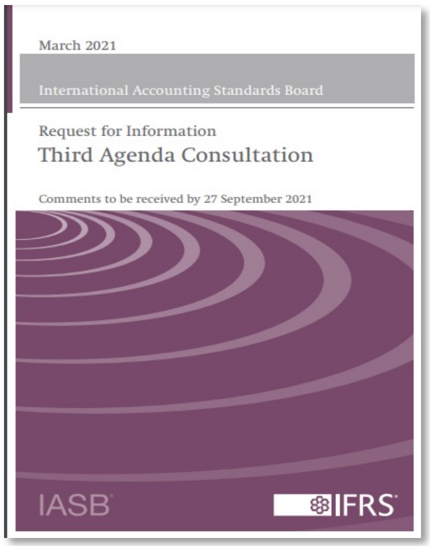
IASB Agenda Consultation 2021 (2)!! / Climate-Related Risks

-- THE MOST "URGENT NEEDS" --


March 2021

International Accounting Standards Board

Request for Information

Third Agenda Consultation

Comments to be received by 27 September 2021

IASB IFRS

Online workshop

21th IFRS Digital Reporting Workshop

Date and time : 25th Aug 2021, 18:30-20:30 JST

Climate Related risks on the Financial Statements

We have been discussing disclosure related issues since 2014. mostly investors and related market participants in Japan and inviting foreign friends. Discussion themes are chosen by IFRS or Corporate Governance issues and responding public consultation of IASB or other organizations in sometimes. Since we responded EU consultation Fitness Check in 2018, recently also picking up the Sustainable / environment topics as agenda.

Climate-related risk became the most material information for reporting these days. IASB agenda consultation 2021 also raised this topic. Some people said, "Is this the area that the new Sustainability Standards board will cover?" Yes, it will also be discussed in the new board as non- financial disclosure. But before that, the most emergency needs of the information of Climate-related risks are improving "description on the financial Statement" and "audit" so that we can discuss metrics more.
Today, we will understand how the Climate Accounting Analysis has been analysing current disclosure and consider what is needed. Those discussions must be good to send to IASB as a consultation response.

	Who join the discussion?
Attendees (Japan) *attendees have joined this workshop as private,	17 Investors, 2 Investor(Analysts) organization, 3 sell-side analyst, 2 pension & insurance & bank, 7 Information providers/Researchers, 3 Company side (include Independent non - executive director, support service), 7 Auditor, 1 Academic 7 Regulator & Accounting setter & stock exchange, 1 other
Attendees (outside Japan)	2 Investors & its organisations, 2 Information providers/Researchers, 1 Auditor, 1 regulator

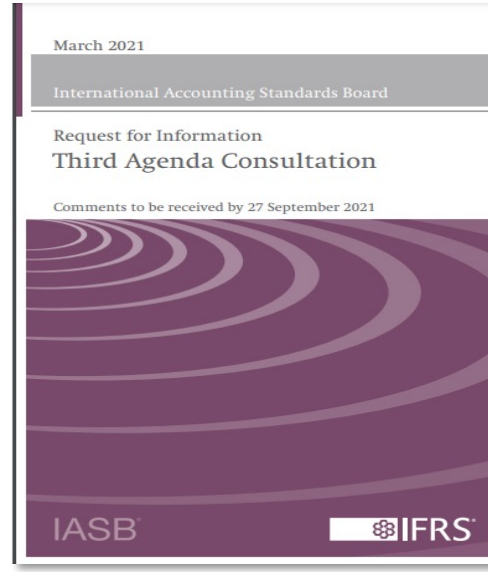
What is Agenda Consultation of IASB

Once every five years, the IASB publishes such a document, asking what agenda the IASB should address for the next five years. One of them is climate change risk. It is extremely long-term risk, and it is said that current standards cannot cover the long-term risk.

IFRS is principled based. **So it can reflect remote risks such as impairment and assumptions**. **Standards require companies to reflect future uncertainties**. Many companies do not seem to know that current standards can reflect climate change risk. So the IFRS Foundation and the IASB provided Educational material, indicating that a number of standards require disclosure of future uncertainties. But is this enough, or should the standard notation be improved? For example, IAS1 looks as if it wants to write about uncertainty until the next year. That's not what IAS1 really wants, but it's easy to misunderstand. IAS36 seems to be telling us to look at future risks in up to five years. But the risk of climate change is longer. Therefore, this expression should be deleted. It may also require clarification criteria for longer-term risk disclosure. And it may be necessary to develop accounting for various types of Pollutant pricing mechanisms.

According to the IPCC released in August, there is no doubt that global warming is due to human activity, and the rate of global warming is rising. So the move towards decarbonisation must accelerate. Companies that do not take effective measures against decarbonisation will not only be disadvantageous to investors but will also affect business continuity. To that end, companies should actively promote how much they are working on decarbonisation. At the same time, this also has the problem of concentrating investment on companies that are labelled as environmentally friendly. Some companies will just be more exaggerated than they are actually doing. Unfortunately, there aren't many ways to verify them. Third-party verification is required, and financial audits can verify corporate behaviour.

It may be good to have the opportunity to show what the company is doing, but if they are serious about it, it should be reflected correctly in the current financial statements. And it should be verified by audit.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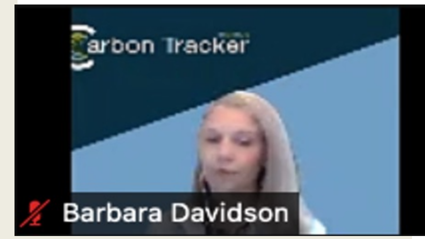
IASB

IFRS

- IAS1 Presentation of Financial Statements
- IAS2 Inventories
- IAS12 Income Tax
- IAS 16 Property, Plant and Equipment
- IAS 38 Intangible Assets
- IAS 36 Impairment of Assets
- IAS 37 Provisions. Contingent Liabilities and Contingent Assets
- IFRIC 21 Levies
- IFRS 7 Financial Instruments Disclosures
- IFRS 9 Financial Instruments
- IFRS 13 Fair Value Measurement
- IFRS 17 Insurance

Climate Accounting Analysis (CAA)

CAA is a method of analysing whether a company disclosed future risks that it may face from climate change in its financial statements (FSs) or whether the auditors appeared to consider these issues in their audits, as required under current accounting and auditing standards. Two teams analysed the 2020 FSs and audit reports of 107 companies.

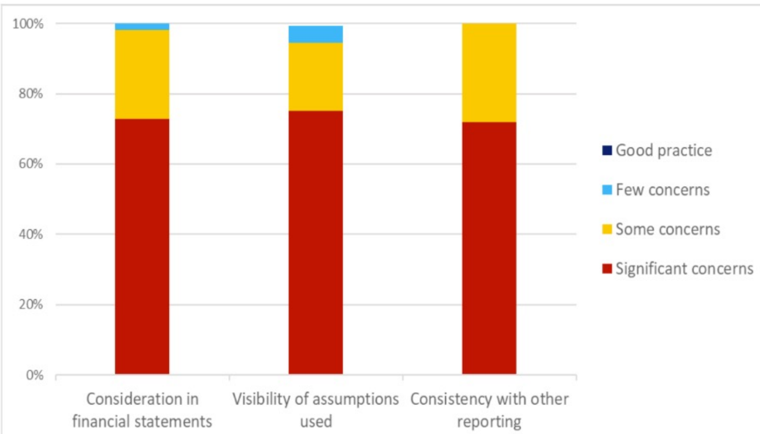


- We looked at FSs to see if climate change risk is considered, if the relevant items reflects transition risk such as regulation changes, if there was consideration of emission targets, and what is written in the note (such as the accounting policy). How did management evaluate it, not just mention it, impairment of assets and inventories, asset lives and retirement obligations, how those issues are considered, and if not, why? Is it material? Then look at the key quantitative climate change assumptions. Are production changes, demand changes, related liability, and corporate assumptions (e.g. commodity or carbon prices) consistent with addressing climate and /or the other reports published? Is there anything different from FSs, such as the sustainability report?
- In the audit report, we looked at KAMs (Key audit matters). How are the effects of climate change assessed ? How did management view risks and targets with an understanding of these? We saw some discussions in impairment testing, but did the auditors consider climate change in deferred tax assets, asset lives and residual values, and what the auditors did if it is a matter as the corporate disclosure. Also, whether the auditor used independent climate change experts, etc., whether the assumptions used by management are in the right scenario for climate change, how consumer demand will change depends on the scenario, what about carbon tax, and so on. Then we especially looked whether the auditor commented on consistency of company reporting. Note we also looked at US companies and their auditors. No US auditors provided evidence of assessing climate as part of their audits.
- Many auditors, not just companies, did not provide evidence to consider climate change. Many companies mention climate change outside of FSs or in other reports, but only 30% reflect it in their FSs, and 20% of auditors have evidenced it in their audit. In addition, about 25% of companies disclosed quantitative assumptions/estimates that they used. Without this assumption, it would be difficult for investors to evaluate companies in different scenarios. It also indicates that many may still be inconsistent with what they are talking about outside FSs. The audit report, only two commented on the inconsistency of corporate disclosure. Companies continue to improve their climate change targets, but the differences between FSs and other reports are significant. No company used the assumptions aligned with the preferred pathway of no more than 1.5 degrees warming and net zero by 2050. (this was requested by investors). The oil and gas sector was better than other sectors. UK companies also scored relatively well. We didn't look at Japanese companies this time (focus was Dec 2020 year ends). A summary will be published in September.

Climate Accounting Analysis (2)

■ Result of 107 companies analysis

Results: financial statements

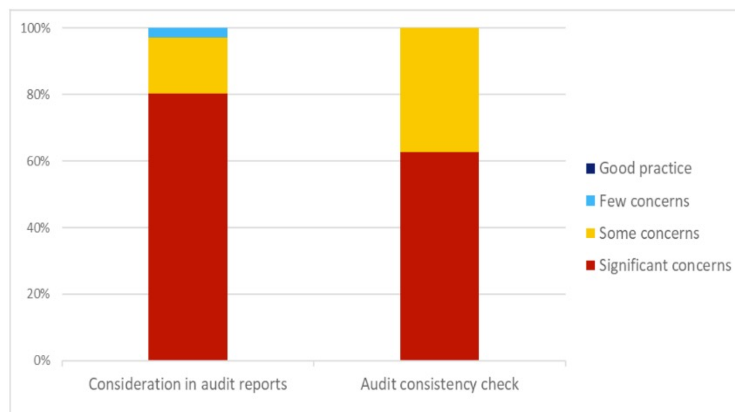


Source: Carbon Tracker and CAP analyses

Regarding the ratings for the three points that should be in FSs, red is significant concerns if companies/auditors don't mentioned at all. Blue is, if there are a few Concerns. And dark blue is if it is a good practice (none were scored with dark blue) Oil and gas companies scored better over transparency and reporting. Some had considered climate and the future prices of oil & gas for example, in their impairment testing. Others haven't considered it, but they give quantitative information that were used. The consistency with other reports is not good. Many addressed climate change risk in their narrative explanation, but did not say anything in FSs.

Next is audit. Again, it's a very disappointing result on consideration of climate in audit reports. The auditor's consistency check appears better, but this is only because many company reporting was consistently limited on discussing climate-related risk.

Results: audit reports



Source: Carbon Tracker and CAP analyses

Rolls Royce

Rolls Royce
UK, Industrials

Accounting		Climate Assumptions		Audit		Date of analysis: April 26 2021
Judgements	Consistency with other reporting	Visibility	Paris alignment	Visibility in KAMs	Consistency check	Year end: December 2020 Report date: March 31 2021 AGM: May 13 2021
Some concerns	Significant concerns	Significant concerns	Significant concerns	Some concerns	Significant concerns	CA 100+ company, so seen by investors as key to driving global net zero emissions

Summary view:
- Rolls Royce displays an impressive commitment to consider climate change, and has significantly advanced its communication on the issue over the year as well as continuing to invest despite financial challenges.
- However, while climate is mentioned in the financial statements (and by the auditor) the incorporation in the financials does not reflect the broader discussion and approach. The audit committee will consider climate assumptions in 2021.

Background

The Business
- One of the three main engine suppliers for the civil aerospace business, Rolls Royce is highly dependent on activity levels in, and the long-term success of, the aviation industry.
- This is particularly true given that its revenues, and particularly its profits, largely arise from long-term servicing agreements associated with engine sales. Typical engine programmes run for 30-55 years and are loss-making in the early years, only turning profitable later through the service contracts. A core determinant of servicing demand is the number of flying hours.
- Large engine flying hours in 2020 were down to 43% of 2019 levels, leading to a reported loss in the civil aerospace segment of some £2.5bn.
- In addition to the civil aerospace business, Rolls Royce has significant defence and power systems businesses. The largest portion of the power systems segment is power generation.

Approach to climate change
- Rolls Royce is targeting net zero GHG emissions in operations and facilities by 2030, though the fact that this excludes product test emissions illustrates the scale of its challenge in relation to Scope 3. It has committed to become fully net zero carbon by 2050, including Scope 3 emissions. It intends to publish a roadmap to deliver this in 2021.
- The company aims to use its engineering expertise to help the globe transition to net zero – and hopes for growth from this activity from 2025 – but recognises the need to restore financial returns and rebuild its balance sheet first. Nonetheless, it details investments and research and development into relevant technology areas which continued through 2020.
- While it is developing electric power systems for flights, Rolls Royce believes that power to weight ratios mean that only gas turbines will be suitable power sources for large aircraft and long-haul flight for decades to come. It is thus experimenting with sustainable aviation fuels.
- The only element of its business model that Rolls Royce does not acknowledge as potentially impacted by climate change risks is 'capture through-life value of in-service products'. This seems to reflect a perception that climate will only have an impact some time in the future.

Accounting: judgements and consistency with other reporting

Accounting judgements		Some concerns

- The company reports under IFRS standards.
- The Basis of Preparation discussion in the Accounting Policies note to the accounts includes a climate change section. This states that management has considered climate change's impact in the light of narrative reporting disclosures, including the net zero targets. It states: "These considerations did not have a material impact on the financial reporting judgements and estimates, consistent with the assessment that climate change is not expected to have a material impact on the Group's going concern assessment to September 2022 nor the viability of the Group over the next five years." As well as highlighting specific investments, it notes that the impact of climate change has been considered with regard to key estimates, including on impairment assessments of intangibles and goodwill, deferred tax and long-term contracts.
- Of these highlighted areas, climate change is only specifically referenced in relation to deferred tax. The planning horizon of 5 years does not reflect the 25-year typical length of Rolls Royce's long-term service contracts.
- A small £9m impairment was taken in a Power Systems JV because of changes to climate change regulations in a particular (unspecified) market.

Consistency with other reporting		Significant concerns

- The company sets out extensive commitments and ambitions in relation to climate change in the narrative reporting elements of its Annual Report. These include: a TCFD report, sustainability disclosures, and also references within risks discussions (which are much better articulated than in the 2019 Annual Report), business model reporting and viability statement.
- Rolls Royce details its technological R&D on zero carbon offerings, which have continued through 2020. These include: the UltraFan engine, which enjoys enhanced efficiency; testing of existing engines with sustainable aviation fuel; fuel cell technologies, hybrids and electric engines; and small modular nuclear power stations.
- Despite the references to climate change in the financials, these are not as well developed as the substantive narrative reporting discussions of the issues and concrete steps being taken.

Climate assumptions in accounts: visibility and Paris alignment

Visibility of climate assumptions in accounts		Significant concerns

- It does not appear that climate-related assumptions are disclosed.
- Nevertheless, some key sensitivities are disclosed: (i) if engine flying hours fall by 15% over the remaining lives of contracts, this would lead to an adjustment of £100m-130m (90% of which as a cut in revenues, the remainder as onerous contracts, and so an increase in cost of sales); (ii) if flying hours fall by 5% then impaired assets would be subject to a further £50m impairment; (iii) a 5% fall in workshop visits (again, largely a function of flying hours – which the accounts note may be influenced by climate change) would reduce expected profits, leading to a reduction in the deferred tax asset by around £100m; and (iv) a 15% fall in widebody flying hours would lead to a further provision of £10m-15m for onerous contracts.
- The audit committee states that the impact of climate change on assumptions will be a key area for its focus in 2021.

Paris alignment		Significant concerns

- With no disclosure, there can be no alignment with the goals of the Paris Agreement.

Audit: visibility in KAMs and consistency check

Audit firm: PricewaterhouseCoopers LLP	Responsible partner: Ian Chambers
Audit standards: ISAs as adopted in the UK	

Visibility in Key Audit Matters		Some concerns

- There is an explicit reference to climate change in the auditor's report. It is referenced in the deferred tax KAM as one of the variables that needs to be considered in developing future forecasts, particularly for forecasts beyond the company's normal 5-year forecasting process.

Rolls-Royce states that climate change has not yet had a significant financial impact. The assumptions are not disclosed and do not reflect the risks or targets mentioned in other reports.

However, in 2021, they will announce a roadmap for their targets, saying they will focus on Assumptions. Many companies now think that climate change cannot be estimated for more than five years, but some explain it for more than five years. IFRS is principle based. If it is important, assumptions made should be disclosed.

Analyst of CAA

Discussion

My question is now that as accounting in line with the Paris Agreement, the highly uncertain such as the cost of future alternative energy, or technological advances such as hydrogen, is it not enough only to put the cost that we have known now. Is there is any good practice?

Investor in Japan

Even if it is difficult, companies have to comply with the requirements of the standard. But what company really need to do is to tell investors what's going on now and what they're going to do in the future. When making an assumption, such as how to shift to a target, is necessary to include what steps you intend to take and what kind of plan you have if you have an ambitious target. If you can't do that, you need to clarify it and put in a visible assumption anyway. I think this is a complicated area. It may not fit the cycle of the annual report, but you need to be clear about what you are doing and what you are not doing.

Analyst of CAA

Did you also observe the differences between sectors?

Issues are vary by sector. Oil and gas companies have different assets than manufacturers. The company we chose this time has a lot to explain to investors about climate change. Goodwill is a big problem for them. Consider future cash flows and perform impairment tests, but the cost of climate change will fluctuate. There will be various other costs in the future. The differences between sectors are an interesting subject. Oil and gas companies get higher scores, because they are in severe situation. There are many factors to consider in auditing. Some other sectors are not so linked to accounting impacts from climate now but should also be clear if climate is not yet considered material to their f/s.

Analyst of CAA

Voices of Japanese investors /users on CAA reports

It was very interesting. To tell the truth, in terms of comparing global companies with Japanese companies, I felt that disclosure of BP and VW must be high level. I checked Toyota, but it was hardly written. Eneos, it wasn't too bad. As Sue said, the oil and gas industry, demand for disclosure must be strong. Still, the level of disclosure was not very high in Japan. That's what I felt. This report is very good from an investor's practical point of view. The evaluation of how far the company is from the Paris Agreement is also a good first insight and a quick check. It's a good start to a conversation with a company. As for KAM, I'm skeptical that these climate change requirements fit well into small companies. However, I think this is a requirement of IFRS, so if Japanese companies choose IFRS, such valuation will be very useful. I think climate change is a long term and related to macro issues. Companies must relate these factors to their long-term strategy. However, some Japanese companies now think that disclosure is just disclosure. Ultimately, I hope Japanese companies will be able to incorporate these issues into their strategies.

Investor in Japan

It may be good for Japanese companies to know that even UK, EU, and US companies can't do well. Japanese companies tend to rely on best practices. Each company is evaluated for the quality of disclosure (comply of standards requirement) in this report, so I think it is good.

It is not whether companies are good or not. How the valuation has been done, what kind of assumption is used for the impairment test, how the oil price is selected.... etc.

Analyst of CAA

Understood. But what we said as "quality of disclosure", not mean so many things, meant comply level. As I said before, many Japanese companies still apply J-GAAP, where Disclosure of the management assumptions has just begun this year. Goodwill is still amortising, so many companies are less likely to face a serious impairment situation. That's why companies are not used to the disclosure that we discussed today. But we meant that it is good to know that difficulties even for UK and EU companies that are accustomed to IFRS. All Japanese investors who commented today said that it would be helpful if you analysed Japanese companies.

I think there are companies are also working on technologies like CCUS. Energy companies also will be influenced by them. Expectations are limited with current products. On the other hand, when engaging with a company, while discussing innovation and new technology, there are also concerns about green washing.

When I discuss how to achieve a target, it's costly and how effective it. If you need it, you have to produce, but what about the cost?, and if you need to impair existing assets? However, there is always a concerns whether this method is green wash, or not?. Companies need to indicate how they iplan to reduce emissions, and show us intermediate goals, and explain which technology needs to be improved, what technology you are trying to use, can it be proven, and it's timeframe, and the expected cost ....

Analyst of CAA

Is Assumption for the Impact of Climate Change, difficult?

There are requirements that may be associated with diversifying climate-related risks among existing IFRSs. However, all of these accounting standards and requirements have not been specially developed to represent only these climate risks. In that respect, I think it might be happened, even if these companies do not meet the very stringent criteria for assessing their financial position. Were these findings really disappointing or as expected for you? How would you rate narrative disclosure outside of FSs? Do you think that initiatives such as EU's CSRD and ISSB stabilisation can quickly improve the situation so that it is not too late?

Analyst Japan

We have not evaluated the narrative report. Only financial statements and audit reports. Though I read narrative reporting. There may be other initiatives in the future.
As for the question of whether I was really disappointed, this is an existing requirement back in the beginning (November 2019) result. However, I was surprised that it did not change even after the standards setter said that this disclosure was necessary last year. I was very disappointed with these results even after the large audit firms responded to the IASB and indicated that they would encourage more transparency of these issues. (see December 2020 GPPC letter)

Analyst of CAA

It is difficult for companies to include specific risks and assumptions related to climate change in FSs. That is because I think climate change risks are not yet directly linked to accounting in many cases. I think some European companies are looking at the financial impact of climate change in an advanced way, that is because regulations are being developed to enable the consideration of financial impact. It will take some time to establish a certain methodology on what assumptions should be made to estimate the financial impact of climate change in Japan. I think education is important to raise awareness about the financial impact of climate change, but it would be good to disclose how the company thinks about it as narrative(non-financial) information, which auditors read and consider consistency with FSs and auditors' knowledge obtained during the audit.

But with regard to accounting, despite the impact of climate change on society, whether or not it is denied, I think that companies cannot help but consider the impact of pending regulations and consumer preferences on their operations, products, and demand. Both financial and non-financial

Analyst of CAA

Whether or not the risk of climate change can be reflected in FSs depends on how many years the management can predict that it will affect the future. If the impact can only be predicted 10 years from now, it will not be reflected. I think it will be difficult without modifying IFRS a little. I think it's better to clearly state what the company has to do. If IFRS remains the same and is discussed solely in the new ISSB, perhaps separate statements (financial and non-financial) that do not connect to each other will only appear in one report. Also, if new technology makes it difficult to make assumptions, guidance is needed.

Why Climate Change risk must be reflected on the FS?

- "I understand that cash flow is difficult to predict, but IFRS says it's okay to predict more than five years, and some companies have asset lives as long as 20 to 30 years or more. Companies should consider at least a little more. There must be some points to consider, such as whether lives are appropriate. There should be something that can be started today due to climate change. Waiting for the IFRS to be amended will delay the response to climate change. ”
- "In Nick Anderson's 2019 paper, it was confirmed by the board that climate change should be reflected in financial statements, assumptions and discount rates should be considered, and valuation risks should be considered. We've also seen examples of companies disclosing 9 years or so in longer-term assumption, with growth rates after that. We're discussing factors to take into account the impact of climate. Impairment, asset life, asset retirement in some industries. There's no excuse for not doing these with discount rates and best estimates under current accounting standards**. Even if the standards are developed and move forward, they still have to comply now**. "

Analyst of CAA

What I can say now is that it is difficult to measure the impact of future climate change. Especially about new technologies and new situations. How should we discount including the impact of climate change, what kind of cash flow will we have? But if we can't evaluate it, we can't explain it to our clients, so I don't have a good idea right now … I hope there's a good way to do it.

Investor in Japan

BHP wanted to dispose of its petroleum business and S&P communicated that it will downgrade BHP for becoming less diversified in comparison to its peers. So there are other factors that need to be considered as well. I agree that businesses need to keep an eye on the long-term sustainability goals but have also to manage short-term considerations. Even if the impacts will affect in 10-year or 20-years time, businesses need to consider broad market impacts and consumer perceptions. If investors and consumers move away for not meeting ESG or sustainability agenda - the impact could be on cost of capital. As a minimum, I think everyone should cover these points qualitatively in financial statements, like sensitivity analysis or worst-case scenario. I think it's tricky to change the standard or change the measurement guidance

Analyst in London

Let’s send response to the consultation!

Management assumptions are important for reflecting climate change risk in FSs, planning for Paris alignment, and disclosing the impact on future cash flow. It is generally accepted that assemblies within five years will be disclosed based on evidence of impact.

However, it is inconsistent with the non-financial explanation. More non-financial explanations can be made, and information inconsistencies increase. In particular, Japanese companies, which have few IFRS-applied companies, tend to have few cases and few explanations behind “management assumptions”.

IFRS on climate change risk is

1. To make it easier for companies and auditors to make decisions, we recommend to make clarify the items should be disclosed based on the necessary standards, rather than only "judging by yourself".

2. we recommend to take necessary measures, such as extending the Assumption period along with non-financial measures and reviewing the requirements for long-term forecast uncertainty.

3. We would like to improve the obstacles (if any) so that company can make disclosures that are evidence of non-financial explanation.

Then, if we do not start improving the standards as soon as possible, the ISSB (International Sustainability Reporting Board) standards will begin to be created. One of the expectations that the IFRS Foundation sets the bard for sustainability reporting is its consistency with FSs. IFRS should be developed in line with ISSB development work.

Discussion is to be continued….