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Directors and Strategic Reports – ESG and Narrative Reporting

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Overview of the session

- Introduction to ESG and sustainability
- Current ESG reporting requirements and their application
- Introduction to TCFD – objectives and requirements
- Introduction to how ESG will impact the numbers and disclosures in the financial statements
- IFRS Sustainability standards – S1 and S2 – international response

Introduction to ESG and sustainability

Introduction to sustainability and ESG

Sustainability

- “Meeting the needs of the present without compromising the ability of future generations to meet their own needs”

United Nations Brundtland Commission (1987)

Environmental, social and governance (ESG)

- Environmental: how organisations impact and are impacted by climate change and broader environmental issues such as biodiversity
- Social: this includes factors ranging from modern slavery to international development and nutrition
- Governance: the means by which a company is controlled and directed by the board

ESG – glossary of terms

- TCFD – Task force on Climate-related Financial Disclosures
  - Created by G20 and Financial Stability Board (formed by G20) following the Paris Agreement of 2015
- IASB – International Accounting Standards Board
  - Independent private sector body created to develop International Financial Reporting Standards
- EFRAG – European Financial Reporting Advisory Group
  - Independent group with EU support to review and advise EU on implementation of IFRS recommendations
- IFRS S1 and S2 – sustainability Standards issued by IASB
- CSRD – EU Corporate Sustainability Reporting Directive
- ESRS – European Sustainability Reporting Standards
  - Adopted by EU in 2023 will be revised in light of issue of IFRS S1 and S2

ESG risks and opportunities

- Changing demographics
- Social inequality including forced labour
- Consumer preferences
- Risk management processes
- Board composition
- Physical and transition
- Investor confidence
- Market ratings
- Reputation
- Availability of social, sustainability-linked and SDG-linked bonds
- New technology

TCFD | TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

Climate Change Is a Financial Risk

Climate-related risk is non-diversifiable and will have a financial impact on many companies:

REVENUES

EXPENDITURES

ASSETS AND LIABILITIES

CAPITAL AND FINANCING

Initial exercise

- How does your family plan and manage what impact you have on the environment?
  - Is the environment and sustainability important to you?
    - On a scale of 1 to 10 where 1 is not important at all
  - What tangible steps have you taken to manage and control this issue?
    - State 3 if you have taken any
  - How do you measure the success of your actions?

Current ESG reporting requirements

Current legal requirements

- Management discussion and analysis
  - Directors' reports – legal content required
  - Strategic reports and future plans
  - Sustainability reports – larger (listed) entities
- Market and listing rules
  - Full sustainability reporting
  - Compliance with TCFD recommendations
- IFRS – S1 and S2 – if endorsed and adopted within local reporting requirements
  - Progress and scope various around the world

Taskforce on Climate-related Financial Disclosures (TCFD)

With effect from accounting periods beginning **on or after 6 April 2022**, over 1,300 of the largest UK-registered companies and financial institutions have to disclose climate-related financial information on a mandatory basis in line with TCFD recommendations. This includes many of the **UK's largest traded companies, banks and insurers, as well as private companies with over 500 employees and £500 million in turnover**.

TCFD | TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

Taskforce on Climate-related Financial Disclosures (TCFD)

TCFD recommendations are grouped into four areas:

Governance – disclose the organisation's governance around climate-related risks and opportunities

Strategy – disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's business, strategy and financial planning where such information is material

Risk management – disclose how the organisation identifies, assesses and manages climate-related risks

Metrics and targets – disclose the metrics and targets used to assess and manage climate-related risks and opportunities where such information is material

Governance

Include information such as:

- Board-level knowledge and training
- Board oversight on climate change (frequency of board discussions, examples of how climate-related risks affect board strategic decisions)
- Management’s role in assessing and managing risks(how management reports to the board, remuneration linked to climate-related objectives)

Strategy

Include information such as:

- Identify physical and transition risks over different time horizons
- Link climate impact to financial performance
- Identify appropriate scenario analysis and the resilience of the company’s strategy in each scenario

Risk Management

- Principal risks section of annual report (heatmap)

Include information such as:

- The process that the company uses to identify, assess and manage climate-related risks
- Integration into the current overall risk management process

Metrics and Targets

- Disclose metrics used to assess risks and opportunities in line with the organisation's strategy and risk management
- Disclose scope 1, 2 and 3 GHG emissions
  - Scope 1 – emissions from sources it owns and controls directly – your vehicles and boilers.
  - Scope 2 – emissions it makes directly – heat, light and cooling bought from others outside.
  - Scope 3 – all emissions from those associated with the organisations value chain – suppliers through to customer use
- Describe climate-related targets and performance against those targets

Front half versus back half reporting

- A number of reports have found discrepancies between narrative reporting in the ‘front-half’ of the annual report and the financial statements in the ‘back-half’ of the annual report.

2020 Climate Disclosure Standards Board (CDSB) review of 50 of the largest European companies found 100% provided narrative on climate-related matters and only 10% referred to climate in their financial reporting.

2021 Carbon Tracker report ‘Flying Blind’ revealed 70% of 107 publicly listed carbon-intensive firms did not disclose climate risk in their financials.

Front half versus back half reporting

Largest discrepancies between front half and back half:

- Key assumptions for impairment testing that did not reference climate change and also contained potentially inadequate sensitivity disclosures.
- Lack of clarity over whether climate change uncertainties were taken into account when determining useful lives.
- Not disclosing significant judgements or sources of estimation uncertainty which have a significant risk of resulting in a material adjustment within the next financial year.

FRC – Clear and concise reporting

- Tell the story
- Focus on the most important issues
- Do not repeat information from one year to the next
- Be entity specific
- Avoid immaterial disclosures and boilerplate
- Full completed disclosure checklist does not mean the accounts are necessarily true and fair

Introduction to how ESG will impact the numbers and disclosures in the financial statements

Impact on the numbers and disclosures in the financial statements

- New disclosures are mandated or recommended in the front half of the annual report (strategic report, directors' report, TCFD)
- The back half requires recognition and measurement of transactions and balances in the financial statements
- Disclosures relevant to transactions and balances must be adapted to include accounting policies used, and key judgements and estimates

Is it material?

- Concept of materiality is not just about numerical value when related to climate or ESG issues – investor expectations may make some issues material and therefore merit disclosure

Implications for financial statements

- State 5 financial statement account headings that you would expect to be materially affected by the impacts of climate change and other sustainability issues.
- Just provide the top 5 for your business or industry sector

Implications for the financial statements

- Non-current assets – additional expenditure, useful lives, residual value, stranded assets
- Intangible assets
- Impairment of assets – recoverable amount, value in use inputs

Implications for the financial statements

- Investments – fair values
- Financial instruments
- Provisions and contingent liabilities – future restoration, fines for non-compliance

Implications for the financial statements (continued)

- Carbon offsetting
- Incentives for management and share-based payments
- Inventories

Implications for the financial statements (continued)

- Segmental reporting should enable users to understand how different operations are impacted differently by climate-related matters
- Going concern
- IAS 1

Examples

- Replace windows in freehold owned by the company – asset or expense?
- Three examples of items of PPE whose value could be increasing due to climate issues?
- Should the impairment test consider events subsequent to the balance sheet reporting date? Yes or no?
- Can impairment losses be reversed? If so, where does the credit entry appear?

ISSB progress

International Sustainability Standards Board

- Two exposure drafts were published in March 2022
- The consultation period ended on 29 July 2022
- IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information
- IFRS S2: Climate-related disclosures (with industry-based disclosure requirements in an appendix)
- S1 and S2 are built on the TCFD recommendations and SASB industry guidance

ISSB – Update

- IFRS S1 and S2 both now finalised and issued
- Require entities to disclose information about sustainability and climate related risks and opportunities that would be useful to users of financial statements
- Where to include
  - In annual financial report
  - Covering the same period – with explanations if year end changed; and
  - Including subsequent events
  - With comparatives wherever possible
- Effective from 1 January 2024 – early adoption is possible
- UK yet to finalise endorsement or endorsement process

S1 – General requirements for disclosure of Sustainability related financial information

- Risks and opportunities reasonably expected to affect an entities
  - Cash flows
  - Access to finance; or
  - Cost of capital
  - Over the short, medium and long term
- Scope – can be applied whether using IFRS of other GAAP
- Based on conceptual framework
  - Materiality
  - Fair presentation; and
  - The Reporting Entity

S1 – Core Content

- Governance, strategy, risk management, metrics and targets
- General requirements
  - Apply IFRS Standards and previous SASB Standards
  - Consider Industry Guidance
  - Also consider
    - Guidance from other Standard Setting Bodies – FRC
    - Climate Disclosure Standards Board
  - Use SASB metrics unless not really appropriate
- Disclose guidance referred to and followed
- Location
  - As part of general purpose financial report
  - Refer to and follow legislation
  - With other Management Commentary – Strategic Report etc

IFRS S1 – core content (continued)

- Can and should be cross referenced to other content (including financial statements)
- Inclusion in interim reports is not mandated
- Include statement of compliance which must be compliance in full
  - Exemption for disclosures that are prohibited by law; and
  - Those that are commercially sensitive

S2 - Overview

- Focus on climate related risks and opportunities – both physical and transition risks
- Core content
  - Governance – how entity processes, controls and procedures to monitor and manage
  - Strategy – for managing risks and opportunities to business model and value chain. Considering effect on cash flow, financial performance and position
  - Risk management – processes to identify, assess, prioritise and monitor
    - How integrated?
  - Metrics and targets – progress to achieving including those set by law
    - Including GHG Scope 1, 2 and 3

S2 – GHG emissions reporting

- IASB S2 requires reporting of Scope 1, 2 and 3 (for the first time)
  - Scope 1 – GHG from sources owned and controlled
  - Scope 2 – GHG from purchased or acquired electric, steam, heating or cooling consumed
  - Scope 3 – GHG from value chain as defined into 15 categories in Guidance Published 2011 now embedded in S2
- Scope 3 categories include:
  1. Purchased goods and services
  2. Capital goods
  3. Fuel and energy outside scope of Scope 1 and 2
  4. Upstream transport and distribution
  5. Waste generation
  6. Business travel… etc
- Category 15 requires disclosures relating to investments – for asset managers, commercial banks and insurers
- Scope 1 and 2 to be disaggregated between:
  - Group GHG; and
  - Other investees – JV, associates and unconsolidated SPEs

TCFD guidance for sectors

- There is guidance provided for all sectors
- There is supplemental guidance for certain sectors (October 2021):
  - Financial sector (banks, insurers, asset managers, asset owners)
  - Energy
  - Transportation
  - Materials and buildings
  - Agriculture, food, and forest products
- The non-financial groups account for the largest proportion of GHG emissions, energy usage and water usage.

Practical implementation of TCFD requirements

- Get strategy and governance in place first
- How is your business going to respond to these challenges?
- Make the changes in the business THEN report them
- Get executive buy-in for the oversight and management of ESG issues
- Assign responsibilities – ESG responsibilities should be embedded within the operational team not a standalone function
- Understand investor needs and engage with stakeholders – what information do they want to see to make decisions? (Good governance)
- Set ambitious but realistic timeline to full disclosure – be transparent about when you expect to be able to report against each of the disclosures

TCFD implementation – Review by UK Financial Reporting Council

Summary of FRC review

- Background
  - 25 premium listed entities reviewed
  - All have ‘risen to the challenge’ 22 make specific reference to climate related risks in financial statements
  - Notes that all companies following TCFD disclosures under Companies Act 2006 changes should follow the guidance
- 5 main themes
  - Granularity and specifity
  - Balance
  - Inter-linkage with other narrative disclosures
  - Materiality
  - Connectivity – TCFD and financial statement disclosures

FRC comments on 5 key themes

- Avoid the generic and provide £ where possible
- Risk and opportunity discussion should be balanced
- Link sustainability report to strategic report and other narrative
- If TCFD disclosures omitted explain why:
  - Immaterial;
  - Reliable data not available
  - Must demonstrate how materiality has been applied
- Connectivity includes for example explaining if accounting estimates and judgements are Paris Aligned

FRC key findings – in addition to above

- Strategy
  - Linking risks and opportunities to strategy too general – especially re business and geography
  - Only 25% quantified strategic outcomes – read more like a wish than a defined strategy
  - Didn’t well explain how scenario analysis informed financial planning
- Risk management
  - How prioritised compared with other risks
- Metrics and targets
  - Explain targets (ie Net Zero) more clearly and consistently
  - Provide more historical data and explanations

FRC comments on financial statement disclosures

- Judgements and estimates
  - Very few reported climate change as a relevant factor for sources of estimation uncertainty
- Impairment testing
  - Not all IAS 36 required disclosures provided
  - For example, explaining if climate risk factored into cash flows and discount rates
- Asset useful lives
  - Many explained why not affected by climate change; but
  - Claimed a specific net zero targets which suggested otherwise?

FRC comments -continued

- Segmental reporting
  - Little information whether any IFRS 15 revenue streams will change as a result of climate change
  - Narrative report mentioned huge opportunities but no details given of impact on segments
  - All claimed Chief Decision Maker now receives information on climate change
- Other issues
  - Companies reported emissions rights assets or sustainability linked finance but no real mention in accounting policies
    - So immaterial compared with claims made in narrative disclosures? Or
    - Oversight?

EU action on S1 and S2

- EFRAG conducting review through summer 2025 with the aim of simplifying the 2023 requirements (European Sustainability Reporting Standards) – which duplicated or went beyond S1 and S2 in certain respects
- Key issues
  - Address issues raised by Double Materiality
  - Reduce overlaps between guidance
  - Clarify the language and structure
  - Remove all voluntary disclosures
  - Include exemption for undue cost and delay
- Assurance regime will also have to be determined – how to achieve and verify a ‘fair presentation’
- Consultation to end September 2025 with proposals for Governments then to consider (and Regulated Financial Markets)
  - Who should apply; and
  - When
- TCFD and S1 and S2 remain best practice until such issues as identified above are resolved

- EFRAG – European Financial Reporting Advisory Group

Thank you and any questions? Please do provide us with feedback

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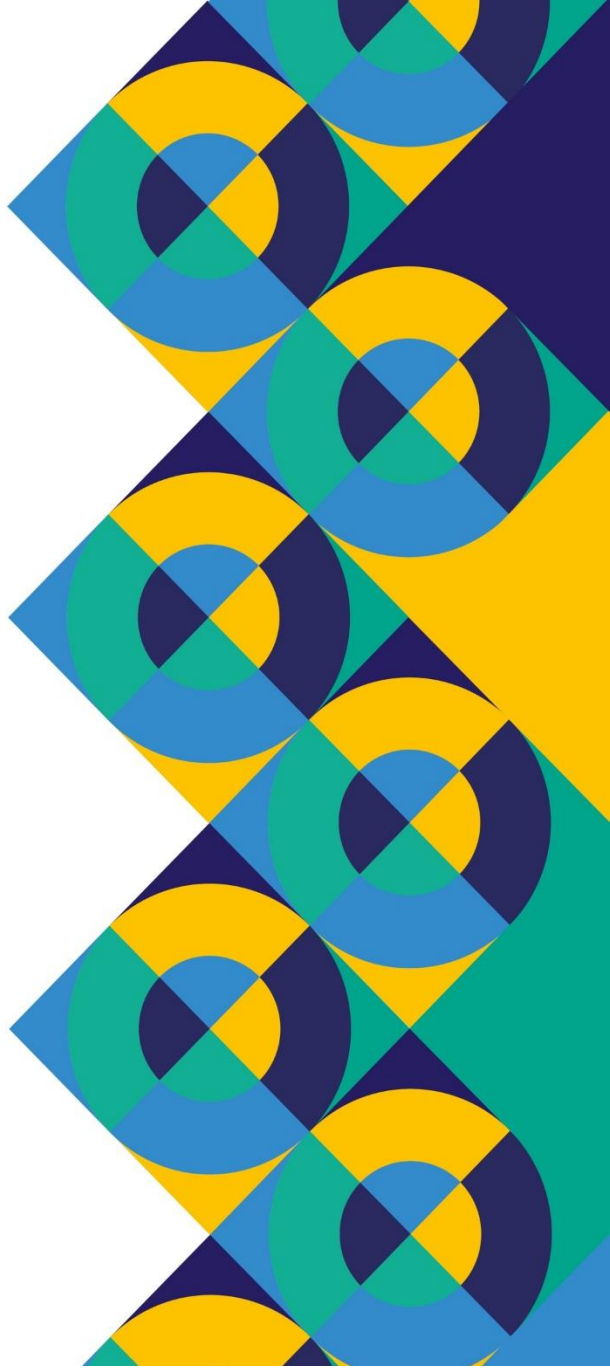

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