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

An analysis of NZX50 March 2023 reporters

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Over the last year we have released reports investigating how climate change was reflected in the financial statements of NZX50 March, June and December 2022 reporters. In this latest version, we look again at NZX50 March reporters to see how, and what, they are reporting in 2023. Once again, our focus is on how climate-related impacts are disclosed in the financial statements and how auditors considered climate-related impacts in key audit matters (KAMs).

This report includes reviews of several companies from the real estate sector, one company from the energy sector and another from logistics. These companies are in sectors that are likely to be impacted by climate-related risks. Have climate change disclosures in the financial statements increased? Have the effects of the recent extreme weather-related events in Aotearoa New Zealand led to any changes in reporting?

Key findings:

13 (2022: 14) businesses on the NZX50 with 31 March year ends have published their annual reports.

6 (2022: 3) reporters discussed the impact of climate-related risks in their financial statements.

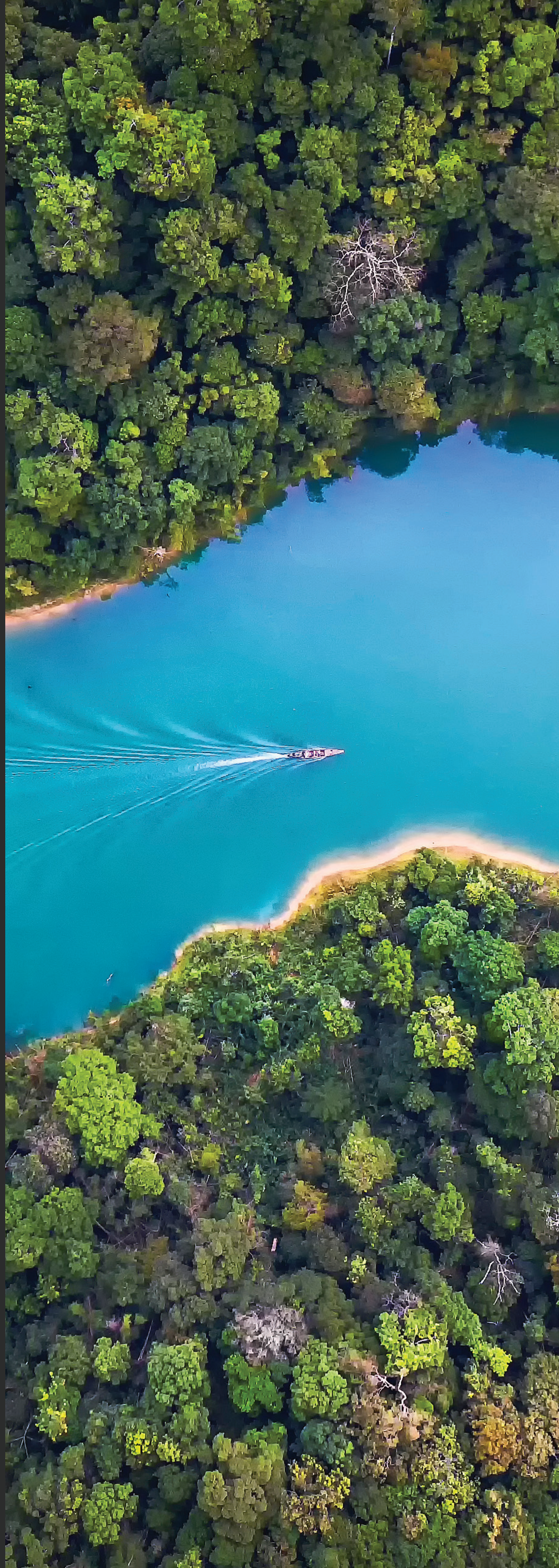
0 (2022: 0) businesses included a quantification of the impacts of climate risk (physical or transition risks) in their financial statements.

10 (2022: 8) reporters included some non-financial climate-related information outside of the financial statements.

4 (2022: 0) reporters elected to voluntarily report against the Aotearoa New Zealand Climate Standards for FY23 noting that compliant reporting is required from FY24. Another 8 reporters mentioned the fact that the New Zealand Climate Standards will become mandatory from FY24.

4 (2022: 4) businesses reported the use of green finance.

2 (2022: 2) audit reports included mention of climate change in KAMs.



Has the disclosure of climate risks by NZX50 March reporters improved?

Our research included many of the same entities as our 31 March 2022 reporters analysis last year[1]. We found that three of the six that mentioned climate change this year also did in 2022. Those who reported the impacts of climate change included similar (if not the same) brief disclosures as they previously had. However, we found more entities discussing the impact of climate-related risks in the financial statements, which is encouraging.

The disclosures remain brief. This is disappointing given the interest from investors, and the regulator, in how companies are considering climate risks as well as how the impact of this is reflected in financial statements. Stakeholder focus also continues to increase following the recent extreme weather events globally and here in Aotearoa New Zealand.

Similar to last year, none of the 31 March 2023 reporters we reviewed quantified the impacts of climate risk or made an adjustment to the numbers in the financial statements. This is likely to be because the impacts are not yet material.

To provide reassurance to investors and other stakeholders such as employees, entities should clearly state in the financial statements if the impacts of climate change are not material. This will help close an expectation gap and stop any guesswork.

What impact have the recent extreme weather events had?

Two 31 March 2023 reporters discussed the impacts of Cyclone Gabrielle and the recent severe weather events in their financial statements, making reference to physical damage to property and related insurance proceeds.

Six reporters discussed these events outside their financial statements, noting how they provided a sobering reminder of the effects of climate change.

However, no reporters noted changes to their approach of assessing climate-related risks and how those could impact their business as a result of these weather events.

The upcoming Aotearoa New Zealand Climate Standards

Four reporters elected to voluntarily report against the Aotearoa New Zealand Climate Standards for FY23 noting that compliant reporting is required from FY24. Another eight reporters mentioned the fact that the New Zealand Climate Standards will become mandatory from FY24. In our last publication we noted that as entities prepare to apply those standards, their thinking about how climate-related risks and opportunities impact their business is expected to mature.

This appears to be the case as only seven of the 31 March 2023 reporters identified climate-related risks and opportunities that could impact their business. For all Climate Reporting Entities, the pathway to full compliance with the New Zealand Climate Standards will have to include a process identifying climate-related risks and opportunities relevant for their business.

Anecdotally, reporters are grappling with the significant effort required to be ready to report under the new Climate Standards. There are risks to be understood, data to be sourced and processes to be implemented. Although preparation is well underway, we are not seeing much of that insight reflected in financial statements or annual report disclosures. We will likely see better quality discussion about the impact of climate change in financial statements and annual reports when those entities start publishing fully compliant climate disclosures in line with the new Climate Standards next year.

How did auditors respond?

Out of the 13 audit reports only two made reference to climate change in key audit matters (KAMs). Both were in relation to the valuation of property and is in keeping with our findings in earlier reports.

KAMs illustrate where the auditors applied most judgement, and provide transparency of the auditors' findings. If climate change is significant to the financial statements, it should be referenced in KAMs. Given there is still limited mention of climate risk in the statements, it follows that it is not covered in KAMs.

1 There are differences due to changes in the makeup of the NZX50.

Why is consistency in annual reports important?

Alongside extreme weather events increasing in frequency, investors and other stakeholders continue to demand more information on how climate-related risks impact businesses. The regulatory focus is on the coherence and consistency of related information reported both inside and outside of an entity's financial statements and the oversight of governance committees.

Why comply with the guidelines?

Not adhering to the guidelines has consequences. The European Securities and Market Authority (ESMA) recently published two enforcement decisions relating to the lack of disclosures on how climate-related risks were considered in preparing the financial statements of a shipping company and an airport management business.

Although in both cases, on request, the entity confirmed that the impact of climate change was considered in preparing the financial statements and no adjustment was required to the numbers, in each case ESMA determined that the missing disclosures constituted a material departure from International Financial Reporting Standards. The entities were required to provide specific disclosures.

The regulator considered the missing disclosures material based on the entity's exposure to climate risks, the lack of consistency and coherence between the carbon reduction commitments and climate-related risks disclosed in the non-financial section of their management report and the information disclosed in their financial statements.

What our analysis found

As outlined above, some of the reports we reviewed identified a number of climate-related risks outside of the financial statements. Examples of these commonly included:

- increasing carbon prices, which will require increased capital investment to help decarbonisation of operations
- increasing costs of repairs to physical assets
- growing risk of insurance retreat as a result of increased frequency and severity of weather events
- rising costs to develop more carbon efficient assets to help meet more stringent regulations in the future.

Some reporters also highlighted net zero or carbon reduction commitments. These will be achieved by using renewable energy, reducing waste from operations and investing in developing greener assets etc.

What companies need to do

From FY24, Climate Reporting Entities will be required to fully comply with the Aotearoa New Zealand Climate Standards. They will be required to disclose the current and anticipated financial impacts of climate-related risks and opportunities as well as the entity's plan to address those risks and opportunities. When they do, stakeholders will be looking to see connections to the financial statements.

For example:

- Are the assumptions and judgements used in producing the financial statements aligned with the identified risks, opportunities and commitments reported elsewhere?
- Have any emissions-intensive assets been impaired?
- Has the 'useful life' of these emissions-intensive assets been reduced?
- Have contingent liabilities been disclosed?
- Have provisions been recognised?

Entities also need to reflect on the level of emphasis placed on climate change risk in the front half of their report or in other external communications. They need to ensure consistency with the extent of disclosure about how those uncertainties have been reflected in the financial statements. For example, several reporters included pages of climate-related impacts discussion in the front half of the annual report or in their separate sustainability report, yet made no, or only a brief reference to climate within the financial statements. This creates an immediate disconnect with an entity's assessment of materiality. If there is no impact in the financial statements, but stakeholders could reasonably expect that it would have, entities should make additional disclosures to explain the lack of impact.

For more on how climate change can impact the financial statements, please refer to our webpage on 'Financial reporting implications of climate related matters.'

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