TCFD = IFRS + Climate Risks

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Normally, when one hears about environmental reporting, it concerns how the company reports on its impacts on the environment. But what if it is the environment that affects the company and the company's financial situation? What if the climate agreement from COP21 in Paris 2015 and its warning that the temperature of the earth may increase only 2° C at maximum were to have an impact on the company's values, risks, opportunities, and corporate strategy in general? What information would investors then need, to be able to assess the potential of the company's stock price? And what information would insurers and lenders need, to evaluate their customers' actual risk profiles?

Bloomberg and TCFD

Following the 2015 United Nations Climate Change Conference (COP21) in Paris and the worldwide subscription to 17 sustainable development goals (SDGs), the G20's Financial Stability Board, headed by James Carney, CEO of the Bank of England, established a subcommittee with Michael Bloomberg as chair. The subcommittee is called the Task Force on Climate-related Financial Disclosure (TCFD).

The purpose of the TCFD is to precisely identify the information needs of the financial sector (banks, insurance companies, asset owners, and asset managers) to evaluate risks and opportunities in the transition to a low-carbon economy, which was one of the main objectives of the SDGs. On June 29, 2017, final recommendations were issued to both financial and nonfinancial companies.[i]

The recommendations contain four reporting areas for all listed companies and all financial companies[ii] that should be incorporated into their financial annual report:

- Governance—corporate governance in relation to climate-related risks and opportunities.
  It is recommended that the board publish its overview of climate-related risks and opportunities, and describe management's role in their assessment and management.
- Strategy—the impact of climate-related risks and opportunities on the company's strategy.
  It is recommended that climate-related risks and opportunities be described in short-, medium-, and long-term, describing also what impact these have on the company's strategy and financial planning. The description should be based on several scenarios, including a scenario projecting a temperature rise of 2° C or below, to show how robust the company's strategy is.

- Risk management—how the company identifies, evaluates, and manages risks related to climate. It is recommended that the company describe the processes that are used to identify and manage climate risks and how these processes are integrated into the company's overall risk management.
- Key performance indicators and targets—historical greenhouse gas emissions and related future targets. It is recommended that the company publish the key ratios that have been used to evaluate risks and opportunities in terms of strategic planning. It is also recommended that the company report its CO_2 emissions[iii]—both historical data and with targets.

Thus, the recommendations include that all companies must relate, at minimum, what financial impact a 2° C scenario will have for the company in the short, medium, and long term, if we are to ensure that the average global warming of the planet does not increase by more than this amount. For the analysis and reporting on these scenarios, the TCFD has prepared an "inspiration catalogue"[iv] of sources that indicate the effects of a 2° C scenario.

A 2° C scenario is not just about what energy forms we will use in the future. Let us say that we actually do reach the maximum 2° C heat increase. This will still imply that there generally will be grave effects: increased water levels in many areas, but also water shortages in certain areas, more episodes of "wild weather", increased risk of forest fires and uncontrolled burns of meadows and fields, to name a few. But there will also be more sick people, just as there probably also will be more social unrest in certain areas due to related refugee flows, etc. So, the 2° C scenario does not have to do only with the oil or energy industry or with which cars and lorries a company has in its fleet, for that matter; it has to do with virtually all companies and all societies.

If a company has activities and/or buildings in areas of the globe that may be flooded, if it is dependent on water (which may also be clean water), if it is dependent on crop yields, if it has machines with engines that use fossil fuels, if it is dependent on goods delivered on "just-in-time" principles—indeed, if the company needs delivery of raw materials/goods at all—then the company should consider and report on the problems that could occur. Are new laws and new taxes expected, or will there be a ban on using certain chemicals? A scenario, of course, could also present new opportunities; these could be in the form of new raw materials, new methods, changes in consumer preferences, new suppliers, or new legislation that might support the company. Regardless of the outcome of these scenarios, the bottom line is that there certainly will be changes.

What makes the TCFD different?

In part, these recommendations may sound like the Danish Statements Act §99a, and maybe that is why the TCFD to date has elicited little response in Denmark, as opposed to, for example, the UK and the United States, where the recommendations have already been discussed intensively in the business media. But there are at least three elements that differ significantly from the Danish Statements Act §99a:

- The focus has moved 180 degrees. It's not about how the company affects the environment, but about how the environment affects the company and its financial position.
- Reporting should not be given in an independent report, but should be incorporated into existing financial reporting—at a minimum in the annual report, but more frequent reporting is recommended.
- The forward-looking element should include scenarios/risk evaluations/stress tests that the TCFD wishes to incorporate in the current risk statements. The purpose is to provide insights to investors, portfolio managers, lenders, insurers, et al. into how climate-related risks and opportunities will affect the company's future cash flows, assets, and liabilities. Hence, the financial sector will be able to make better and sounder financial decisions and to efficiently allocate capital, according to their risk profiles.

This also means that the financial sector makes a future recommendation that the boards, and thus the audit committees, should ensure that environmental reporting is "subject to internal governance processes that are the same or substantially similar to those used for financial reporting."[v] This will probably mean that some boards should be supplemented with new skill levels, and that audit and corporate governance structures should be upgraded in the nonfinancial area.

IFRS and climate risks

However, the classic logic and virtues of the financial statement, according to the International Financial Reporting Standards (IFRS), can actually be reused and/or extended.[vi] There are at least the following connotations to existing IFRS rules, for which the inner logic can be reused/extended through relatively simple means, thus obtaining quite good TCFD reporting:

- IFRS 7: Financial Instruments: Information
  IFRS 7 requires, inter alia, that the company evaluate the importance of its financial instruments in terms of its financial position and performance. And qualitative and quantitative information must be provided about the risks involved in these instruments and how the company manages these

risks. Try to extend the inner logic by replacing the term "financial instruments" with "climate change", et voilà, here is a guide that the company can use to report on its climate risks.
The good thing about reusing IFRS 7 is that some definitions are already given. This is true, among other things, for clarification of recognition, as IFRS 7 applies both to recognized and unrecognized financial instruments. In the TCFD context, it means that the company cannot avoid dealing with climate risks simply by pointing out that climate is not part of the recognised financial accounts; instead, the company should describe whether these risks will have implications for the value of recognized assets and liabilities. In addition, IFRS 7 provides good guidance on how a company performs sensitivity analyses; this guidance can be fully replicated to apply to climate risks as well.

- IFRS 9: Financial Instruments
  IFRS 9 uses logic on not only the recognition of financial instruments based on historical data, but also on impairment tests for future losses.
  - The impairment tests must cover the entire life of the financial instrument on a timely basis. Similarly, impairment tests of assets in relation to environmental risks should cover the entire economic life of the asset.
  - IFRS 9 also requires that you report on the risk of loss even when the risk is very low. Similarly, this should happen for climate-related risks. See also comments on IAS 37 below.
- IAS 36: Impairment of Assets
  Impairment of assets is required when the asset's book value is higher than the recoverable amount. This logic can be directly applied to climate-related risks and the significance they will have for future cash flow from assets and liabilities; relevant scenarios/stress tests should lead to an assessment of whether one or more assets should be written down.
  When assessing the need for impairment, both internal and external sources of information must be considered. Based on this, the external scenario sources referred to by the TCFD should at least be involved, when future impairment testing is required.
- IAS 37: Provisions, Contingent Liabilities, and Contingent Assets
  IAS 37 is directly applicable when dealing with more uncertain conditions, such as scenario analyses of future risks and opportunities created by climate change. So when the climate-related risks are to be calculated in financial terms, there is good support available in IAS 37 for assessing whether a given potential future cost should be listed directly on the balance sheet (and thus also on the income statement) or whether it must be part of the contingent liabilities/assets—or not be included at all (yet). But as with the financial instruments (IFRS 9), the company's management

must be fully transparent about the risks, even if such risks are evaluated as low. This also follows from the TCFD's desire for scenario reviews.

As can be seen, it is not hard to imagine how to incorporate climate risks in concrete terms and to be monetised in the annual report, even with existing rules and logic. Some guidance may be needed about how the forward-looking scenario information should be provided in the annual report, but this is a small amount of work, which the International Accounting Standards Board (IASB) should be able to tackle.

Unfortunately, until recently, the IASB has not addressed nonfinancial reporting. In 2014, the IASB and the International Integrated Reporting Council (IIRC) signed a memorandum of understanding,[vii] but for a long time after this, little happened. But in the spring of 2017, IASB issued staff papers 28 A and B,[viii] which now conclude that the IASB will work more intensively with Wider Corporate Reporting in the future. Similarly, International Federation of Accountants (IFAC) has also released a letter that appeals to the G20 countries for integrated reporting.[ix] Thus there now may be movement on that front.

The TCFD and the auditors

One might ask, where does that leave the auditors? Because the TCFD can reuse existing IFRS rules and logic for the most part, auditors' work may not be significantly different. Consider, for example, ISA 315: "Identification and assessment of risks of material misstatement through understanding of the company and its environment". ISA 315 provides good assistance, for example, to ensure that assets are tested for impairment, provisions and contingent liabilities are complete, and not least that proper evaluation is made of the corporate governance setup.

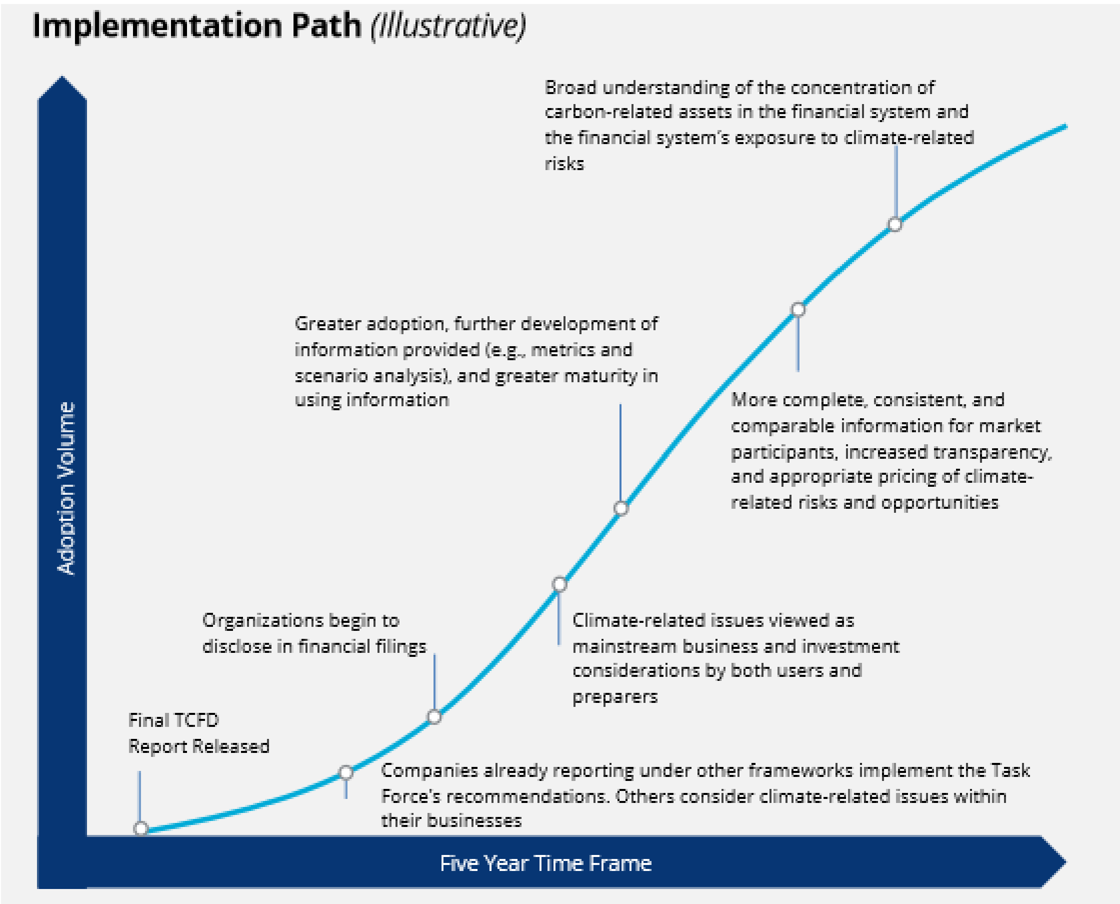
It is true that the environmental scenarios and assumptions used in e.g. the International Energy Agency's scenarios will require some special insights that would be appropriate for the auditors to understand, allowing them to assess solvency in regard to the scenarios that management incorporates in the annual report. Similarly, auditors should also ensure that the company's internal controls take account of climate-related risks. These are also new areas of expertise that will be needed on the board's audit committee. Nevertheless, little new is needed, and perhaps the ISA 315 should also upgrade Annex 2: Conditions and Events That May Indicate Risks of Material Misstatement.

Who and when?

Because the TCFD does not propose a new regulation, but rather makes recommendations directly from the financial industry to its customers and/or investment objects, there is as such no legal requirement for TCFD reporting. However, since many banks, insurance companies, investors, and asset managers already have signed TCFD, it is likely that the customers and the companies in the portfolios they own or manage will be promptly subject to reporting; most likely at least for large companies. In this way, the TCFD reporting will take place on the conditions of the capital market.

The TCFD recommends that all listed companies be subject at least to the generic reporting rules. However, in the latest version of the recommendations (June 2017), the TCFD has set a $1 billion revenue threshold for the additional reporting recommendations for nonfinancial corporations with special environmental activities. Whether this will influence the general TCFD reporting recommendations is still uncertain.

In terms of timing, the TCFD proposes that the implementation of the new recommendations be made in the next five years. But given the implementation plan shown below, the TCFD will start the first implementation monitoring from Q4-2017 until Q2-2018, i.e., already in the annual reports for this year. It is also apparent from the implementation plan that nonfinancial corporations should begin the TCFD reporting relatively soon, because the financial industry is awaiting this reporting, before they can begin.



The TCFD proposals are already partially incorporated into the ESG Guideline from the London Stock Exchange Group and Nasdaq Nordic & Baltic, both of which were published in winter 2016/17.[x] In the words of Michael R. Bloomberg, TCFD chair, "Increasing transparency makes markets more efficient, and economies more stable and resilient."[xi]

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[i] TCFD (2017) Final Report: Recommendations of the TCFD, https://www.fsb-tcfd.org/publications/final-recommendations-report/

[ii] In addition to these generic reporting recommendations for all enterprises, a number of specific supplementary reporting recommendations have been established for both the financial sector and for nonfinancial companies from sectors that are assumed to be most affected by climate change. The selected sectors, in addition to the financial sector, are energy; transportation; construction and materials; and agriculture, food, and forestry. The final version of the recommendations somewhat softens the requirements, specifying that only companies with revenue of more than $1 billion should follow these extra recommendations.

[iii] The recommendation is to report on CO_2 emissions in both scope 1 and 2, and in scope 3 if appropriate.

• Scope 1 = Direct emissions arising from the company's own consumption of fuels and gases

• Scope 2 = Indirect emissions arising from the energy used to produce electricity and district heating/cooling that the company has purchased for its own use

• Scope 3 = Indirect emissions from third-party activities related to the company's value chains, including customers, suppliers, outsourced activities, etc. (Green House Gas Protocol)

For more details on the scopes and data boundaries, see, for example, Jagd, J.T. (2013) Investororienteret CSR Rapportering, Karnov, Copenhagen (in Danish) or Jagd, J.T. (2015) Investor Oriented Corporate Social Responsibility Reporting, Routledge, New York, NY (in English)

[iv] The inspiration catalogue can be accessed at https://www.fsb-tcfd.org/publications/final-technical-supplement/

[v] TCFD Summary Presentation (June 2017), p. 9: https://www.fsb-tcfd.org/wp-content/uploads/2017/06/TCFD-Recommendations-Overview-062717.pdf

[vi] CDSB (2017), Unchartered Waters, discussion paper: http://cdsb.cdnf.net/sites/default/files/tcfd_and_financial_accounting_recommendations_v.1.pdf

[vii] Memorandum of Understanding between the IASB and the IIRC: http://integratedreporting.org/wp-content/uploads/2013/02/MoU-IIRC-IFRS-FOUNDATION-20130204.pdf

[viii] IASB Staff Paper 28 A and B (2017): Wider Corporate Reporting: http://www.ifrs.org/-/media/feature/news/updates/iasb/2017/iasb-update-mar-2017.pdf/

[ix] IFAC (2017) Build Trust. Inspire Confidence: http://www.ifac.org/system/files/publications/files/The-Global-Accountancy-Professions-Call-for-Action-by-G20-Countries.pdf

[x] The LSEG ESG Guideline is available at http://www.lseg.com/sites/default/files/content/images/Green_Finance/ESG_Guidance_Report_LSEG.pdf, and the Nasdaq Nordics ESG Guideline is available at http://business.nasdaq.com/media/ESG-Reporting-Guide_tcm5044-41395.pdf

[xi] Recommendations of the Task Force on Climate-related Financial Disclosures (December 2016), p. ii: https://www.fsb-tcfd.org/wp-content/uploads/2016/12/16_1221_TCFD_Report_Letter.pdf