer also to disclose the above information even where the entity determines there is no current impairment risk. In the face of potentially profound changes in certain industries/markets from climate change or transition policies, and heightened uncertainty over the possible future outlook for an industry, investors have a legitimate interest in having enhanced transparency over critical accounting assumptions and their sensitivity to alternative plausible scenarios. This underpins investors' ability to assess risks to capital.

We would specifically like to see sensitivities presented for faster transition scenario consistent with the Paris Climate Agreement goals and one consistent with a faster warming scenario, given both these reflect plausible pathways and ones which investors are being instructed themselves to report against under TCFD reporting requirements.

This should also be covered under para 125 of IAS1 (Para 31A IAS8) disclosure requirements as set out in Example 4.

<u>Example 4 – Disclosure of assumptions – general requirements (IAS1/IAS8)</u>

This example setting out requirements for assumptions disclosure under IAS1 Para 125 and 129 (Presentation of financial statements) / IAS8 Para 31A and 31E (Basis of preparation of financial statements) is extremely helpful. It fills what we view to be a loophole in the disclosure requirement under IAS36 which permits entities that determine there is no asset impairment due to climate factors (unless the assets include goodwill/intangible with indefinite lives) to avoid providing any details on the assumptions they used in that determination, or associated sensitivities. As highlighted under Example 3, we believe this is harmful for investors in situations of heightened uncertainty given climate change.

We welcome the clear guidance on the application of the standard and support the proposed disclosures intended to help users understand managements' judgements about the future, including:

- the quantitative and qualitative information about key assumptions,
- sensitivities of the non-current assets to these assumptions, and
- reasons for the sensitivities.

We have two suggestions.

First, we would like to see an additional proposed disclosure related to the level at which a change in key assumptions would trigger an asset impairment/material impacts on the reported accounts.

Second, we are concerned about the potential for entities to apply an overly rigid 12-month cut-off in determining whether they expect a change in assumptions, enabling them to ignore expected events that fall just beyond this horizon. We would like to see a specific reference to how a company should approach a negative impact that is expected in, say, 18 months.

An analogous situation is tackled under Example 5 (also IAS 1 para 125), but in that example the negative regulation expected to come into effect after two years needs to be disclosed.

<u>Example 5 – Disclosure of assumptions: additional disclosures (IAS1/IAS8)</u>

We are supportive of this example illustrating the application of para 31 IAS1 in the case of potentially material write-downs on deferred tax assets beyond the 12-month look-ahead to improve investor understanding of risks in the event the government changes its planned rules.

It might be helpful to consider developing one or two additional examples that demonstrates this logic of ensuring entities consider disclosure of potential longer-term impacts for other assets. We agree that omitting this information could reasonably be expected to influence users understanding of the entity's financial position.

<u>Example 6 – Disclosure about credit risk (IFRS7 – Financial instruments disclosures)</u>
This example is particularly helpful in underlining the relevance of climate risks to financial institutions. We also welcome the focus on physical risks, which has been less visible in other examples, but increasingly material to investors.

We are supportive of the key considerations in assessing materiality (e.g. the size of affected portfolios; the significance for credit risk; and other qualitative factors relating to the regulatory and legal environment) and the proposed disclosures, notably:

- Explanation of credit risk practices relating to climate
- Explanation of how climate risks incorporated into inputs to measures of ECL, including the probability of default and loss given default
- Changes in reporting period to estimation techniques or assumptions

- Information on collateral and the exposure to climate risks
- Information on concentrations of climate risks

In addition to the proposed disclosures, we would like to see the following:

- Actual quantitative changes to assumptions (under para 6.4(b)(iii));
- How the entity considered refinancing risks, which has been a particular concern for prudential authorities like the UK's Prudential Regulation Authority[14].
- Sensitivities to plausible changes in ECL assumptions in the event of faster global warming or transition.

Linked to the point above, we would urge the IASB to extend this example, or add another example, demonstrating how transition risk also needs to be factored into financial organisations' ECL assumptions.

<u>Example 7 – Disclosure about decommissioning & recovery provisions (IAS37)</u>

We support this example as clearly setting out the importance for enhanced disclosure of anticipated decommissioning and recovery provisions in the face of a risk of shorter asset lives due to decarbonisation. Investors currently lack sufficient visibility, particularly where high carbon companies assume long or indefinite asset lives, as in this example, and thus essentially enable to company to move these potentially large costs off the balance sheet[15].

We support the suggested disclosures, including the amount of the expected liability (undiscounted), timing and key associated assumptions.

In addition, however, we would also ask:

- That the entity includes disclosure of sensitivities of the provision to plausible scenarios, including associated with the Paris Agreement goals and a faster warming pathway.
- That the example is extended to physical risks as a possible cause of earlier retirement and increased provisions.

<u>Example 8 – Disclosure of disaggregated information (IFRS 18)</u>

We support this example in highlighting how emerging climate characteristics may be sufficiently material to cause an entity to disaggregate its PPE according to these climate characteristics, e.g. separating out the PPE between high carbon and low carbon equipment.

It would be worth also flagging:

- whether this disaggregation would trigger additional disclosures for these different asset groups under other standards; and
- the relevance of physical risk exposure differentials for disaggregated information.

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[14] The PRA most recently raised this in its letter to CFOs in September 2024, but has also raised in past letters: https://www.bankofengland.co.uk/prudential-regulation/letter/2024/thematic-feedback-on-accounting-for-ifrs-9-ecl-and-climate-risk

[15] Concerns over off-balance sheet decommissioning and restoration obligations (or Asset retirement obligations as they are known under US GAAP) has been a long-standing concern for investors. Carbon Tracker's analysis of the problem underlines why investors require more disclosure: https://carbontracker.org/reports/overlooked-why-oil-and-gas-decommissioning-liabilities-pose-overlooked-financial-stability-risk/

***Q3: Do you have any other comments on the ED?***

In addition to our suggested amendments above, we would like to propose adding new examples to cover the following:

- **Climate-related litigation or related legal or regulatory infringements** (**IAS 1 and IAS37)**: If a company is subject to noncompliance with laws and regulations, and it has an impact on the financial statements (for example, penalties, fines, or lawsuits), then it should disclose such matters in the notes to the financial statements. Currently, we have found that in cases of ongoing climate litigation or sanctions, the disclosures have been very limited. We would welcome an example that made clear the importance of giving sufficient visibility of the potential quantitative consequences of such legal or regulatory action.
- **Going concern assessment** (IAS1, para 25): We would welcome an example that demonstrated how companies materially exposed to transition or physical risk incorporate this into their Going Concern assessment, and associated disclosures.
- **Climate commitments and provisions (IAS 37)**. In light of the recent Agenda decision, we would support an example that clarifies disclosure expectations around emissions reduction commitments and associated provisions.