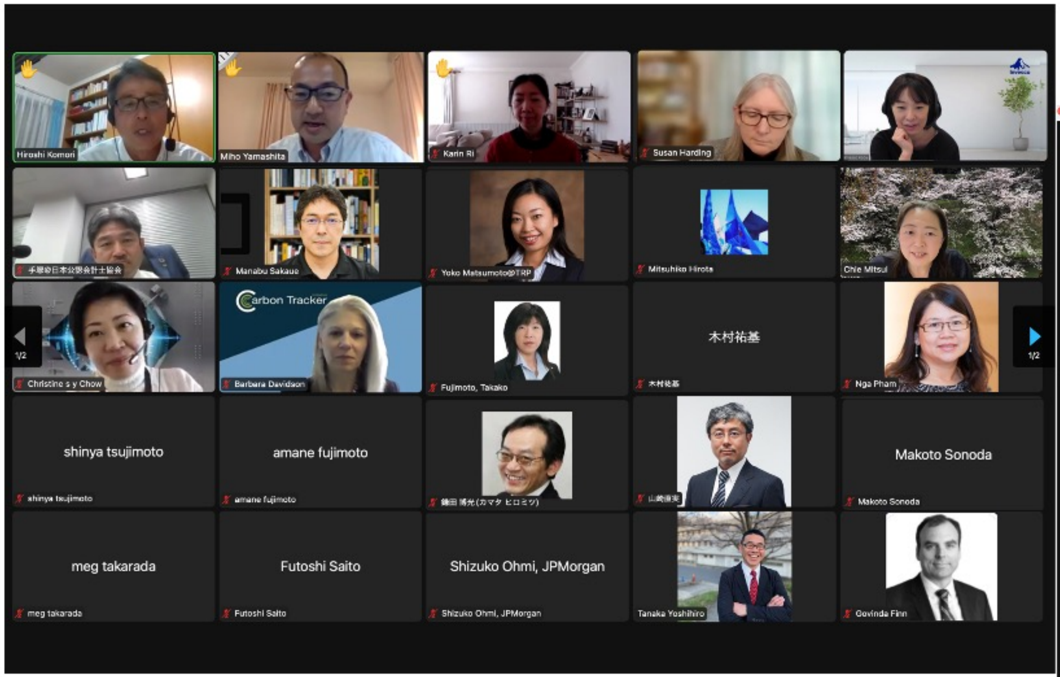
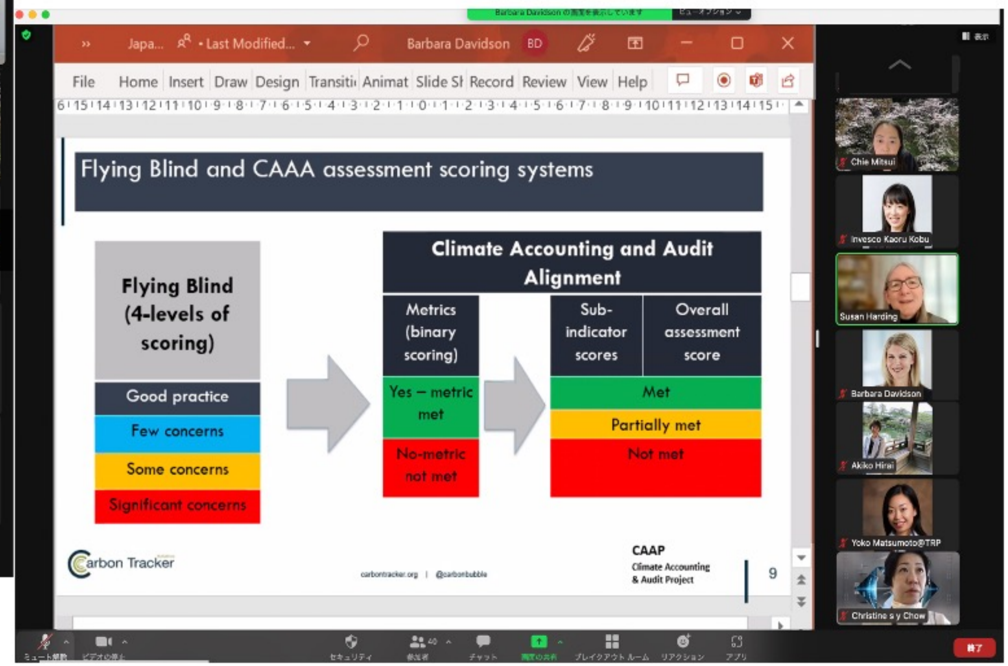
Climate Risk Financial Disclosure

(Climate Accounting Analysis II)

--- How Japanese companies can improve disclosure?! ----





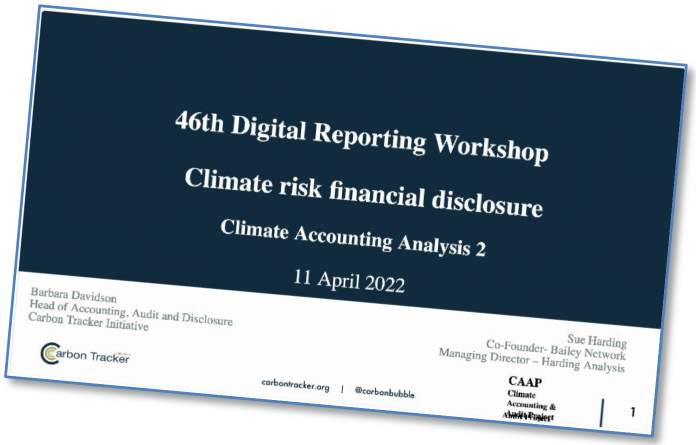
Online workshop

46th Digital Reporting Workshop

Date and time : 11th April 2022, 18:30-20:30 JST

Climate risks on the financial statements

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



We had a workshop entitled “Climate Related-risk IASB Agenda Consultation (2)” on August 25, last year. https://www.arx.cfa/~/media/F5C4FD3D590547B0AB10A636EA29E14C.ashx
An activity called Climate Accounting Analysis was introduced and discussed issues of the financial disclosure about climate risk. We were able to how difficult to disclose it.
This time, we had a second workshop on the same topic. The highlight of the second analysis is some Japanese companies' cases…

	Who join the discussion?
Attendees (Japan) *attendees have joined this workshop as private,	19 Investors, 3 Investor(Analysts) organization, 4 sell-side analyst, 1 pension & insurance & bank, 5 Information providers/Researchers, 3 Company side (include Independent non - executive director, support service), 9 Auditor, 2 academic 9 Regulator & Accounting setter & stock exchange, 2 other
Attendees (outside Japan)	4 Investors, 4 Information providers/Researchers, 1 academic, 1 other

The result of second round of Climate Accounting Analysis

Almost of all targeted companies couldn't

Target
Part of CA100+ Benchmark
164 Companies

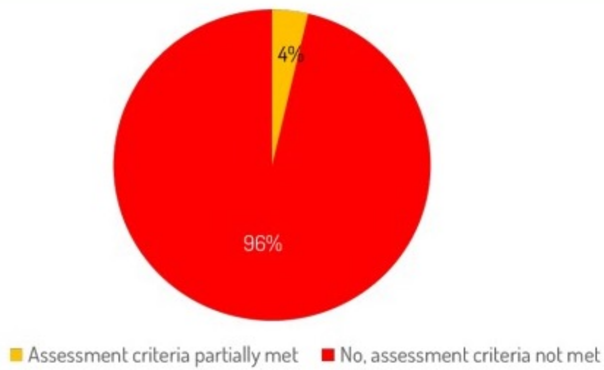
New assessment
3 Sub-indicators
・Financial statements
・Audit Report
・Alignment Net zero GHG by 2050

7 metrics
・Financial statements
1. demonstrate how material climate-related matters are incorporated.
2. disclose the quantitative climate-related assumptions and estimates.
3. are consistent with the company's other reporting (contingent on demonstration of consideration).

・Audit Report
1. identifies how the auditor has assessed the material impacts of climate-related matters (contingent on financial statement metric 1).
2. identifies inconsistencies between the financial statements and 'other information'.

Climate Accounting and Audit Alignment Assessment – Overall scores*

Sub-indicator scores	Overall assessment score
Met	
Partially met	
Not met	



*Of 164 companies assessed

No company received an overall Yes score. **Only six companies/ auditors achieved a Partial score.** These were bp, BHP, Glencore, National Grid, Rio Tinto and Shell.

- They **provided evidence of comprehensive consideration or provided quantitative disclosures.**
- All six reported using IFRS Standards.
- **Three of these companies,** Rio Tinto and Shell, received a "Partial" score only because their auditors (KPMG and EY, respectively,) scored well.

Carbon Tracker Initiative
carbontracker.org | @carbonbubble
CAAP
Climate Accounting & Audit Project

・Alignment Net zero GHG by 2050 (or sooner)
1.financial statements use, or disclose a sensitivity to, assumptions and estimates aligned with achieving this.
2. audit report identifies that the assumptions and estimates that the company used were aligned with achieving this (or provides a sensitivity analysis).

[Visit full methodology]

Why it is the accounting matters?

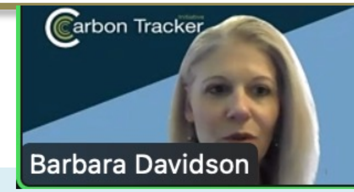
Accounting requirements affect company profitability and asset values

Climate change could be relevant for:

- asset valuations and impairments;
- useful lives of assets;
- potentially unprofitable contracts;
- provisions and liabilities arising from decommissioning, fines or penalties; and
- credit losses on loans and other financial assets

Reported profitability and asset values affect:

- investment decisions by companies and investors
- executive remuneration



Accounting requires that **the value of a company's assets and liability be reflected in the balance sheet**. They connect to the **prediction of future cash flows** and which can be materially affected by climate change. For example, climate change regulation, or phase-out of relevant products, has potential impacts on assets and liabilities. In other words, can companies continue to use these assets whether they must be retired quickly, and what is the expected liability? There are so many examples, products that will be changed with energy transitions, changing consumer preferences onerous contracts, credit losses... Companies also now have targets to reduce emissions. It may have had to change the strategy of the business, abolish some assets, or change some products to climate change demands. These assessments are not just for investors, they are also necessary for companies themselves think about how to continue investing to earn profits. Another item to note is the structure of executive compensation. For example, we have seen executive compensation targets for carbon-intensive companies include increased production or sales which may contradict the company's own emissions targets. Or, when executive compensation is primarily based on profits, management may not be incentivised to consider the impacts of climate-related issues or company strategies on the financial statements.

Investors ultimately want to know if **accounting is aligned with achieving Net Zero** by 2050 (or sooner) and a 1.5 d scenario. But financial statements should already reflect the company's consideration of climate risk and strategy, including emissions targets and the steps to achieve them. It is also important how the auditors assessed the significant impact of climate-related risk, especially in **KAM**, and **audit risk analysis**.
Regarding Japanese companies, 10 CA100 + were reviewed, but all of the scores are No. It is not special, most CA100+ companies did not fulfil the requirements of the methodology. Only two companies were J-GAAP. If a company files the 20F, the auditor is following the PCAOB. By the way, it was previously said that the consistency check of Japanese auditors was soft. However, JICPA has set requirements for clarifying the responsibilities of auditors, which came into effect in March 2022. (Auditing Standards Committee Statement 720 "Auditor's Responsibilities Related to Other Statements") Therefore, the Japanese Audit Report was also evaluated as having complete requirements.

QA

There are various challenges in reflecting climate risk in financial statements. Especially the impairment of loans (allowance for doubtful accounts). It is theoretically understandable that climate risk affects credit risk and should be reflected in lending impairment, but **IFRS 9 ECL provision stage 1 is a one-year impairment**. On the other hand, global warming is a gradual process that takes decades to progress. How do you think about these **differences in time horizon?**
What should we think about “**other natural disaster risks**”? There is a risk of earthquakes, in Japan. The cause of the earthquake has nothing to do with global warming. Should earthquake risk be reflected in the financial statements?

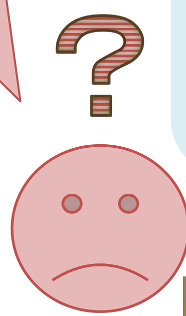
Banker Japan

Since it is not CA100 +, we didn't target financial institutions. However, every company with a finance section and has the same problem. All have **financial receivables with an impairment risk.** It has collateral value, and is necessary to evaluate how the risk affects this. As for physical risk, there can be issues of investing to make assets, for example **facilities near the sea,** more resilient, and risk relating to, for example, insurance costs and availability.

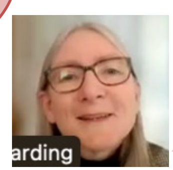
Credit losses also apply at the portfolio level. And there are certain sectors and regions where this is expected to be large. It is already happening that they have to move or modify their assets due to the impacts of physical risks such as weather conditions and the expected increase in impairment risk. **Some locations have already been affected by climate change risk.**

Management uses it judgements but they must be reasonable. **You can ask management about the reasons for their judgments** (e.g, when determining assumptions and estimates to use. The auditor also asssesses this. Investors can also ask about the sensitivity to using net zero by 2050 inputs. Mining companies may have to consider the impacts of the energy transition on demand for their products. Investors also need to ask understand if their capital is at risk including the risks to the company if we if achieving a net zero by 2050 / 1.5 degrees aligned pathway.

I recently participated in an investors group engagement dialogue with a mining company. The company has set out net zero emissions targets, considers three scenarios of energy transition. But **only one scenario is in alignment with the Paris agreement goals**. As for the assumptions used for the current financial statements, the company used a mixture of three scenarios; in other words, the assumptions behind the financial accounts are not Paris-aligned. To answer the question raised by investors about this discrepancy, **the company explained that the assumptions had reflected the general consensus and views** about the current most likely transition pathway.....



Investor
London
Investing
Japan equity

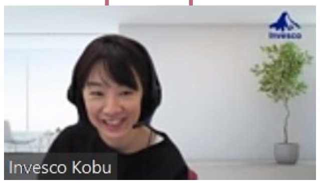


I also think **it is important to disclose those assumptions that were used.** How did the management think the response to the Paris Agreement would have an impact, how did they estimate carbon prices, what other assumptions did they make, and how did this impact cash flow and asset life? When we evaluate Benchmark, we did break down those things.

Panel Discussion !!

What did you think of today's discussion?

Investor perspective

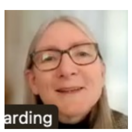


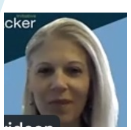
Auditor perspective

It turns out that we should ask about the **possibility that climate change risk is considered in the risk premium** when engaging. Some companies don't write quantitative information about emission reductions, but even if they don't do so, there should be an estimate by data vendors. This will be the start of the climate change risk debate between capital markets and businesses. Also, **I don't think Japanese companies have enough information to make such an assumption now.** They're building that practice right now.

I'm not surprised at the result. This is difficult for companies. Steel industry, petroleum industry, petrochemicals ... all have tremendous transition risks. Emissions are critical to investors investing in these companies. Trading companies are investing in resources and have similar risks, but they have already impaired or amortized those risks. JICPA's Auditing Standards Committee Statement 720 begins to clarify the responsibilities of auditors from the fiscal year ending March 2022. **Japanese auditors have already begun to discuss how climate risk is significant,** especially for companies that belong to industries like the one I just mentioned. We have to look carefully at the companies that have officially announced Net Zero. If an auto company announces that it will stop selling gasoline cars by 2025, the impact on the entire supply chain needs to be carefully watched. How about new technology, hydrogen reduction method, etc. for steel companies? Previously, it was said that the actual reflection of climate change risk in financial statements was a long way off, but now it is not far away…

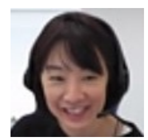
What makes corporate disclosure difficult?





The sustainability team and the accounting team may not work together, or the audit committee may not be exercising sufficient oversight. This is something that all parties have to think about together. That's why we have to clarify the impact and understand the assumptions.

In the past, it may have felt that the safe or conservative thing to do is say nothing. But the risks are there and are increasingly being acknowledged and addressed. Companies should always be doing their own risk assessments, which is changing from moment to moment, and this should be shared.



I don't think a governance system for climate change has been established yet. Many companies have non-financial targets. But I feel they are not aligned with the financial targets. For example, the three-year mid-term management plan is often shown, but it is not aligned with the 2050 Net Zero Target. How should we also integrate both non-financial and financial and then analyse the company? Investors have to learn more about how to evaluate the capabilities of the board of directors and auditors.

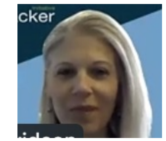
Many Japanese managements will still only think of transition risk as a "potential risk" towards net zero in 2050. The EU taxonomy also announced in January that it would include nuclear power and natural gas. **These may change again.** There are still uncertainties in the decisions of directors. It is a difficult decision for business owners to give up on their current business.

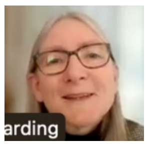
Discussion all

Investor
Japan
Pension fund

How much ready are auditors and audit firms for the difficult situation of 2030 and 2050 ?... Investors are also struggling with how to deal with the inexperienced situation.

First of all, the audit firms may be advising companies on how to disclose sustainability and TCFD. In that case, they appear to be ready. As for the audit opinions, most of the opinions that we have seen that address these issues are from the EU/UK. I don't know how many are ready in general, but examples good audit reports are Deloitte for bp, E&Y for Shell. KPMG was also good in Rio. We have seen auditors address these issues at the national level, not the global level. In the case of audit opinions for companies that file a 20F, we have seen examples where the local opinion includes a discussion of climate risks but the opinion in the 20-F does not. These different audit reports are from the same company and the same audit firm. It's very strange especially since the requirements in the US do not differ that much.





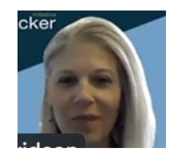
I've heard that auditors are doing a lot of work, such as training and internal guidance ... but I've never seen them manifesting themselves. They are trying to make a difference. However, I don't think there is much information about what they paid attention to and what they did in the audit report. Investors cannot know if they do a good job without disclosure. There needs to be a change in mindset.

I think the auditor is not completely ready. However, it will be relatively easy for auditors to understand human capital, human rights and climate change. I think we can understand the relationship between that information and financial statements. I'm positive about that. However, providing assurance for this information would be difficult.

ESG Analyst
Australia
Covering Japanese Companies

Companies and auditors that disclose that they are unable to make an assessment on the company's climate risk and its impact on financial statements should be forthcoming about why they are unable to do so. Investors want to understand what are the barriers or challenges in providing such an assessment.

Some auditors are also looking to see if the company is using inputs or provide sensitivities that are aligned with Net Zero. In some audit reports, we've also seen auditors challenging management's assumptions. What I'm curious about are the cases where they have emissions targets but it is not clear how achieving these targets will impact current assets and liabilities. I would like you to ask more questions about how companies intend to reach their goals, especially their interim (2030) targets. For example, will their asset lives shorten as commodity prices decline. Just ask the company. This workshop is also helpful. I hope you will take the next step.



After hearing this comment, I thought we needed more basic scientific numbers. That would make it easier for companies to make better assumptions and be evaluated by auditors.

What we found this discussion?

- Impact from climate change risk is no longer far in the future; it can impact current financial statements
- It is essential to reflect the impacts in the FSs, but there are few companies have. Inconsistent with the scenario have been seen in many companies. Even if it’s a work in process, this information is necessary.
- Similarly, investors and auditors are in the process of better understanding these issues.
- All stakeholders need to work together.

However, even if a large company responds first, some smaller compnies do not care about such trend.

It is expected that the disclosure difference should become wider.

Investor in Japan

What should Japan and Asian countries do?

The effective stewardship and CG codes working together as a positive reinforcement cycle that validates the significance of quality, consistent and transparent reporting that inform all stakeholders is important. It's a matter of discussion together. It's not easy, but I think Japan can take leadership. There is a community to discuss in Japan.

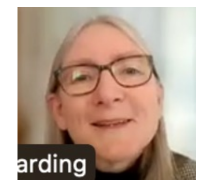
Investor London

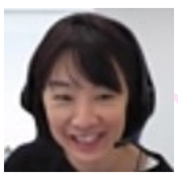
The IFRS Foundation's Asia / Oceania office is also located in Tokyo.
We want to do our best together with Asian and Oceanian countries for better sustainability disclosure.

Toward future, next step

Investors should engage with companies to disclose the information investors need to better understand these issues. At the same time engage with auditors or audit committees (or the equivalent). Auditors should interact with audit committees / Boards to understand what impact climate change risk has and how they intend to resolve it, and show evidence of consideration. We are not looking for perfection. It's important to see what was considered, even if it wasn't aligned with achieving net-zero by 2050. And it is important to ask why climate-related issues are not reflected in the FSs. We are all in the process of learning. **I find the formation of the ISSB (International Sustainability Standards Board) very positive.** I especially hope it will help improve consistency across a company's reporting. Oversight by the IFRS Foundation which has an established due process and oversees the IASB is another positive aspect of the ISSB.

I also think that ISSB's inclusion under the IFRS Foundation will help with connectivity. In the first place, what kind of information that is outside the financial statements is not financially connected? **When IFRS foundation handles narrative reports its connectivity should make the two proceed together** and it will be easier to use for investors. Auditors can also see this connectivity. Narrative reports can also help to understand the FSs. Both can help each other. It's great, but there would be challenges in the future to move forward.





Many large companies can improve themselves. But at the same time, we also **have to engage with small companies.** They still don't really know what the climate change disclosure will be like. It just says "climate change is important". It is expected that climate and other various ESG risks to be reflected in their long-term strategies and financial target.

Tokyo Stock Exchange recently made a market reform, the new PRIME market still includes 1800 companies. Some companies are very, very small. In my opinion, I wonder whether all of them can disclose climate change risk at the right time. We must push the preparer's climate change disclosures. The collaboration between ISSB and IASB is critical. Management commentary will connect the two. I would like to pay attention to these developments.

Discussion is to be continued….

Other information from Carbon Tracker

CTI Power and Utilities sector research -Japan

Japan should seek to rapidly reduce its dependence on the increasingly volatile LNG market.

- Price spikes drove Japanese retail energy prices up to five-year highs in 2021
- Expect increased competition from European buyers => reduce dependence Russian supplies
- Japan should reduce LNG market exposure to protect the public from effects of future price spikes

Around 60% (6 GW) of Japan's planned pipeline of new gas-fired power stations is unviable to build under a NZE2050 scenario.

- Japan has a legally binding target of reaching net zero emissions by mid-century.
- If closures of unabated gas plants are enforced in time to deliver this goal, new build units in Japan will be operational for only 10 years before being shuttered,
- Owners could risk missing out on 2/3 of anticipated cash flows.

New renewables capacity competes favourably on cost with Japanese gas-fired power stations. We project:

- It will be cheaper to build new solar and onshore wind capacity in Japan than new gas plant capacity by 2024 and 2025, and existing gas capacity by 2026 and 2027, respectively.
- New solar w/ battery storage technology will become cost competitive by the early 2030s

More information
https://carbontracker.org/reports/stop-fuelling-uncertainty-why-asia-should-avoid-the-lng-trap/