Update: May 2024

In Brief:

The importance of reflecting climate change in the financial statements

Why is reflecting climate change in the financial statements important right now?

In the current financial year, climate reporting entities (CREs) are preparing their first mandatory climate-related disclosures (CRD) in compliance with the Aotearoa New Zealand Climate Standards (NZ CS) issued by the External Reporting Board (XRB).

The disclosure of climate-related matters in the financial statements has been and continues to be an area of regulatory focus. While the Financial Markets Authority's approach for monitoring CRDs will be more educative in the first years of the regime, what is reported in the financial statements (including the impact of climate risks) is determined by established reporting standards and existing compliance rules.

All companies, not just CREs, must consider climate-related matters when applying the standards if their impact is material to the financial statements as a whole. The International Accounting Standards Board (IASB) recently re-published its educational material: Effects of climate-related matters on financial statements that highlights the potential impacts, and required disclosures, to be provided in financial statements to reflect the effects of climate-related matters, which now have to be disclosed by CREs in their CRDs. The concept of connectivity between disclosures in the financial statements and non-financial reporting is currently being explored across our domestic and international standard-setters, including the External Reporting Board[1] (XRB).

As CREs are now having to publicly report the climate-related risks and opportunities relevant for their business under NZ CS, it is now more important than ever that these entities are able to demonstrate how they have considered climate change when preparing their financial statements.

Key considerations in determining the financial statements impact

Climate-related risks can have a broad impact on the financial statements as highlighted by the IASB in its educational material on this topic. Of course the magnitude of the impact will depend on the organisation's activities, the sector it operates in, its physical location, etc.

There is a lot to think about, so below we outline the key considerations an organisation should think about when determining the impact of climate change on the financial statements.

1. 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.

To ensure connectivity and coherence between the CRD and the financial statements, management should consider the following:

What are the key climate-related risks and opportunities relevant to the entity? What are the potential business impacts of those risks and opportunities? These could include:

- Decreased sales and revenue due to supply and demand disruptions.
- Increased direct and indirect compliance costs resulting from future regulations and directives.
- Increased insurance premiums due to higher risks of extreme weather events, floods, and rising sea levels.
- Increased sales and revenue from greener products, etc.

What financial statement line items could be impacted? Potential financial reporting implications include, but are not limited to:

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

Is climate reporting embedded into the financial reporting processes? Financial reporting and internal control processes should include climate-related considerations to ensure that finance teams and operational teams are routinely thinking about these throughout the financial reporting process.

What is the time horizon associated with each of those risks and opportunities? Apart from its amount, the timing of cash-outflows from potential climate-related impacts will affect how it may be factored into the recognition or measurement of financial statement line items and the disclosures required. For example, events and circumstances impacting the key assumptions underpinning a value-in-use impairment assessment could result in different financial reporting impacts depending on the timing of those events and circumstances. For instance those that are expected to crystallise earlier could impact the cash flows in each period, versus those that are likely to eventuate much later may only impact the terminal value calculation in the assessment.

Is the impact likely to be material? While accounting standards do not specifically mention climate, they do require consideration of climate-related matters when the effect of those matters is material for the financial statements as a whole.

An item could be material based on its nature or magnitude, or a combination of both. In other words, an item of information could be material regardless of its size. In the context of climate-related matters, readers may expect disclosure in the financial statements, regardless of the numerical impact.

What is the appropriate level of disclosure? Consider whether disclosures are required under a particular accounting standard (e.g. impairments or property, plant and equipment (PPE), etc). Given the uncertainty surrounding climate change, the requirements in IAS 1 around disclosure of significant judgements, major sources of estimation uncertainty etc are important. Even if the impact is immaterial, a disclosure to this effect, and explanation of why it is not material, would be relevant information financial statements users are likely to be expecting.

Don't forget climate-related commitments: Apart from climate-related risks and opportunities, organisations should also consider the accounting implications of any net-zero or other commitments to achieve carbon reduction targets. These commitments may require provisions to be accounted for or could impact the estimated useful life or residual value of assets.

In line with the FMA's expectations the above thought process should be documented in high-quality technical papers for all material areas impacted by climate risk. This includes materiality assessments, and analysis and conclusions for accounting areas impacted by climate change.

The FMA's expectations also include adequate documentation in minutes of board and audit committee meetings that includes discussions, analysis and conclusions for accounting areas impacted by climate change.

Illustrative examples

The below are a couple of simple examples of how climate change may impact the financial statements.

Example 1: Impact on impairment assessment
A supermarket retail group has committed to sourcing all its own branded products from carbon-neutral certified farms within three years. Management expects this commitment to increase input costs by 5%, but only a 3% price increase for products would be viable due to similar programs expected from competitors. The group is preparing a value in use impairment model with a 5 year cash flow forecast.

Answer: The entity's impairment assessment would need to consider the impact on gross margin and adjust forecast models accordingly. Management will need to adjust the gross margin in their forecast models down by 2% in each period affected, including the forecast cash flows and the terminal value.

Example 2: Impact on useful life and residual value of PPE

Company A has made a commitment to become carbon neutral by 2030, as discussed in the environmental section of its annual report and in various press releases. Company A estimates that some older machines (such as production machines, ships, etc) will need to be replaced by more energy-efficient machines.

Answer: An analysis was performed and it was identified that the useful economic lives of some of the assets in the fixed asset register needed to be shortened in order to appropriately reflect that those assets would be replaced over the next 7 years.

The adjustment to the estimated useful life of the asset is prospective, as it is a change in estimate. IAS 8 requires disclosure about the effects of changes in estimates. Even if the quantitative impact may not be material, management may choose to include a narrative explanation of this change in estimate in the PPE note to align financial statement assumptions with the company's environmental strategy.

In both of the above examples, in addition to the disclosure requirements of the specific standards, the disclosures requirements of IAS 1 related to significant judgments and estimation uncertainties should be considered because of the uncertainties around the amount or timing of cash flows as a result of potential climate-related impacts (e.g., increase in input costs, requirement/need to replace certain machines, etc).

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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