MOORE

WILL CLIMATE RISKS AFFECT YOUR FINANCIAL STATEMENTS?

INTRODUCTION

The focus on sustainability and the rapid advancements in sustainability reporting standards have been developing at a frenzied pace. To remain relevant and competitive and to comply with relevant recommended reporting requirements, businesses must consider how climate-related risks affect their financial statements. This article focuses on how climate-related risks can impact financial statements.

Globally on 26 June 2023, the International Sustainability Standards Board (ISSB) issued the International Financial Report Standards (IFRS) S1 General Requirements for Disclosure of Sustainability-related Financial Information (IFRS S1) and IFRS S2 Climate-related Disclosures (IFRS S2). These two sustainability standards listed are effective for annual reporting periods beginning on or after 1 January 2024. In Singapore listed companies and large companies - annual revenue exceeding S$1 billion and total assets exceeding S$500 million are required from FY2025 and FY2027 respectively to apply both standards together to be compliant with the IFRS Sustainability Disclosure Standards.

IFRS S2 builds on the requirements of IFRS S1 and integrates the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) to provide a global baseline for companies to disclose climate-related financial information. An important principle in the ISSB standards is the concept of "connected information". This concept centers on how the information disclosed in the company's sustainability report are addressed and how they affect the company's financial statements. It is therefore important to disclose and explain to the users of general purpose financial statements, how sustainability information is linked to the relevant information in the financial statements.

While IFRS S1 and S2 adoption is voluntary for non listed and smaller companies, more jurisdictions and companies are embracing these sustainability standards. This means that we can expect to see more climate-related information in 2025 based on companies applying the sustainability standards for their 2024 reporting cycle.

WHAT ARE CLIMATE RELATED PHYSICAL AND TRANSITION RISKS

Let us first examine climate-related risks and how climate uncertainties can potentially affect your financial statements.

Climate-related risks, as defined by IFRS S2, comprise of climate-related physical risks and transition risks:

Physical Risk

Physical Risks can be acute (event-driven) or chronic (from longer-term shifts in climatic patterns). Climate chaos such as storms, floods, droughts, heatwaves are just some types of acute physical risks. Examples of chronic physical risks are changes in precipitation and temperature which could lead to sea level rise, reduced water availability, biodiversity loss and changes in soil productivity.

Transition Risk

Transition Risks are those arising from efforts to transition to a lower-carbon economy. Examples of Transition Risks include policy, legal, technological, market and reputational risks.

These climate-related risks can have a financial impact on the financial statements.

HOW FINANCIAL STATISTICS ARE AFFECTED?

	Illustrative Potential Impact on Balance Sheet	Illustrative Potential Impact on Income Statement
Physical Risks and Transition Risks	**Valuation of property, plant & equipment (PPE)** • Damaged PPE or early retirement of PPE to comply with greenhouse gas (GHG) emissions regulations • Potential impairment of PPE due to restrictions (or drop in revenue resulting from changes in customer preference for goods produced by existing machinery) • Change in depreciation due to shorter useful lives and/or lower residual values	• PPE write-offs • Higher depreciation expense • Impairment loss on PPE • Higher depreciation expense
	Valuation of inventory • Inventory write-off due to extreme weather event • Inventory obsolescence due to changing customer preferences driven by concerns about high emissions	• Higher inventory write-off/Higher allowance for inventory obsolescence • Higher costs to comply with safety of products or tracking of emissions • Potential costs due to disruption to supply chain.
	• **Recognition of contingent liabilities and provisions**	• Higher carbon pricing • Higher research & development expenses in new & alternative technology • Higher compliance costs/decommissioning or abandonment costs/penalties/insurance premiums/onerous contracts • Higher costs to track emissions • Changes in resource availability and energy prices
	• **Recognition of sustainability-linked loans and potential embedded derivatives;** • **Classification of sustainability-linked loans as compliance with loan covenants linked to sustainability targets can be hard to determine** • **Accounting for carbon credits or emission trading allowances**	• Gain/loss on recalculation of the gross carrying amount of sustainability-linked loans at amortised cost when changes in cashflows arising from the sustainability -linked feature do not reflect market interest rate movements. • Fair value changes of embedded derivatives • Accounting treatment for carbon credits/emission trading allowances to be determined

[1] *A more comprehensive discussion on climate-related risks and potential financial impacts can be found in the "Final Report on the Recommendations of the Task Force on Climate-Related Financial Disclosures".*

IMPACT ON DISCLOSURE IN FINANCIAL STATEMENTS

There is growing interest among investors and other stakeholders in understanding how the key assumptions and judgments underlying the information disclosed in the annual report on climate-related matters align with the financial statements. This increasing attention has heightened the need for companies to bridge the information gap by providing enhanced disclosures on the impact of climate-related matters in their financial statements.

Beyond the disclosures required by specific accounting standards, companies must also consider the overarching disclosure requirements of International Accounting Standards (IAS) 1. Information is considered as material if its omission, misstatement, or obscuring could reasonably be expected to influence the decisions of primary users of financial statements. Companies can include the potential effects of climate-related matters in their disclosures, some examples are as follows:

Assumptions on the major sources of estimation uncertainty and about the future that have a significant risk of causing a material adjustment to carrying amounts in the next financial year.

For example, impact of climate change on the cost base of the asset or adjustments to forecast income expected to be generated from the asset should be considered in the cash flow projections for estimating the value-in-use (VIU) of non-financial assets.

Significant judgments that have material effect on amounts recognised in the financial statements.

As an illustration, companies will estimate VIU of the cash generating unit (CGU) for impairment testing of goodwill. The cash flow estimation is usually premised on a five-year forecast and the final year cash flow is used to extrapolate cash flows to calculate the terminal value. There is an underlying assumption in the extrapolation the business has a steady state of development. However, some businesses may have climate transition actions which will not be completed within the five-year forecast period. Management has therefore assessed that it will be more appropriate for a longer cash flow forecast period so that the impact from climate transition can be properly incorporated in the cash flow projections. The final year of the extended forecast period is then used to calculate the terminal value. In this scenario, the company should therefore disclose that the longer cash flow projection period and the rationale for using a period of more than five years.

The impact of specific transactions, events, or conditions necessary to provide an adequate understanding of the entity's financial position and performance.

For instance, there could be new or changes to legislation due to climate change that have not been enacted at the reporting date. Companies should still consider the effect of the legislation on the financial statements and make appropriate disclosures.

In a nutshell, while changes in key assumptions related to climate-related risks may or may not necessarily lead to material adjustments in the measurement of assets and liabilities for the immediate future, the impact over the longer term could well be significant. Such adjustments over the longer term could be substantial. Given these circumstances and investor expectations, companies should consider disclosing key assumptions related to climate-related risks, even if the risk of material adjustments immediately in the next financial year is deemed low.

IMPLEMENTATION OF CLIMATE REPORTING IN SINGAPORE

In Singapore, the implementation of mandatory climate reporting will be phased in over the next few years:

From Financial Year (FY) 2025: all listed companies in Singapore must report on Scope 1 and 2 emissions.

From FY2026: SGX RegCo will conduct an in-depth review of listed companies' experience and readiness in reporting Scope 3 GHG emissions and create the implementation roadmap for disclosures of Scope 3 GHG emissions. Ample notice will be given to issuers prior to effective date. In the implementation roadmap, larger issuers will likely be prioritised for reporting.

From FY2027: large non-listed companies (those with annual revenue of at least S$1 billion and total assets of at least S$500 million must report on Scope 1 and Scope 2 emissions (excluding Scope 3).

No earlier than FY2029: large non-listed companies may need to report on Scope 3 emissions.

The Singapore Business Federation (SBF) recently launched NetZeroHub.SG, a free platform to assist local companies in Singapore to calculate emissions using approximately 200 factors tailored specifically to the Singapore context. This is timely as all listed companies are required to report their Scope 1 and 2 emissions from FY2025.

WHAT'S COMING?

2024 is a critical year to start considering the impact of climate risks on financial statements as businesses step up on their implementation of various climate transition strategies amid global regulatory shift towards mandatory climate-related reporting and the rise of compliance carbon markets and ecosystem.

IFRS S1 and S2 are principle-based standardise. The market requires more practical guidance as investors seek transparency on consistent information between sustainability report and the financial statements. To address these concerns, the International Accounting Standards Board (IASB) published the Exposure Draft Climate-related and Other Uncertainties in the Financial Statements in July 2024. There are eight proposed principles-based illustrations on how an entity can apply the requirements in IFRS Accounting Standards to report the effects of climate-related and other uncertainties in its financial statements. These examples focus on areas such as materiality judgments, disaggregation of information, and disclosures about assumptions and estimation uncertainties. They can also be applied equally to other types of uncertainties beyond climate-related uncertainties.

This example illustrates how an entity discloses information about its impairment testing affected by key assumption about future GHG emissions. For example, a company's operations generate a substantial amount of GHG emissions and it is subject to GHG emissions regulations in several jurisdictions where it operates. The company needs to acquire emission allowances in certain of the jurisdictions it operates in due to jurisdictional regulations. The company expects such regulations will become more widespread in the future.

The company has allocated a significant amount of goodwill to one of its CGUs and tests this CGU for impairment at least annually. The entity has identified its assumptions about future emission allowance costs as key assumptions, meaning they are among the most sensitive factors affecting the CGU's recoverable amount. Applying paragraphs 33–38 of IAS 36 Impairment of Assets in measuring the CGU's value in use, the entity bases cash flow projections on assumptions that represent management's best estimate of the range of economic conditions that will exist in the future. These assumptions include assumptions about future emission allowance costs.

In applying IAS 36, the company must disclose its key assumptions, including those emission allowance cost assumptions such as the future price of GHG emission allowances and the future scope of emission regulations. It will also have to explain its approach to determining the values assigned to these key assumptions. For example, the company should disclose whether its assumption about the future price of GHG emission allowances is consistent with external sources of information and, if not, how and why it differs from such sources of information.

The company also evaluates whether an impairment loss would result from a reasonably possible change in the entity's assumption about the future price of GHG emission allowances. If so, the amount by which the CGU's recoverable amount exceeds its carrying amount; the values assigned to the key assumption; and the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure the recoverable amount, in order for the CGU's recoverable amount to be equal to its carrying amount must be disclosed.

Ensuring consistency between information about climate-related uncertainties in financial statements and sustainability reports is essential for enhancing investor confidence and attracting capital and external financing. It is also pertinent for directors to consider the increased potential liabilities associated with climate-risk reporting, disclosures and the risk of greenwashing.

The Exposure Draft is open for comment until 28 November 2024.

We should be watching this space.

To find out more, please reach out to:

Lao Mei Leng
Partner, Assurance & Advisory, Sustainability
E: laomeileng@moorestephens.com.sg
T: +65 6329 2706

Michelle Chong
Partner, Assurance & Advisory, Risk Management
E: michellechong@moorestephens.com.sg
T: +65 6329 2775

Tan Lip Kiam
Director, Assurance & Advisory, Sustainability
E: tanlipkiam@moorestephens.com.sg
T: +65 6329 2685
