CLIMATE-RELATED DISCLOSURES: PREDICTING THE DIRECTION OF TRAVEL

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As the urgency of addressing climate change continues to gain traction (see Climate change by the numbers) and as the risks posed by a failure to meet global net-zero emissions targets are catalogued with greater precision, pressures to promulgate climate-related disclosure requirements for public companies are likely to produce, in very short order, a fundamental shift in corporate disclosure. Regulators outside the United States are further ahead of their US counterparts in terms of embracing climate-related disclosure requirements, but that too is changing.

- In the United States, the staff of the Securities and Exchange Commission ("SEC") has been directed by Chair Gensler to develop rules mandating climate risk disclosure, which would represent the first such rulemaking by the SEC, going well beyond the interpretive guidance issued by the SEC in 2010 that was based on then existing disclosure principles (which are largely unchanged today).
- In the European Union, there are a range of inter-locking initiatives that form part of the EU's action plan for financing sustainable growth and the European Green Deal. These include updates to the Non-Financial Reporting Directive, new technical standards for the Regulation on sustainability-related disclosures in the financial services sector, a classification system for environmentally sustainable economic activities under the EU Regulation on the establishment of a framework to facilitate sustainable investment, and a proposed Corporate Sustainability Reporting Directive. The United Kingdom, now outside the European Union, has its own climate-related disclosure initiatives.
- At COP26, the Trustees of the IFRS Foundation launched the International Sustainability Standards Board (ISSB) to set sustainability standards under IFRS (the accounting standards generally followed across the globe, except in the United States), which has the blessing of the organization behind the Task Force on Climate-related Financial Disclosures (TCFD), the Value Reporting Foundation (formed by the Sustainability Accounting Standards Board and the International Integrated Reporting Council) and the Climate Disclosure Standards Board (see Launch of ISSB). The ISSB will be setting out IFRS Sustainability Disclosure Standards.

While the foregoing initiatives are in various stages of development and evolution, there is good reason for public companies to be following the unmistakable trend towards mandatory climate disclosure and to be considering the impact not only of updated, or new, climate-related disclosure requirements, but also the potential interplay between those disclosure requirements and financial reporting reflected in their financial statements.

For SEC reporting companies, the most significant change in the reporting landscape could be a move to mandatory line item disclosure, in place of the principles-based approach enshrined in existing SEC disclosure requirements. The timing of the recently released Sample Letter to Companies Regarding Climate Change Disclosures is curious in that it supports an argument advanced by those critical of

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mandatory line item disclosure, namely that the existing disclosure principles that underpin the business, risk factor and MD&A sections of SEC periodic reports, together with guidance set forth in various SEC interpretive releases issued over the years (dating, in the case of MD&A, back to 1989), should have been sufficient to prompt a range of climate-related disclosures, including the items listed in the Sample Letter, subject to the overriding qualification of materiality (which threshold the Sample Letter preserves).

While predictions around SEC action, prompted in large part by the change in administration and the forceful statements made in support of a more directed approach by the SEC issued first by then Acting SEC Chair Allison Herren Lee and then Chair Gensler, have focused on the "front half" of SEC reports, less has been said about the "back half" – the financial statements. It would be a mistake though to lose sight of the potential impact of evolving climate-related disclosure obligations on financial reporting.

Commentators outside the United States, in particular, have focused for a few years now on the question of whether IFRS requirements need to be updated to reflect climate-related consequences to businesses, which commentaries also highlight that, like existing textual disclosure requirements, existing IFRS requirements should have prompted more climate-related disclosure in financial statements. Disclosure could flow from specific line item requirements, or the overall requirement (*e.g.,* in IAS 1) to disclose in financial statement notes information not presented elsewhere in the financial statements but relevant to an understanding of them. Taken together, these could include, for example, the possible impact of:

- physical risk and transition risk on asset values, potentially triggering impairment
- the effects of climate change in terms of litigation risk
- the effects of climate change on duration of asset viability for purposes of depreciation and amortisation expense
- the effects of climate change on fair value measurements
- climate mitigation efforts on reserves for accelerated obsolescence
- commitments to achieve net zero on depreciation of assets that need to be decommissioned
- stranded assets or decreased production capability
- potential changes in legislation in response to climate change
- voluntary participation in carbon pricing programs
- the use by financial institutions of the Partnership for Carbon Accounting Financials (PCAF) standards (Scope 1, 2 and 3) on corporate liquidity

In September 2021, the Center for Audit Quality ("CAQ") released a paper, Audited Financial Statements and Climate-Related Risk Considerations, in which it notes that, while US GAAP does not explicitly refer to climate-related risks, companies are required to consider these risks when the effect could reasonably be material to the financial statements. Financial reporting requirements for climate-related risks will, by definition, vary from company to company and depend on multiple factors, including the nature of the business, the industry, geographic footprint and the significance of the climate-related risk to the business, among others. The CAQ is cognizant of the growing trend of companies to make public commitments to be carbon neutral or carbon negative by a specified date. The financial reporting impact of these commitments similarly will vary depending on a range of factors, such as management actions taken or proposed to be taken to achieve these commitments, the timing of those management actions and the associated costs. Ultimately, US GAAP recognizes that management's assessment of

materiality is a key consideration, and the dates chosen for climate-related commitments will be a critical component of the required assessments.

Separately, from an audit perspective, the CAQ notes that auditors would consider information outside the financial statements, including public statements, transcripts of earnings calls, sustainability reports and the “front half” of SEC reports (including the business description, discussion of legal proceedings, risk factors and MD&A) and, under applicable standards of the Public Company Accounting Oversight Board (PCAOB), would consider “whether such information, or the manner of its presentation, is materially inconsistent with information appearing in the audited financial statements.” The CAQ recognizes that the dialogue among stakeholders as to whether, and if so how, financial reporting requirements for climate-related risks need to be adapted to meet evolving needs, is an ongoing one.

Public companies should be considering the potential impact of SEC rulemaking on how they describe their businesses, and draft risk factors and MD&A, in the context of a range of consequences flowing from climate change. There could also be an accompanying Staff Accounting Bulletin, but even if there is not, the impact of updated guidance in respect of climate-related disclosures or new climate-related disclosure rules, or both, will likely affect both the “front half” and the “back half” of annual and other periodic reports. While the scope of SEC rulemaking and the timing of the proposals (and related implementation dates) are uncertain, the direction of travel should be viewed as unmistakable.

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