How is the impact of climate change reflected in the financial statements of the NZX50?

An analysis of NZX50 June-September 2023 reporters

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This publication continues our investigation into NZX50 companies and their journey to prepare for the adoption of the Aotearoa New Zealand Climate Standards (NZ CS). It follows our earlier analysis of March, June and December 2022 and March 2023 reporters.

In this latest version, we revisit NZX50 June-September reporters to see how, and what, they are reporting this year. Once again, our focus is on how climate-related risks and impacts on the financial statements were disclosed and how auditors considered climate-related impacts in key audit matters (KAMs).

This report includes reviews of companies from a variety of industries, many in sectors that are likely to be impacted by climate-related risks including several companies from the industrials, utilities, real estate and financial services sectors.

In our previous reviews, the number of entities discussing climate-related risks and impacts in their financial statements has varied from one reporting season to the next. Those who are more likely to be impacted by climate-related risks and impacts (and often those with the largest market capitalisation) started to make disclosures earlier than most. Although some entities are starting to provide better quality, more entity-specific considerations compared to the disclosures we have seen previously, overall the disclosures continue to be brief.

In line with the expectations of the Financial Markets Authority (FMA) on the impact of climate risks in financial reporting, we hope to see a significant increase in the number of entities discussing climate-related risks and impacts in their financial statements. We would also expect to see a lift in the general quality of those disclosures as Climate Reporting Entities (CREs)[1] start reporting under the NZ CS.

1 Around 200 large financial institutions covered by the FMC Act are required to publish climate-related disclosures for financial years commencing on or after 1 January 2023, in accordance with the NZ CS published by the External Reporting Board (XRB). The organisations are known as Climate Reporting Entities (CREs). CREs include large listed companies (large meaning a market capitalisation exceeding $60 million); large registered banks, licensed insurers, credit unions, building societies, and managers of investment schemes (large meaning assets exceeding $1 billion). Some Crown financial institutions (via letters of expectation) are also expected to report.

Key findings[2] (compared to June-September 2022 NZX50 reporters):

- **30 (2022: 28) businesses** on the NZX50 with 30 June-30 September year ends have completed their financial reporting.
- **15 (2022: 9) reporters** discussed the impact of climate-related risks in their financial statements.
- **29 (2022: 24) reporters** published climate-related disclosures outside the financial statements.
- **8 (2022: 0) reporters** voluntarily early adopted or (without stating full compliance) reported 'in line with' or 'with reference to' the Aotearoa New Zealand Climate Standards.
- **8 (2022: 8) businesses** disclosed the use of green finance.
- **4 (2022: 3) audit reports** mentioned climate change in KAMs.

Additional key findings for June-September 2023 NZX50 reporters:

- **14 businesses** discussed the recent extreme weather events (four in the financial statements and 10 outside of the financial statements in the annual report).
- **4 businesses** quantified the impacts of the recent extreme weather events (three in the financial statements and one outside of the financial statements in the annual report).

2 In our analysis we looked through the Fonterra Shareholders Fund and included data from the financial statements and sustainability report of Fonterra Cooperative Group Limited (Fonterra Cooperative) given the Fund invests only in the economic rights of Fonterra Cooperative.

How did June-September 2023 reporters reflect climate-related impacts in their financial statements?

Our review found that all of the reporters who mentioned climate change in their financial statements last year, also did so this year. A few more reporters who did not in 2022, made disclosures this year.

As entities prepare for the adoption of the NZ CS, they will be required to identify any material climate-related risks and opportunities relevant for their business. The next step is to also consider how those may impact the preparation of the financial statements. (For more on this refer to the section below on the External Reporting Board (XRB) Staff Guidance on climate-related matters in the financial statements).

A significant change has been that eight of the reporters voluntarily adopted early or chose to report 'in line with' the NZ CS one year before it becomes mandatory. Doing this reflects a higher level of maturity in thinking about climate-related impacts relevant to their businesses. Six of these same reporters also discussed climate-related impacts in their financial statements.

The discussion of financial reporting impacts of climate-related matters remains brief and generic. However we are also starting to see more thought coming through in entity-specific disclosures. Some reporters that had more extensive disclosures last year continued to build on that momentum as their thinking about climate-related impacts on their business matured. These reporters provided more granular information on what was considered and how, with a better connection between what was discussed in climate-related disclosures outside of the financial statements.

Four businesses quantified the impacts of the recent extreme weather events such as physical damage of property, insurance reimbursements or business interruptions.

Examples of what we have seen

Below are some extracts of disclosures where the reporter started making connections between the climate-related risks identified in their climate-related disclosures and what was discussed in their financial statements including explaining how some of those risks were considered.

In their 2023 Annual Report, **Freightways Group Limited** (Freightways) identified the potential of extreme weather events and sea level rise to cause prolonged or sustained disruption to the transport network as a significant physical climate-related risk in its climate-related disclosures. They highlighted that those risks could result in higher costs for transportation (among other operational impacts).

PHYSICAL CLIMATE RISKS

TABLE 2: SIGNIFICANT PHYSICAL CLIMATE-RELATED RISKS

RISK TO FREIGHTWAYS	CLIMATIC DRIVERS	TCFD RISK TYPE	OPERATIONAL IMPACT
1. Extreme weather events and sea level rise cause prolonged/sustained disruptions to the transport network	Extreme weather Sea level rise Increased temperature	Acute/chronic	Temporary disruption to certain transport routes Delays in service delivery $\boxed{\text{Higher costs for transportation}}$ Significant alteration to network design, routes

In their "Impairment tests for indefinite life intangible assets" financial statements note disclosure, Freightways discussed how the risk of increased costs of transportation could be managed and recouped. Because of this, no adjustments have been made to the forecast cash flows in the value-in-use (VIU) calculations in relation to climate change.

(i) Key assumptions used for value-in-use calculations

On an annual basis, the recoverable amount of goodwill and brand names is determined based on the greater of value-in-use and fair value less costs of disposal calculations specific to the CGU or group of CGUs associated with both goodwill and brand names.

The value-in-use calculations use pre-tax cash flow projections based on financial budgets prepared by management and approved by the Board for the year ended 30 June 2024. Cash flows beyond June 2024 have been extrapolated using growth rates which take into consideration current and forecast economic conditions for the relevant products and industries. A probabilistic approach was also adopted where a number of different growth scenarios were considered and weighted by likelihood of achievement. In addition, the sensitivity of the main financial variables was tested and considered in the final estimation. No adjustments have been made to forecast cash flows for the unknown impacts of future legislative changes in relation to climate change, as further disclosed in the note "Climate change" below.

Revenue growth rates and a consistent EBITDA margin assuming costs increase in line with revenue, reflecting both historical and expected growth, have been applied to the value-in-use calculation with the same scenarios and sensitivities applied as described in the Significant estimate – sensitive to changes in assumptions section below. Growth rates have been aligned with the observed long-term inflation for each geographic region and each CGU's ability to increase customer prices and grow with nominal GDP. Pre-tax discount rates, reflecting the current environment in financial markets and the countries each CGU or group of CGUs operates in, have been used. The CGU or group of CGUs specific growth rates and pre-tax discount rates applied are:

Climate change

Freightways strongly believes that sustainable business practices are fundamental to our future. These include minimising the environmental impact of our daily operations and actively seeking initiatives to protect the environment.

More than 95% of Freightways' emissions come from the combustion of transport fuel, including that of our contracted couriers. The most significant financial impact would therefore be due to an increase to the cost of fuel and the cost of carbon credits linked to the volume of fuel used. Freightways would expect, however, to be able to recoup most of that impact as mechanisms are already in place to adjust prices for movement of the price of fuel. The risk of disruption due to natural events linked to climate change can be managed through the flexibility of our network across New Zealand. Finally, most of the vehicles used in the Express Packaging businesses are owned by contractors and Freightways is exploring ways through which it will be able to facilitate the transition of the vehicles to electric or hydrogen.

The auditor's report to the shareholders of Freightways included a Key Audit Matter (KAM) related to the impairment assessment of goodwill and indefinite lived brand names. The auditor's audit procedures relating to the estimates and judgements in the VIU models included obtaining an understanding of management's assessment of the likely impacts of climate change.

"Based on the level of headroom and the sensitivity to impairment of each CGU, our audit procedures relating to the estimations and judgments in the VIU models included...obtaining an understanding of the current and forecast outlook for the business and management's basis for determining the key assumptions in preparing the forecast cash flows. This included management's assessment of the likely impact of climate change..."

Fonterra Co-operative (Fonterra) disclosed changing customer and consumer preferences as a climate risk relevant to the business, which might result in a decrease in demand, price impacts etc. Fonterra also identified changing market regulations and market access as a climate risk which could result in a reduction in demand or supply.

Risk	Description	Risk type	Location	Time horizon	Anticipated impacts	Strategic mitigations
Changing customer and consumer preferences	Shift in customer and/or consumer preferences away from Fonterra products due to environmental credentials relative to competitors, which may result in a decrease in demand, price impacts, the ability to return sufficient value for farmer shareholders and/or a decrease in milk supply.	Transition	Global	Long	We anticipate there will be increased consumer interest in dairy alternatives such as plant-based or lab-derived options, but global demand for sustainable dairy will continue. Our ability to differentiate on sustainability will be critical. Our leading low-emissions dairy position coupled with our emissions reduction plans will help protect our long-term customer relationships and grow brand value. This will require ongoing investment, resource and partnerships to deliver our climate ambitions.	– Deliver our Climate Roadmap – Continue to develop sustainability solutions for customers, including partnership and co-investment opportunities – Continue to deliver on-farm support (e.g. Farm Environment Plans and Co-operative Difference)
Changing regulations and market access	Changes in local and global regulations creating an inability for the Co-op and farmers to meet compliance obligations, customer requirements and/or access markets, which may result in either a reduction in demand or supply.	Transition	Global	Medium Long	We anticipate the regulatory landscape will continue to prioritise climate activities alongside credible and transparent reporting. We also anticipate the global regulatory landscape will increasingly incorporate climate objectives, such as carbon border adjustment mechanisms, which will influence how we will access markets in the future. This will require ongoing monitoring and resource to effectively respond to regulatory changes.	– Monitor domestic and global regulatory landscape – Continue to participate in policy consultations – Advocate for our sustainability credentials to maintain market access – Continue to deliver on-farm support (e.g. Farm Environment Plans and the Co-operative Difference)

Source: Fonterra Climate-related Disclosures 2023

In its financial statements, under estimates of useful lives of PPE, Fonterra disclosed that the impact of these risks, consistent with its climate-related disclosures, were considered in estimating the useful lives and residual value of existing assets.

Judgement is involved in determining the assets' residual values and useful lives, which are reviewed and adjusted each financial year, based on the Group's ten year outlook.

The estimates of useful lives may be impacted by climate-related risks in future and changes in expectations, for example the following events may shorten estimated useful lives of existing assets and result in an acceleration of depreciation:

- Milk supply and demand: In the event milk supply and demand reduce faster than expected, a plant closure may become necessary before the end of an existing asset's useful life; and
- Capital expenditure: In the event regulatory change or other factors require larger or earlier future investments, existing assets may need to be replaced before the end of their useful lives.

The Group's New Zealand ingredients manufacturing sites are utilised as a single network for processing raw milk supply. In estimating useful lives and residual values of its New Zealand ingredients manufacturing assets, the Group has considered the impact of:

- Possible flat or declining milk supply scenarios (together with individual plant peak milk processing requirements);
- Regulatory or environmental matters (such as the New Zealand Government's Emissions Reduction Plan);
- The Group's investment in sustainability, including its decarbonisation plan to exit coal by 2037 and electrification of the vehicle fleet;
- Technological advancements; and
- Changing consumer preferences and market competition.

Source: Fonterra Financial Statements 2023

On the flipside to the examples above, some entities that did mention that climate-related impacts were considered in the preparation of financial statements, did not explain how those impacts were considered. And some who did have climate-related disclosures, did not discuss any risks identified in those statements in the financial statements.

Has New Zealand's record breaking weather affected what was reported?

The National Institute of Water and Atmospheric Research (NIWA) reported that climate change led New Zealand to record warm temperatures throughout 2023 and exacerbated the extreme rainfall events during the first half of the year.[3] These weather events claimed lives, displaced many, and brought destruction of assets and infrastructure.

Unsurprisingly, 14 reporters (four in the financial statements and ten outside) discussed the impacts of those weather events, including physical damage to their assets, business interruptions etc. However, even though it seems that the world is already starting to experience the impacts of climate change, not all entities who discussed these extreme weather events somewhere in their annual report, considered climate-related risks and related impacts in their financial statements. Certain entities who reported physical damage of assets as a result of the 2023 weather events, still concluded that they do not expect a material impact as a result of future climate-related impacts.

How did auditors respond?

Out of the 30 audit reports four made reference to climate change in Key Audit Matters (KAMs). There were a further two KAMs where the KAM itself did not mention climate change but was related to note disclosures which did.

KAMs relate to matters that are considered the most significant in the audit of the financial statements and where the auditor applied the most judgement. They provide transparency to the auditor's findings.

Climate change can increase estimation uncertainties, impact the assumptions about future scenarios and the likelihood of those scenarios used in accounting estimates. Therefore, it is not surprising that KAMs that mentioned climate change were related to matters requiring the organisation to assess the impact of climate-related matters on key assumptions used in accounting estimates: the valuation of property, plant and equipment, impairment assessments and estimation of useful life of assets.

The upcoming Aotearoa New Zealand Climate Standards

From 1 January 2023, CREs are now required to prepare annual climate statements in accordance with the NZ CS issued by the XRB. This means that reporters with 31 December 2023 reporting date will be the first to mandatorily prepare their climate-related disclosures in compliance with those standards.

As mentioned above, eight NZX50 reporters with June-September 2023 year ends have voluntarily adopted early or (without stating full compliance) reported 'in line with' or 'with reference to' the Aotearoa New Zealand Climate Standards this year.

Others have stated that they are in the process of developing a pathway to be ready for the new standards. This will include a process of identifying climate-related risks and opportunities relevant for their business.

Those who will have to report under the NZ CS next year, should start preparing now, if they have not yet. Based on our experience, significant effort is required to be ready to report under the NZ CS. There are risks to be understood, data to be sourced and processes implemented.

Consideration of the NZ CS may help companies better identify matters, including climate change, that affect the financial statements. We expect that as CREs start publishing climate disclosures, we will see more reporters providing quality discussion about the impact of climate change in their financial statements.

XRB staff guidance on climate-related matters in the financial statements

In November 2023, the XRB issued Staff Guidance on Climate-related matters in financial statements to help CREs understand the requirements in New Zealand accounting standards relating to climate-related matters in financial statements.

3 https://niwa.co.nz/news/2023-so-far-nzs-record-breaking-weather

The guidance states that as CREs start reporting in line with the mandatory climate-related disclosures, they will need to help users understand whether, how, and to what extent, climate-related matters identified in those disclosures are reflected in their financial statements.

While accounting standards do not specifically mention climate, they do require consideration of climate-related matters when the effect of those matters is material. Potential financial reporting implications include, but are not limited to:

- Impairment of assets.
- Useful life and residual value of assets.
- Fair value estimates.
- Expected credit loss calculations for loans and receivables.
- Provisions and contingent liabilities etc.

Unsurprisingly, most of the examples of disclosures we are seeing relate to the above areas of the financial statements.

It's also worth highlighting that many entities are making public commitments to reduce their carbon emissions. In addition to the climate-related risks and opportunities, the potential financial reporting impacts of net zero or other carbon reduction commitments must be considered in the preparation of financial statements. These commitments could also have an impact on the estimated useful life and residual value of the entity's existing assets. Organisations will need to think about whether these promises create a constructive obligation and the recognition of a liability. Finance teams should stay in close contact with their sustainability or environmental teams, who are developing the organisation's plans and response to climate change and make sure there is consistency with estimates and assumptions used in financial reporting as well as other forms of public communication.

For more examples of when accounting standards may require entities to consider the effects of climate-related matters, preparers can refer to the educational material of the IFRS Foundation (republished in July 2023) or our webpage dedicated to this topic.

The XRB guidance states that financial statements and climate-related disclosures should supplement and complement each other – together they should present a coherent picture. While there should be a connection between them, there are also valid reasons for differences in reporting. For example, financial statements reflect the entity's expectations and assumptions about the future. Climate-related disclosures focus on forward-looking information that reflects the climate-related risks and opportunities of an entity. This may involve a higher degree of uncertainty and judgement.

When preparing financial statements and determining what connections to make, the key point to keep in mind is user needs – will they be left in doubt about whether, how, and to what extent, climate-related information has been taken into account in financial statements? While there are valid reasons for differences between financial statements and climate-related disclosures (e.g. differences in estimates and assumptions underpinning the climate-related disclosures and those underpinning the financial statements), if users could reasonably expect that a particular climate-related disclosure would impact the financial statements and it does not, entities should make additional disclosures to explain why this is not the case.

In addition to focusing on user-needs, entities can drive consistency by:

- Governance buy-in: Directors will be approving both the financial statements and the climate-related disclosures. Among other things, they will need to be comfortable that the coherence principle has been met and can help set the tone on what they view as being of importance to users. Not surprisingly ten out of 15 reporters that had climate-related discussion in the financial statements mentioned in their climate-related disclosures or elsewhere in their annual report that their boards had specialised committees or included members with climate-related, or broader ESG and sustainability expertise. Seven of the 15 reporters also had climate and sustainability linked KPIs for their CEOs and key management.
- Collaboration: Having well-connected teams who are talking the same language is important. A high degree of connectivity between the people responsible for preparing each type of reporting gives a better chance of achieving coherence between the reports.

Where do I find more information?

For more on how climate change can impact the financial statements, please also refer to our PwC New Zealand webpage on financial reporting implications of climate related matters.

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