CLIMATE-RELATED REPORTING: SHARING REFLECTIONS ON THE 2021/22 REPORTING SEASON

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Senior stakeholders from a range of UK organisations gathered in late summer 2022 at an ICAEW Financial Reporting Faculty round table to discuss climate-related reporting. It was a chance to reflect on the outcome of the first reporting season since the Financial Conduct Authority's (FCA) listing rules introduced a requirement for premium-listed entities to disclose under the Task Force on Climate-related Financial Disclosures (TCFD) framework on a comply-or-explain basis.

The discussion focused on assessments of the degree of progress in climate-related reporting in the UK, issues around the connectedness of 'front half' and 'back half' climate-related disclosures, implementation challenges and developing expectation gaps.
In general, there was a positive view around the table of progress made. Many noted a marked improvement in climate-related reporting in the 2021/2022 reporting season – perhaps unsurprising given the introduction of the new listing rule. However, the maturity of the reporting process and the disclosures varied significantly between companies, with plenty of progress still to be made in, for example, addressing data and knowledge gaps, and the challenges of scenario analysis.

Climate-related data collection processes are still in their infancy

OVERVIEW OF UK CLIMATE-RELATED REPORTING TIMELINE

2017	**TCFD published** Voluntary adoption
2021 year ends	**FCA requires TCFD on comply-or-explain basis** Premium-listed entities only
2022 year ends	**FCA requires TCFD on comply-or-explain basis** Expanded to standard-listed entities
2023 year ends	**BEIS TCFD-aligned mandatory regulations come into force for April 2023 year-ends onwards** Wider scope of entity, including certain AIM-listed and large private companies
2024 onwards	**International Sustainability Standards Board requirements likely to be adopted** Scope of UK entities subject to mandatory reporting may increase

ARE CLIMATE-RELATED MATTERS BEING UNDERSTATED IN THE FRONT HALF OF ANNUAL REPORTS – OR OVERSTATED?

Round-table participants expressed mixed views about the appropriateness of coverage of climate in the annual report. Ahead of the discussion, faculty staff undertook desktop research that showed 51% of the sampled FTSE 350 annual reports identified climate change as (or part of) a principal risk in 2020 (figure 1). This increased significantly to 74% the following year. These results suggest that climate-related matters are being increasingly recognised – but why?

Some suggested that where the new TCFD comply-or-explain listing requirements apply, boards and senior management are now compelled to consider climate matters more carefully than ever before. There is also an ever-increasing awareness of investor demand and expectation in this area, which could be leading companies to respond by reporting climate change as a principal risk where previously they had not. Or perhaps the rising frequency and impact of extreme weather events has influenced the increased recognition of climate-related matters. Nevertheless, more consistency needs to be applied to using a materiality lens when producing climate disclosures.

Some attendees pointed to a 'speak first, act later' mentality. In many situations, the strategy element of decision-making within companies comes first, without a full plan of action – or the governance and resources needed – to back it up. Many of the transition plans that major companies are beginning to commit to are therefore still rather aspirational, or something of a PR exercise, yet to be built into internal budgeting and sometimes made ahead of an assessment of what is actually possible. This can, at times, make statements around climate change and climate risks in the front half of the annual report feel somewhat empty or overstated.

By contrast, others pointed to a reluctance among those outside of the more obviously affected sectors (such as transportation and oil and gas) to accept that their businesses might be affected. A commonly held view among participants was that all companies are exposed in some way to climate-related risks, be this directly or indirectly, and that those concluding that their business is largely unaffected ought to reconsider. Have these businesses performed a full and thorough analysis of their value chain before reaching the conclusion of 'no impact'? The risk assessment process may simply be at a relatively immature stage for some, and others lack the resources required, which leads to climate-related risks being understated.

The pendulum may be swinging between too much and not enough disclosure of climate-related matters in annual reports, but the story is not quite the same when it comes to the financial statements.

Management is now compelled to consider climate matters more carefully than ever before

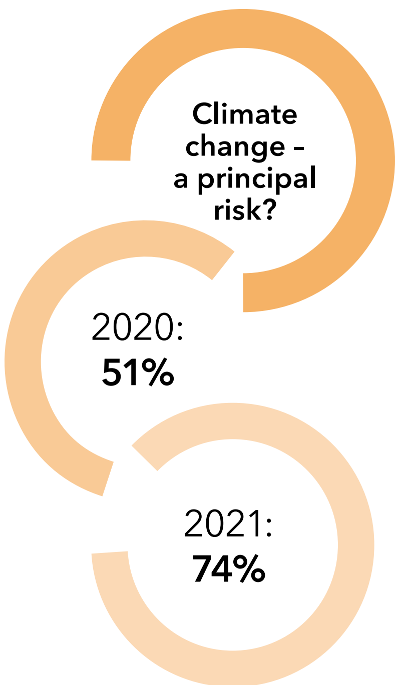

Figure 1: In August 2022, the faculty reviewed 35 randomly selected FTSE 350 annual reports for both 2020 and 2021 year-end reporting periods to establish how many identified climate change as a principal risk (or as one element of a principal risk) within the strategic report

WHY ARE CLIMATE-RELATED MATTERS NOT FILTERING THROUGH TO THE FINANCIAL STATEMENTS?

As part of the faculty's review of annual reports, it was observed that 46% of 2021 reports made reference to 'climate' in the financial statements, compared with 26% in the previous year – a marked increase. However, of the 26 companies that identified climate change as a principal risk in 2021, 12 of these (46%) made no further mention of climate in the financial statements at all. This statistic alone suggests an imbalance – something that was commented on in the Financial Reporting Council's (FRC's) CRR thematic review – whereby the degree of emphasis placed on climate-related risks in the front half of the annual report is not always consistent with the extent of climate-related impacts disclosed in the financial statements.

But why is this the case? Round-table participants had plenty of observations to make. First, that tendency for companies to set out their intentions before embedding them into their operational plans. It will take time for companies to work through this process and so it is understandable – if not ideal – for those that are at an earlier stage of climate reporting to paint a slightly imbalanced picture.

Challenge from audit committees, where they exist, is not always as robust or informed as it could be. Companies need to better communicate ways in which audit committees have challenged assumptions and estimates embedded in the financial statements that may be affected by climate.

It's important to recall when evaluating the narrative disclosures in the front half that the time horizons discussed are often much longer term than those considered by accounting standards. Forecasts and budgets used by management to produce cash-flow projections for impairment reviews usually cover a period of five years or less. Even IAS 36 *Impairment of Assets* states that projections should cover a maximum period of five years unless a longer period can be justified. It might be difficult to connect these projections with plans and scenarios described in a company's front half that look ahead considerably further, although climate risks should be appropriately factored into any long-term growth rates used.

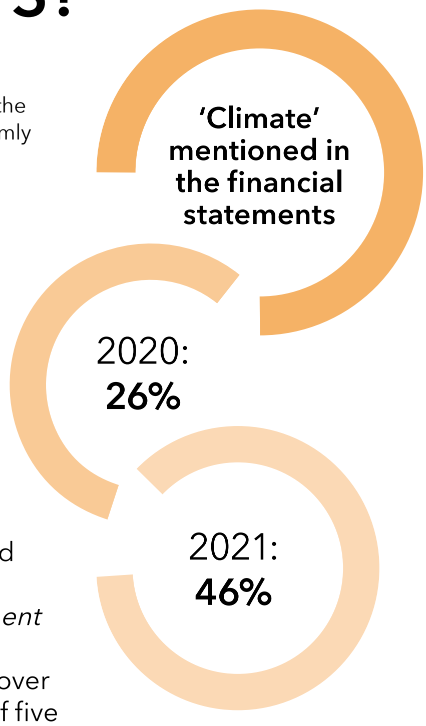

Figure 2: In August 2022, the faculty reviewed 35 randomly selected FTSE 350 annual reports for both 2020 and 2021 year-end reporting periods to establish how many mention 'climate' in the financial statements

There are elements of other accounting standards (for example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) that affect the degree to which climate-related commitments are reflected in financial statements. In this context, participants pointed to paragraph 112 of IAS 1 *Presentation of Financial Statements* which requires reporters to provide relevant information not specifically required by IFRS standards.

Figure 3: The faculty review of annual reports highlighted a lack of connectivity in those that identified climate change as a principal risk in 2021

WHAT UNDERPINS THE CORE CHALLENGES TO EFFECTIVE CLIMATE-RELATED REPORTING?

In practice, many companies still lack robust climate-related data to underpin reporting, both internally and externally. Climate-related data collection processes are still in their infancy and the associated difficulties are abundant. Some of the challenges identified by the FRC Lab's environmental, social and governance data project include difficulties obtaining data from suppliers, risks of errors within the data collected and the volume of data required. Additionally – and critically – there is still a real lack of experience and education, particularly within finance teams, which are less likely than, for example, sustainability teams to have been part of the same learning journey when it comes to climate reporting. Considering climate as part of the well-trodden path of financial reporting, and applying the rigour associated with the financial reporting process, is something that finance teams are more than capable of once they are given the right resources and guidance to do so.

Scenario analysis is one element of the TCFD recommendations that is not well understood. Boards and audit committees need to prioritise investing time to understand this complex area of climate-related reporting. The TCFD Knowledge Hub has a page dedicated to scenario analysis to help reporters in this area.

WHO IS RESPONSIBLE FOR CLIMATE-RELATED REPORTING?

Within organisations, who are the teams or individuals responsible for:

- producing a company's TCFD disclosures?
- connecting the front and back half of annual reports in respect to climate matters?
- ensuring climate is adequately addressed in the financial statements?

Co-operation across the company is required to produce good-quality climate disclosures throughout the annual report, from finance teams to IT departments, sustainability teams to board members. It takes a concerted effort to bring these teams and individuals together in a way they may not have experienced previously. And everyone is aware that adequate resource to deal with new requirements, additional data collection, extra systems implementation and so on, is a universal and major challenge, especially in these straitened times. However, ignoring it is no longer an option.

It takes a concerted effort to bring these teams and individuals together

REVIEWS OF CLIMATE REPORTING STATUS: A SELECTION

Below is a selection of recent reports exploring different elements of climate reporting and TCFD compliance. Further resources can be found at icaew.com/nfr

Deloitte.

A CLOSER LOOK
(MARCH 2022)

Explores the investor demand for improvements to corporate reporting in line with the Paris Agreement on climate change and considers ways in which the information gap can be bridged between investor demand and accounting standards. A useful read to help reporters connect changes of company strategy in response to climate-related risks/opportunities, to financial statement effects.

pwc

THE GREEN SHOOTS OF TCFD REPORTING
(MAY 2022)

Analyses the first 50 companies to report under the TCFD listing rules and includes recommendations for how climate reporting can be enhanced. A useful read for those already reporting under the TCFD framework who are looking to improve reporting ahead of future additional regulatory requirements, as well as understanding the common pitfalls.

FRC

CRR THEMATIC REVIEW OF TCFD DISCLOSURES AND CLIMATE IN THE FINANCIAL STATEMENTS
(JULY 2022)

Seeks to assess the quality of the TCFD disclosures provided by premium-listed companies in response to the TCFD comply-or-explain listing rule, as well as the extent to which financial statements reflect the impact of climate change. A useful read to help reporters understand what good practice looks like in this rapidly changing regulatory environment.

DOES CLIMATE REPORTING EXIST BEYOND PREMIUM-LISTED ENTITIES?

Those subject to the TCFD listing rules today are at the large end of the scale in terms of company size. Beyond these companies, many of the round-table participants felt that climate reporting is barely happening – in fact, for some it's still an alien concept.

Beyond the large listed companies, climate reporting is barely happening

Of course, this will have to change as the scope of regulation expands to capture a far wider range of entity. For reporting periods beginning on or after 6 April 2022, new climate-related company and limited liability partnership regulations come into force that are TCFD-aligned, although not quite the same. Education is absolutely essential for those yet to report under any climate-reporting framework and there are plenty of resources out there – but even that guidance can be difficult to navigate.

Watch this space for further support from ICAEW to help you find your way through the maze.

IS CLIMATE-RELATED REPORTING HEADING IN THE RIGHT DIRECTION?

The most recent reporting season has undoubtedly produced a positive step-change in climate-related reporting – for UK premium-listed entities at least. Accepting that most are not at the end of the journey towards high-quality climate-related reporting, yet are still striving to achieve it, is important. To that end, transparency is crucial. If, for example, there appears to be a disconnect between the scenarios considered in a narrative TCFD disclosure and an impairment review in the financial statements, companies need to explain. Similarly, if sufficient climate data is not available for particular analysis to be undertaken – in line with the listing rules – companies need to disclose that fact.

In general, our round-table participants were not big fans of negative statements in the annual report. However, as the FRC pointed out in its recent thematic review, where an expectation has been created in the narrative report that a company may be exposed to climate risks (for example, by including climate change as a principal risk), but no material impact on the financial statements is identified, an explanation would be valuable to describe how this conclusion has been reached.

Transparency is crucial

For many UK reporters, a good start has been made. Others say that there is still a long way to go, and new regulatory requirements will accelerate the pace of this change. The bar set by regulators is only likely to become higher. The market expects improvements year-on-year. In this ever-evolving sustainability reporting landscape, companies must strive for better, with the support of investors, auditors and regulators.

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