FINANCIAL STABILITY BOARD'S TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

IMPLICATIONS FOR AUSTRALIAN BUSINESS AND CORPORATE REPORTING

BE HEARD.
BE RECOGNISED.

CPA AUSTRALIA

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THE FINANCIAL STABILITY BOARD

The Basel, Switzerland based Financial Stability Board (FSB)[1] was established in 2009 in its present form to coordinate at the international level the work of national financial authorities (central banks in the main) and international standard setting bodies. The purpose being to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. The FSB monitors and assesses vulnerabilities affecting the global financial system and proposes actions needed to assess them. In addition, it monitors and advises on market and systemic developments, and their implications for regulatory policy.

The impetus for the enduring current structure and broadened mandate of the FSB can be identified in the Group of Twenty (G20) countries response to the 2007-2008 Global Financial Crisis (GFC) which continues to be reflected in the FSB's four core areas of policy reform; building resilient financial institutions, ending 'too-big-to-fail' approaches to financial institution national regulation, making derivatives markets safer and transforming shadow banking into resilient market-based finance.

THE FSB'S TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

The Task Force on Climate-related Financial Disclosures (TCFD), chaired by Michael R. Bloomberg, was established in December 2015 to develop a set of voluntary, consistent disclosure recommendations for use by companies in providing information to investors, lenders and insurance underwriters about their climate-related financial risks. The rationale for the FSB embarking on this endeavour is outlined in the Executive Summary to the TCFD June 2017 Final Report[2] where it is emphasised that one of the essential functions of financial markets is to price risk[3] to support informed, and thus, efficient capital allocation decisions. Irrefutably, accurate and timely disclosures of current and past operating and financial results are fundamental to this function. Over and above this, the GFC brought into sharp relief the need also for market participants to understand with appropriate depth and sensitivity, the governance and risk management context in which financial results are achieved and future operating prospects are set. Against this, one of the most significant, and perhaps most misunderstood, risks that organisations face today, and into the future, relates to climate change. Before addressing the recommendations, it is worthwhile briefly outlining the categorisation of climate-related risks and opportunities adopted by the TCFD.

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[1] http://www.fsb.org/

[2] https://www.fsb-tcfd.org/publications/final-recommendations-report/

[3] An illustration of how markets efficiently price risk can be seen in CPA Australia's recently commissioned research "Sustainability information and the cost of capital: An Australian, United Kingdom and Hong Kong listed company study: https://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/sustainability/sustainability-and-the-cost-of-capital-report-2017.pdf

CLIMATE-RELATED RISKS

The Task Force has divided climate-related risks into two major categories: (1) risks related to the *transition* to a lower-carbon economy and (2) risks related the *physical* impacts of climate change. Four forms of transition risk are described; policy and legal, technology, market and reputation. Reproduced here is TCFD's more detailed description of litigation or legal risk as it is germane to some of the discussion in this article that follows:

> Recent years have seen an increase in climate-related litigation claims being brought before courts by property owners, municipalities, states, insurers, shareholders, and public interest organizations. Reasons for such litigation include the failure of organizations to mitigate impacts of climate change, failure to adapt to climate change, and the insufficiency of disclosure around material financial risks.

Turning to physical risks, acute physical risks refer to those that are event-driven, including increased severity of extreme weather events, whilst chronic physical risks refer to longer-term shifts in climate patterns. The reader will certainly appreciate that these risks – both transition and physical – are interconnected, and moreover, that the broader category of environmental-related risks, which include also water crises, are further interconnected with many other risks, such as large-scale involuntary migration and geopolitical conflict.[4] Turning to opportunities, these include resource efficiency, alternative energy sources, product and service innovation, new market opportunities and organisational resilience.

THE TCFD RECOMMENDATIONS AND THEIR IMPLICATIONS FOR CORPORATE REPORTING

The TCFD has developed four core recommendations on climate-related financial disclosures that are applicable to organisations across sectors (both financial and non-financial) and across jurisdictions. The recommendations are structured around four thematic areas:

- Governance: The organisation's governance around climate-related risks and opportunities.
- Strategy: The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.
- Risk Management: The processes used by the organisation to identify, assess and manage climate-related risks.
- Metrics and Targets: The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Each of the recommendations are accompanied by supporting recommended disclosures, for example those for Governance are: (a) Describe the board's oversight of climate-related risks and opportunities and (b) Describe management's role in assessing and managing climate-related risks and opportunities. Just in case you might be tempted to think that the requirements are general and descriptive, do not be deceived for, as we will see, the potential level of detail and associated analysis in a number of dimensions of disclosure affect financial accounting and corporate reporting, are potentially wide ranging. Space here does not permit elaboration; however, the reader should be

[4] For a detailed analysis of these interconnections see *The Global Risks Report 2017* 12th ed., World Economic Forum.

aware also that the documentation developed by the TCFD is likewise very extensive. It is possibly the most comprehensive effort to-date to explain and set a path towards enabling future organisational transparency and market resilience in the face of the global phenomenon of climate change. The recommendations contain; a detailed section on scenario analysis[5] relevant particularly to the determining and articulation of strategies to build an organisation's climate-related risk resilience, has detailed guidance for all sectors across each of the four core recommendations including analysis of alignment with other disclosure frameworks, supplemental guidance for significant financial[6] and non-financial[7] sectors and contains insightful tabular information such as that cross-referencing types of climate-related risk and opportunity to potential financial impacts.[8]

LOCATION OF DISCLOSURES

Although the stated purpose has been to develop a set of voluntary disclosures, the TCFD has recommended the preparers of climate-related financial disclosures provide such disclosures in their mainstream (that is, public) annual filings. It is relevant to explore the rationale for this strong preference as it will, in part, influence how both litigation risk and financial accounting considerations may play out. The TCFD has undertaken extensive review of practices across the G20 countries and conclude the presence of well-developed approaches to the inclusion of material information pertaining to risk. Similarly, many G20 countries have implemented regulatory guidance requiring the collection and reporting of climate-related information (primarily greenhouse gas emissions and energy consumption and production), yet these are not explicitly expressed in terms of risk/ opportunity relationships, nor financial impact.[9] Addressed through mainstream annual filings thus presents as an appropriate platform for drawing together and developing disclosure practices, with the additional benefit of fostering shareholder engagement and promoting a more informed understanding from investors and others. Moreover, the controls which have emerged to ensure the quality of, and to identify responsibility for, information presently found in annual financial filings are, in the TCFD's view, appropriate to material climate-related information.

FINANCIAL IMPACTS

As part of context setting, the TCFD observes in relation to the linkage between climate-related issues (risks and opportunities) and financial impacts, that this is poorly understood because of (1) limited knowledge of organisational impact; (2) the tendency to deal with risk in the near term; and (3) difficulty in quantification. Nevertheless, the linkages start to become apparent once regard is given to specific risks and opportunities, and the manner in which strategy and risk management are subject to challenge and compelled, hopefully, to adapt. Thus it is readily conceivable to trace climate-related risks and opportunities through to operational practices and behaviours, ultimately to measurement

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[5] Part D page 25. Expressed in simple terms, scenario analysis seeks to model at an individual business level forward-looking assessments of the effect of transition and physical risks based upon the so-called 2°C consensus limitation on global warming adopted as part of the UNFCCC December 2015 Paris Agreement (COP21) or made with reference to policies underlying a signatory country's Nationally Determined Contribution (NDC).

[6] Banks, Insurance companies, Asset owners and Asset managers.

[7] Energy, Transportation, Materials and buildings, and Agriculture, food and forest products.

[8] Tables 1 and 2, pp 10-11.

[9] The nature of this type of information asymmetry is explored in an in-depth study commissioned by CPA Australia "Carbon Reporting – Regulatory and voluntary disclosures": https://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/sustainability/carbon-reporting-regulatory-and-voluntary-disclosures.pdf?la=en

response (revenues, expenditures, assets and liabilities, and capital and financing) and medium of disclosure (income statement, cash flow statement and balance sheet). To this, it is vital also to recognise that many of the recommended disclosures will be captured in narrative reporting which, dependent on particular jurisdictional approaches, are subject to regulation and oversight.

CONSEQUENTIAL CORPORATE REPORTING AND FINANCIAL ACCOUNTING IMPLICATIONS

The TCFD in its Final Report[10] summaries a number of key issues considered across its extensive deliberations and identifies areas of future work – one of which is accounting considerations.[11] It is pointed out that the Task Force considered the interconnectivity of its recommendations with particular financial accounting standards developed by the two primary standards setting bodies (IASB and FASB). Foremost, are those standards dealing with measurement and disclosure of contingencies and management's assessment and evaluation of long-lived assets. These are seen as critical in conveying climate-related issues in terms of an organisation's ability to meet future reported earnings and cash flow goals.

The Task Force goes on to express a distinct expectation that in most G20 countries financial executives would recognise that the disclosure recommendations should result in more quantitative disclosures, focussing in particular on climate impact metrics and how these relate to asset impairment. Further implications of an organisation's evaluation of climate-related risks and opportunities pertaining to the financial executive function are in such critical areas as accessing capital and stress testing evolving scenario analysis, particularly in terms of assumptions on cash flow analysis and the linkages to asset impairment assessments.

Necessarily, advancement in these areas contemplated by the Task Force will draw on a combination of international and jurisdictional factors affecting the form, content and regulation of corporate disclosure at a national level. With these challenges and complexities in mind, CPA Australia along with Chartered Accountants ANZ and the law firm MinterEllison convened under the auspices of the Commonwealth Climate Law Initiative[12], a key stakeholder roundtable as a catalyst for analysis leading hopefully to proactive positive response to the TCFD initiative. Three broad themes were traversed:

- First, to what extent do existing Australian financial accounting and auditing rules, methods, guidance and systems require, permit or prohibit the TCFD Recommendations?
- Second, where may the TCFD Recommendations promulgate friction, disharmony or inconsistency between financial statements and narrative disclosures? What is the role and contribution of audit and assurance in assessing such inconsistencies?
- Third, what are the implications of identified uncertainties, shortcomings or inconsistencies for litigation risk, information asymmetries, risk mispricing and broader market/economic adaptiveness?

Such discussions are necessarily both preliminary and speculative in nature given the wide constituency of involvement in the full supply chain of corporate disclosure and that we are only at the

[10] Section E page 32.
[11] Section E-7 page 37.
[12] http://www.smithschool.ox.ac.uk/research-programmes/ccli/

threshold of understanding the transformational implications of climate change, not so much as a physical phenomenon, but rather as a market and business imperative. The interplay of various accounting standards[13], auditing standards[14], director narrative reporting[15] and governance disclosure requirements[16], along with the surrounding penumbra of corporate regulation[17] is, without doubt, complex. Nevertheless, early actions both here and abroad are necessary to engendering a heightened sense of urgency, necessary if the TCFD's five-year implementation path is to be achieved within which timeframe there would be substantial progress towards "complete, consistent, and comparable information - - - and appropriate pricing of climate-related risks and opportunities".[18]

CLIMATE RISK LITIGATION – A TEMPORARY ABERRATION OR HARBINGER OF CHANGE?

Navigating through such a complex and likely increasingly unsettled area of the law to pinpoint where, how, and against whom climate-related litigation risk may fall is neatly encapsulated in a Memorandum of Opinion prepared by Noel Hutley SC and Sebastian Hartford-Davis.[19] A few of the many salient elements of the Opinion are reproduced here:

> It is - - - worth bearing in mind that annual reports constitute and contain representations, which will often become the focus of allegations of misleading and deceptive conduct in company litigation. It is well established that non-disclosure of material information can, depending on the circumstances, constitute misleading and deceptive conduct. [para. 12]

Further,

> It would be difficult for a director to escape liability for a foreseeable risk of harm to the company on the basis that he or she did not believe in the reality of climate change, or indeed that climate change is human-induced. The court will ask whether the director *should have known* of the danger. - - - The law often had to deal with liability in negligence in the context of rapidly developing science. - - - At a certain point, however, ignorant defendants become liable for those risks on the basis that a reasonable person would have known of them. When it comes to climate change, the science has been ventilated with sufficient publicity to deduce that this point has already passed. [para. 34]

On this basis, there is little doubt that the current structure of Australian corporate law has the potential of providing an open-door through which climate-related litigation can take place – what we

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[13] A non-exhaustive list would include AASB 6 Exploration for and Evaluation of Mineral Resources, AASB 13 Fair Value Measurement, AASB 136 Impairment of Assets and AASB 137 Provisions, Contingent Liabilities and Contingent Assets.
[14] The more immediately apparent are ASA 701 Communicating Key Audit Matters and ASA 720 The Auditor's Responsibility Relating to Other Information.
[15] Foremost are the operating and financial review required of listing company directors under section 299A of the Corporations Act 2001 and the accompanying regulatory guide from ASIC RG 247.
[16] Refer ASX Corporate Governance Council, Principles and Recommendations 3rd edition (2014) generally, and in particular Principle 7: Recognise and manage risk.
[17] Directly applicable of course are the numerous provisions within Part 2M.3 (Financial Reporting) of the Corporations Act 2001, though highly relevant also are provisions such as s 769C (Representations about future matters taken to be misleading if made without reasonable grounds) and s 1041E (False or misleading statements) (refer also ASIC Act 2001 s 12DA), along with the general duties and powers of directors covered in Part 2D.1.
[18] Refer Final Report of the TCFD Figure 12 page 42.
[19] "Climate Change and Directors' Duties" (7 October 2016) prepared for MinterEllison in collaboration with The Centre for Policy Development and The Future Business Council.

don't yet have is actual testing before the courts.[20] On the present 'accommodations' within the law, we need look no further than the duty of care and diligence[21] which is based on negligence law concepts for an objective test of a reasonable foreseeability of harm. The broad principle-based expression of this provision has enabled interpretation over time to elevate expectations of a positive duty to inquire and be informed. Furthermore this general duty is increasingly brought into play where there have been parallel breaches of specific duties around disclosure, which themselves have evolved to accommodate a widening basis of reliance-based loss.

What do overseas climate-change litigation developments tell us? Two are worthy of brief mention; Exxon Mobil in the United States and Cairn Energy PLC in the United Kingdom.

In the former two forms of action are evident. The first is majority (62 per cent) shareholder voting in an annual meeting in favour of resolutions demanding more open and detailed analysis of risks posed to Exxon Mobil's business by policies emerging in response to the Paris Agreement. Though non-binding and rejected by directors, this is a reversal on a similar prior year resolution and follows on from comparable pension fund led proposals with other significant US petroleum companies.[22] The second matter is the setting in motion a class action[23] claiming that within a defined trading period (February 19 through October 27, 2016) Exxon "repeatedly highlighted the strength of its business model" yet "Exxon's public statements were materially misleading" as they amongst other matters contradicted "Exxon's own internally generated reports concerning climate change [which] recognized the environmental risks caused by global warming and climate change" and that "a material portion of Exxon's reserves were stranded and should have been written down." Commenting on the class action lawsuit, David Hasemyer a journalist with *inside climate news*[24] observed, with reference to the remarks from a University of Denver securities and corporate law professor, that "shareholders will have a much easier task proving Exxon failed to lower the value of its oil reserves than proving it deceived investors about climate change's role in charting the company's future." Relating this to possible developments in Australia, this reference to the type of 'dual-pronged' approach to liability is revealing – an accounting 'hygiene'/ technical issue which may provide a more certain path, compared to the uncertainties of proving a misleading and deceptive conduct induced loss.

It is nevertheless important to mention in passing the early indication of some Australian jurisdictions embracing what is termed 'market-based causation' whereby the causal relationship does not involve direct reliance on a disclosure document. Rather the omission or misleading statement within the document has inflated the security price above that which the plaintiff would have otherwise paid, such that upon release of omitted information or correction, a loss has been suffered. One can only speculate at this point in time as to the securities price impact of belated climate risk disclosures and whether this may form the basis of actionable claims for investors. Needless to say though, companies and their directors will need to be proactive adopting a strong stance of transparency.

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[20] At the time of writing, it has been reported in the media (ABC News 8 August 2017) that lawyers with the firm Environmental Justice Australia are assisting two shareholders of the Commonwealth Bank in claims that the Bank's 2016 annual report did not give a true and fair view because of omission to disclose its climate-related risks. The bank has announced it vigorous defending of its position and disclosures.

[21] Section 180.

[22] Diane Cardwell, *The New York Times* May 31, 2017, "Exxon Mobil Shareholders Demand Accounting for Climate Change Policy Risks"

[23] The Rosen Law Firm, New York, Press Release November 8, 2016 – "Equity Alert: Rosen Law Firm Announces Filing of Securities Class Action Lawsuit Against Exxon Mobil Corporation – XOM".

[24] November 21, 2016.

Finally, to the UK development. This involves a Referral to the FRC's Conduct Committee by law firm ClientEarth the disclosures in, and actions around, Cairn Energy PLC's 2015 Annual Report and Accounts. Space here does not permit comparison between UK and Australia law dealing with narrative disclosures by directors. Nor can detailed explanation be given to differences in the statutory directors' duties, particular those relating to the interests served and promoted. Nevertheless, whilst divergence is evident, both jurisdictions adhere to distinct common law foundations, such that particular elements of CleintEarth's Referral echo very closely the observations of Hutley SC and Hartford-Davis. Regarding the extent to which the directors of Cairn Energy PLC may or may not have factored climate risk into their risk assessments and reporting thereon, the Referral states the following:

> In any event, even if Cairn's directors had not already formed the view that climate risks constitute a material trend or factor likely to affect the business within its standard investment cycle (which seems highly unlikely on the available evidence), any reasonable director standing in the shoes of the Cairn directors would reach a conclusion that it was. [para. 75]

SOME CONCLUDING OBSERVATIONS

Amid the ongoing clamour and short-termism of Australia politics, it is difficult to discern how the Australian government will respond to the TCFD recommendations post their presentation to the G20 Summit in Hamburg in July. However, earlier in April the Australian Senate Economics References Committee issued its report of the Inquiry into Carbon Risk Disclosure in Australia (*'Carbon Risk: A Burning Issues')* in which direct reference is given to the need for a coordinated government response to the recommendations. Similarly, the Committee's recommendations foreshadow the need for stock exchange, corporate regulator and prudential regulator adjustment to their policy instruments to reflect the developments emanating from the TCFD. Regardless, of the timing and nature of any formal endorsement from government the mere existence of the TCFD and its recommendations has heralded the imperative for change.

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