Position paper

Materiality and climate-related financial disclosures

CDSB is an international consortium of business and environmental NGOs. We are committed to advancing and aligning the global mainstream corporate reporting model to equate the relevance of information about business' use of and effect on natural capital with the relevance of information about financial capital for understanding corporate performance.

We do this by offering companies a framework for reporting environmental information with the same rigour as financial information. In turn this helps them to provide investors with decision-useful environmental information via the mainstream corporate report, enhancing the efficient allocation of capital. Regulators also benefit from compliance-ready reporting materials.

Recognising that information about natural capital and financial capital is equally essential for an understanding of corporate performance, our work builds the trust and transparency needed to foster resilient capital markets. Collectively, we aim to contribute to more sustainable economic, social and environmental systems.

CDP (formerly the Carbon Disclosure Project) provides the Secretariat for CDSB.

CDSB was formed at the World Economic Forum's annual meeting in 2007 and builds on the activities of CDSB Board members.

CDSB seeks to standardise environmental information reporting through collaboration and by identifying and coalescing around the most widely shared and tested reporting approaches that are emerging around the world. The CDSB Framework therefore adopts relevant principles from existing standards and practices with which business is already familiar. It has been prepared in line with the objectives of financial reporting and the reporting approaches offered by other organizations as well as complementing and supplementing them to offer a means of incorporating environmental information into an organization's mainstream report.

Further information about CDSB can be found on its website www.cdsb.net.

We welcome your input and discussions. If you would like to comment on this paper, please contact us at info@cdsb.net.

For further information, please consult our website,
www.cdsb.net/materiality.

Introduction

Materiality and the TCFD

The Task Force on Climate-Related Financial Disclosures (TCFD)[1] issued its final recommendations in June 2017. The recommendations represent a set of guidelines designed to improve the development and use of climate-related financial disclosures. The recommendations encourage organizations to disclose in their mainstream annual financial filings information about:

Governance
How climate-related risks and opportunities are governed;

Strategy
The actual and potential impacts of climate-related risks and opportunities on their businesses, strategy and financial planning;

Risk management
How climate-related risks are identified, assessed and managed;

Metrics and targets
How these can be used to assess and manage relevant climate-related risks and opportunities.

***Box 1**: Summary of the main recommended areas of disclosure*

In this paper, CDSB looks specifically at what the Task Force says about the application of materiality to climate-related financial disclosures. In high-level terms, we refer to materiality as a concept designed to guide the application of professional judgement for the purpose of determining acceptable levels of information disclosure in mainstream reports and thereby informing decision-making by the users of those reports. The concept of materiality is also used for the purposes of determining error thresholds in assurance engagements, but this is not within the scope of this report. Here we will focus on material *information* rather than thresholds for identifying material *errors*.

Why focus on materiality?

From the outset of its work, the TCFD has recognised materiality as being essential for incorporation into its work. However, materiality has remained a contentious theme from the inception of the TCFD right through to the publication of the final recommendations.

When establishing the TCFD and setting out its remit, the Financial Stability Board (FSB) emphasised[2] that "any disclosure recommendations by the Task Force would be voluntary, would need to incorporate the principle of materiality and would need to weigh the balance of costs and benefits."

However, the Phase 1 Report[2] acknowledged the "considerable disagreement over what constitutes a "material" climate risk that triggers disclosure requirements in most jurisdictions" even though some existing laws already require disclosure of material climate-related risk in mainstream reports and that "the divergent range of approaches [to climate reporting] reflects the lack of consensus around what constitutes a material climate risk."

The results of the public consultation on the TCFD Phase 2 Report[3] identified materiality and the location of disclosures as "key themes" for the TCFD to address in its final report. The consultation responses called on the TCFD to "clarify which recommended disclosures depend on materiality assessment and provide flexibility for organizations to provide some or all disclosures in reports other than financial filings."

In its final recommendations, the TCFD admits that "the financial impacts of climate-related issues are not always clear" and that for many companies "identifying the issues, assessing potential impacts and ensuring material issues are reflected in financial filings may be challenging." The final recommendations advise companies to "determine materiality for climate-related issues consistent with how they determine the materiality of other

1 Financial Stability Board Task Force on Climate-Related Financial Disclosures. [Online] Available from www.fsb-tcfd.org

2 Task Force on Climate-Related Financial Disclosures (2016) Phase I Report. [Online] Available from www.fsb-tcfd.org/publications/phase-i/

3 The Task Force conducted two public consultations. The first followed the April 1, 2016 publication of its Phase 1 Report. A second public consultation followed the release of the TCFD Phase 2 Report in December 2016. Materiality and the location of disclosures emerged as a key theme from the second consultation.

information included in their financial filings."

We have decided to focus on materiality because it has always represented a pervasive challenge in corporate reporting. Reviews by various organizations refer to variations in the interpretation of materiality due to differences in audience, purpose and scope[4]. The lack of clarity about how to interpret materiality is reflected in the accumulation of clutter in corporate reports[5]. The effective application of materiality is crucial for clear and concise communication of decision-useful information. However, it can be difficult to navigate the "reporting infrastructure" that applies to mainstream financial reporting and how to effectively intergrate the TCFD recommendations.

CDSB provides practical resources for sustainability and finance professionals who will need to work together, possibly for the first time, to devise an inter-disciplinary approach to follow the TCFD recommendations.

This paper sets out how the application of materiality has developed for the purposes of financial and sustainability reporting respectively.

We also consider selected guidance on mainstream reporting that could help companies provide material climate-related financial disclosures. We hope that this paper will provide a useful resource for discussions across companies' departments, including the board level, about how to prepare future disclosures based on the TCFD recommendations.

Structure of this paper

Summary of TCFD statements on materiality

In the first section, we summarise what the TCFD says about the application of materiality to climate-related financial disclosures. It organises the TCFD statements on materiality around some main themes, but does not analyse or apply any value judgement to those statements.

Integration of climate-related financial information into the mainstream report

We focus on what certain existing mainstream reporting standards and guidance documents already say about the definition and application of materiality and how they align with the TCFD statements on materiality.

This section also provides a brief overview of some existing obligations to report climate information and how companies have responded.

Common themes on the application of materiality and challenges

We identify common themes from the mainstream reporting model that might help companies determine material climate-related financial information more effectively. We also consider the challenges those common themes present for climate disclosure.

Practical strategies

Finally, we suggest possible strategies for addressing the challenges associated with applying materiality judgements to climate change-related financial information.

4 International Integrated Reporting Council (2015) Materiality in <IR> - Guidance for the preparation of integrated reports [PDF] Available from https://integratedreporting.org/wp-content/uploads/2015/11/1315_MaterialityinIR_Doc_4a_Interactive.pdf

5 FRC and ASB (2011) Cutting Clutter – Combating clutter in annual reports. [PDF] Available from https://www.frc.org.uk/getattachment/8250571d-4c6d-4d0a-9aa6-ef6a19c1fab2/Cutting-clutter-report-April-20112.pdf

An overview of materiality and related challenges

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Summary of statements about materiality in the TCFD final report and supporting materials

Statements about materiality are dispersed throughout the TCFD Final Report and associated materials. The following summary organises those statements around eight key themes for ease of reference.

Providing material climate-related information is an existing obligation

The TCFD states that disclosure of climate-related information is an existing legal obligation in many jurisdictions and that their recommendations should be used to comply more effectively with those existing obligations, provided that they are compatible with the TCFD recommendations.
"In most G20 jurisdictions, companies with public debt or equity have a legal obligation to disclose material information in their financial filings – including material climate-related information. The Task Force believes climate-related issues are or could be material for many organizations and its recommendations should be useful to organizations in complying more effectively with existing disclosure obligations."
The TCFD stresses that organizations should make financial disclosures in accordance with their national disclosure requirements, which may take the form of a general disclosure of material information or require disclosure of material information in specific sections of the financial filing e.g. in a discussion on risk factors. However, *"if certain elements of the recommendations are incompatible with national disclosure requirements for financial filings, the Task Force encourages organizations to disclose those elements in other official company reports that are issued at least annually, widely distributed and available to investors and others and subject to internal governance processes that are the same or substantially similar to those used for financial reporting."*

Materiality and the mainstream annual financial filings

The TCFD states that material climate-related financial disclosures should be made in mainstream annual financial filings.
"The Task Force determined that preparers of climate-related financial disclosures should provide such disclosures in their mainstream (i.e. public) annual financial filings. The Task Force believes publication of climate-related financial information in mainstream financial filings will foster broader utilization of such disclosures promoting an informed understanding of climate-related issues by investors and others and support shareholder engagement."
Mainstream financial filings are defined[6] as "*the annual reporting packages in which organizations are required to deliver their audited financial results under the corporate, compliance or securities laws of the jurisdictions in which they operate. While reporting requirements differ internationally, financial filings generally contain financial statements and other information such as governance statements and management commentary.*" The Task Force recognises that most information included in financial filings is subject to a materiality assessment and acknowledges concerns expressed by some companies about disclosing information in financial filings that is not clearly tied to an assessment of materiality.

Material to whom and for what purpose?

Disclosures should be made if they are material to an audience of investors, lenders and insurance underwriters. The disclosures are intended to be "*useful to investors, lenders and insurance underwriters in understanding material risks.*" Such disclosures would "*foster an early assessment of these risks*" and "*facilitate market discipline*" as well as providing "*a source of data that can be analysed at a systemic level to facilitate authorities' assessments of the materiality of any risks posed by climate change to the financial sector and the channels through which this is most likely to be transmitted.*"

Recommended disclosures for which a materiality assessment is not required

A materiality assessment is not required for recommended disclosures on Governance and Risk Management. However, these recommended disclosures must be made in annual financial filings in all cases.

"The Task Force recognizes that most information included in financial filings is subject to a materiality assessment. However, because climate-related risk is a non-diversifiable risk that affects nearly all industries, many investors believe it requires special attention. For example, in assessing

6 Climate Disclosure Standards Board (2015) CDSB Framework for Reporting Environmental Information and Natural Capital. [PDF] Available from https://www.cdsb.net/what-we-do/reporting-frameworks/environmental-information-natural-capital

organizations' financial and operating results, many investors believe that it requires special attention and want insight into the governance and risk assessment context in which financial and operating results are achieved. The Task Force believes disclosures related to its Governance and Risk Management recommendations directly address this need for context and should be included in annual financial filings."

Recommended disclosures for which a materiality assessment is required

A materiality assessment is required for recommended disclosures on Strategy and Metrics and Targets. The recommended disclosures must be made in annual financial filings only if and to the extent they are material. "*For disclosures related to the Strategy and Metrics and Targets recommendations, the Task Force believes organizations should provide such information in annual financial filings when the information is deemed material. Certain organizations – those in the four non-financial groups that have more than one billion US dollar equivalent in annual revenue - should consider disclosing such information in other reports when the information is not deemed material and not included in financial filings. Because these organizations are more likely than others to be financially impacted over time, investors are interested in monitoring how these organizations' strategies evolve.*" The Task Force distinguishes between recommended disclosures that require a materiality assessment to be undertaken and those that do not as highlighted in Table 1.

How to determine materiality where an assessment is required

Materiality should be determined using the same approach for determining any other material information to be disclosed in annual financial filings. "*In determining whether information is material, the Task Force believes organizations should determine materiality for climate-related issues consistent with how they determine the materiality of other information included in their financial filings. In addition, the Task Force cautions organizations against prematurely concluding that climate-related risks and opportunities are not material based on perceptions of the longer-term nature of some climate-related risks.*"

What to disclose about materiality

Guidance for all sectors provides that under recommended disclosure (b) on Risk Management "organizations should describe their processes for prioritizing climate-related risks including how materiality determinations are made." But what about climate-related issues that are not yet material, but likely to be in the future? The TCFD sets out seven principles for effective disclosure to underpin its recommendations. The first principle states that disclosures should present relevant information and that disclosures should therefore be "*eliminated if they are immaterial or redundant to avoid obscuring relevant information.*" However, "*the Task Force encourages organizations where climate-related issues could be material in future to begin disclosing climate-related financial information outside financial filings to facilitate the incorporation of such information into financial filings once*

Materiality assessment is not needed because information is necessary to provide insight into context in which results are achieved	Materiality assessment is needed to determine whether and to what extent information is provided in annual financial filings	Disclose in annual financial filings	Consider disclosing in "other reports"
Governance		Always	
Risk Management		Always	
	Strategy	If material	If in four non-financial groups and above threshold
	Metrics and targets	If material	If in four non-financial groups and above threshold

Table 1: Recommended climate-related disclosures that require a materiality assessment and those that do not

climate-related issues are deemed to be material."

Integration of climate-related financial information into the mainstream report

At this stage, we know that information prepared in accordance with the TCFD recommendations:

- May be used to comply more effectively with existing legal obligations in certain jurisdictions to disclose material information. If there is a conflict between national obligations and the TCFD recommendations, the national obligations supersede the TCFD recommendations;
- Should be disclosed in mainstream annual financial filings, but may also appear outside those filings in "other reports" in certain circumstances;
- Is designed to serve an audience of investors, lenders and insurance underwriters, although other stakeholders might find the information useful;
- Should include recommended disclosures on governance and risk management in all cases, whether material or not;
- Should include recommended disclosures on strategy, and metrics and targets, if material; and
- Should apply materiality determination processes, where necessary, consistent with "how to determine the materiality of other information included in their financial filings."

In this part of the paper, we consider:

- The challenge of integrating climate information into mainstream reports;
- The "reporting infrastructure" (standards, frameworks, codes and practices) that is already in place to support mainstream reporting and that applies, by extension, to climate-related financial information; and
- Guidance that is already available on how materiality of information, both generally and climate-related where guidance is available, should be determined for inclusion in mainstream reports.

The challenge of integrating climate information into mainstream reports

By advising companies to "provide climate-related financial disclosures in their mainstream (i.e. public) annual financial filings," the TCFD firmly places its recommendations into the existing mainstream reporting model. This model includes the requirements and practices that lead companies to publish the annual reporting packages in which they deliver their audited financial results under the corporate, compliance or securities laws of the countries in which they operate, as well as other financial reporting including governance statements and management commentary. This model is influenced and informed by the work of financial standard setters such as the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), corporate governance regulators, stock exchanges and securities commissions. The TCFD appears to have taken a similar approach to the [Enhanced Disclosure Task Force](http://www.fsb.org/2016/05/enhanced-disclosure-task-force-completes-its-work/)[7] by relying on and enhancing some of the established content requirements for mainstream reports, particularly relating to risk, governance and strategy. Some regulators have also introduced amendments to, or interpretations of existing laws and practices in order to incorporate, directly or indirectly,[8] climate change reporting requirements into existing reporting infrastructure.

United States

The Securities and Exchange Commission (SEC) issued interpretive guidance[9] designed "to remind companies of their obligations under existing federal securities laws and regulations" to disclose principal risks, including climate risk. The SEC specified the sort of information companies should disclose, including:

- The specific risks they face as a result of climate change legislation or regulation that is "reasonably likely to have a material effect on the registrant's financial condition or results of operation";
- The impact on their business (where material) of treaties or international accords relating to climate change, such as the Kyoto Protocol and the EU Emissions Trading Scheme; and
- The indirect consequences of legal, technological, political and scientific development regarding climate change.

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7 Financial Stability Board (2016) Enhanced Disclosure Task Force completes its work [Online] Available from http://www.fsb.org/2016/05/enhanced-disclosure-task-force-completes-its-work/

8 That is, either through specific requirements on incorporation of climate change related information or more indirectly through incorporation of requirements to report on environmental or non-financial information.

9 Securities and Exchange Commission (2010) Commission Guidance Regarding Disclosure Related to Climate Change. [PDF] Available from https://www.sec.gov/rules/interp/2010/33-9106.pdf

Canada

In Canada, the Canadian Securities Administrators issued CSA Staff Notice 51-333 to provide guidance for public companies on existing environmental disclosure requirements, including climate-related issues.

United Kingdom

In the UK, requirements for quoted companies to report greenhouse gas emissions have been incorporated into the Companies Act 2006. There are also obligations for certain companies to prepare a Strategic Report, which includes information, including any relevant policies, about environmental matters – this is discussed in more detail further on in this report.

European Union

The European Non-Financial Reporting Directive 2014/95/EU requires that environmental (and other) information should be included in the "non-financial statement" within the management report that forms part of the wider annual report.

Even where direct or indirect requirements to report climate-related risks and opportunities have not been introduced, companies in many jurisdictions are required to report their "principal risks" as part of their mainstream reporting requirements. Generally, risks are understood as possible negative outcomes that affect liquidity, capital resources, net sales, revenues, income from continuing operations, future operating results, future financial condition, operations, economic position or achievement of strategic objectives.
Climate change is predicted to cause any or all of these possible negative outcomes and, in that sense, should not be treated any differently from other risks faced by business. The SEC guidance, for example, treats climate change in the same way as any other principal risk. This is arguably the rationale behind the approach taken by the TCFD and others, such as SASB and the International Integrated Reporting Council (IIRC)[10] to incorporate climate disclosure, and wider sustainability-related subjects, into the existing mainstream reporting infrastructure. The CDSB's Framework for Reporting Environmental Information and Natural Capital[11] is designed to assist companies in adapting, rather than expanding, their mainstream reports so that environmental information is interspersed and positioned in the relevant sections of the mainstream report and links between companies' strategies and environmental performance are more evident.

However, climate-related disclosure practice has historically developed outside the mainstream reporting model. Sustainability reporting practices, specialist research into

carbon-asset stranding risks and voluntary climate change reporting have developed outside the mainstream reporting model through the work of non-governmental organizations and specialist reporting initiatives.

There is no agreed process for incorporating the resulting content and practices into the mainstream reporting model or for applying existing mainstream reporting infrastructure to disclosure of material climate-related financial information. The TCFD refers to "the interconnectivity of its recommendations with existing financial statement and disclosure requirements" and cites the relevance of International Accounting Standards on contingent liabilities and assets and on asset impairment. CDSB's initial research[12] reveals both challenges and opportunities in achieving integration of climate-related practices into existing mainstream reports.

Challenges in integrating sustainability information into mainstream reports are also evidenced by research conducted by WBCSD, which shows significant discrepancies between the way in which material issues are identified and disclosed in mainstream reports and sustainability reports respectively. WBCSD's research[13] found that, on average, only 29% of the issues that were deemed material and disclosed in sustainability reports were also disclosed in the risk section of mainstream reports. The research also found that 35% of the companies examined showed no alignment between material issues identified in sustainability reports and mainstream risk filings; 57% of companies showed some alignment, albeit using different language; and only 8% of companies showed full alignment

10 International Integrated Reporting Council. [Online] Available from https://integratedreporting.org/

11 Climate Disclosure Standards Board (2015) CDSB Framework for Reporting Environmental Information and Natural Capital. [PDF] Available from https://www.cdsb.net/what-we-do/reporting-frameworks/environmental-information-natural-capital

12 Climate Disclosure Standards Board (2017) Uncharted waters: How can companies use financial accounting standards to deliver on the TCFD's Recommendations? [Online] Available from https://www.cdsb.net/news/task-force/692/uncharted-waters-how-can-companies-use-financial-accounting-standards-deliver

13 World Business Council for Sustainable Development (2017) Sustainability and enterprise risk management: the first step towards integration. [PDF] Available from http://www.wbcsd.org/Projects/Non-financial-Measurement-and-Valuation/Resources/Sustainability-and-enterprise-risk-management-The-first-step-towards-integration

between material risks reported in the sustainability report and mainstream risk filings. It is not clear whether and to what extent the misalignment is attributable to the existence or not of legislation, regulation or standards requiring (directly or indirectly) climate disclosure in mainstream reports or whether materiality considerations contribute to the misalignment between mainstream and sustainability reports. Evidence from the Reporting Exchange[14] shows an exponential increase in the number and breadth of reporting requirements related to GHG emissions disclosure year on year with 141 regulations and laws in place across 58 countries.

KPMG's Survey of Corporate Responsibility Reporting 2017 shows that 90% of surveyed companies in France acknowledge and disclose the financial risks of climate change compared with 61% or less of companies in Germany, the UK, U.S. and Japan. This is reinforced by Carbon Clear's research[15] into the FTSE 100 companies, which revealed that over a third do not show "an assessment of materiality of climate change issues or an assessment of the risks climate change poses to their business". This could be indicative of a correlation between regulatory sophistication in France since the enforcement of Article 173 and mainstream reporting of climate risk. However, unless regulation prescribes specific disclosures, materiality also has a role in eventual disclosures. For example, research by CDSB[16] into the FTSE 350's response to English law requiring disclosure of greenhouse gas emissions and other environmental information found that 44% of companies that did not disclose information in response to the statutory requirement cited materiality as the main reason for doing so.

Despite the specificity and authority of the SEC guidance, research by Ceres[17] suggests that the corporate response has been poor. Ceres' 2014 research found that about 40% of S&P 500 companies are silent on the subject of climate change in their mainstream reports. Those that do report provide little discussion of material issues and do not quantify impacts or risks. However, as with WBCSD's research, Ceres' study showed that most S&P 500 companies that disclosed via CDP's reporting system provided significantly more information through that channel than in their mainstream reports. In their April 2016 Concept Release[18] seeking public comment on modernizing business and financial disclosure requirements, the SEC has acknowledged concerns about climate disclosure and has requested feedback to determine whether their current disclosure guidance needs to be updated to elicit information that would permit investors to evaluate material climate risk.

A 2017 study by the Chartered Professional Accountants of Canada[19] finds that although 79% of the companies reviewed had some form of climate-related disclosure, there was a "broad spectrum of company's specific disclosures with few companies providing a meaningful analysis demonstrating the actual and expected impacts of climate-related developments on financial results and the company's business, operations and strategy." Only 8% of companies disclosed company-wide GHG emissions data in their mainstream reports, with ten percent of companies directing investors to other external reports (e.g. the CDP submission) where the data could be found.

These findings are in line with ClientEarth's recent analysis of Cairn Energy[20] PLC's UK annual report which makes only two brief statements about climate change, leaving it impossible for readers to discern how important the directors consider climate-related risks to be or what the impacts of those risks might be on the company's operations and strategy. By contrast, Cairn Energy's CDP response shows that its directors are monitoring these risks and that their thinking is much more developed than the annual report would suggest, with the directors considering many of the risks from climate change to be

14 World Business Council for Sustainable Development. [Online] Available from https://www.reportingexchange.com/

15 Carbon Clear (2016) Sustainability Reporting Performance of the FTSE 100 | 2016 Results. [Online] Available from https://news.carbon-clear.com/news/sustainability-reporting-performance-of-the-ftse-100-2016-results

16 Climate Disclosure Standards Board (2016) Comply or explain. [PDF] Available from https://www.cdsb.net/comply-or-explain-review-ftse-350-companies%E2%80%99-environmental-reporting-annual-reports

17 Ceres (2014) Cool Response: The SEC & Corporate Climate Change Reporting. [PDF] Available from https://www.ceres.org/resources/reports/cool-response-sec-corporate-climate-change-reporting

18 Securities and Exchange Commission (2016) Concept Release on Business and Financial Disclosure required by Regulation S-K. [PDF] Available from https://www.sec.gov/rules/concept/2016/33-10064.pdf

19 CPA Canada (2017) State of Play: Study of climate-related disclosures by Canadian Public Companies. [PDF] Available from https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/sustainability-environmental-and-social-reporting/publications/climate-related-disclosure-study

20 ClientEarth (2016) Investor briefing: Complaints filed against SOCO International PLC and Cairn Energy PLC. [Online] Available from https://www.documents.clientearth.org/library/download-info/investor-briefing-complaints-filed-against-soco-international-plc-and-cairn-energy-plc/

"likely", "highly likely" and "virtually certain" and the magnitude of impact of many of those risks to be "medium" and "high".

The findings highlighted in studies by WBCSD, Ceres, CPA Canada and ClientEarth indicate that companies have identified and reported material sustainability (including climate change) information, but mainly outside the mainstream report. This might be attributable to the type of disclosures prepared by sustainability professionals based on different concepts of materiality. These might have been prepared using processes and practices developed specifically for voluntary reporting through specialist platforms such as CDP, sustainability reports or GRI filings. However, the TCFD recommendations bring climate disclosure into the mainstream and this will raise questions about whether "material" for sustainability reporting purposes (and other non-mainstream channels) is, or is not, material for the mainstream report.

Identifying climate risks and opportunities with financial impacts might be the key to unravelling the complexities inherent to this question. The TCFD emphasises that "disclosure of the financial impacts of climate-related risks and opportunities on an organization is a key goal of the Task Force's work," including how those issues are likely to affect an organization's future financial position as reflected in its income statement, cash flow statement and balance sheet. Major categories of financial impact are therefore to be categorised based on whether they affect:

- revenues or expenditures in the income statement;
- assets and liabilities on the balance sheet; or
- capital and financing on the balance sheet.

The TCFD states that financial executives "should be involved in the organization's evaluation of climate-related risks and opportunities." For some companies, this will mean sustainability and finance professionals working together and across different departments for the first time and learning about each other's processes, systems and practices. The examples below aim to give sustainability professionals a brief overview of the standards and information with which their compliance, legal and controls colleagues work in order to prepare mainstream reports.

Examples of mainstream reporting infrastructure that could help with implementation of the TCFD recommendations

The TCFD Final Report gives indications about where help may be found to integrate climate-related financial information into mainstream report.

The Task Force notes that the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have already issued standards to address risks and uncertainties affecting companies, and the TCFD recommendations require companies to determine materiality consistent with how they do so for the purposes of financial filings, generally prepared according to standards developed by the IASB and FASB.
We therefore start our analysis below by looking at the IASB's pronouncements on materiality. Appendix 4 to the TCFD Final Report references certain frameworks, codes, standards and laws that are relevant to, or already request sub-sets of, the climate-related financial information covered in the recommendations. Further on, we focus our analysis on a disclosure framework listed in Table A4.1, i.e. the UK Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

IASB pronouncements on materiality from the Conceptual Framework and Management Commentary Practice Statement

The TCFD advises companies to *"determine materiality for climate-related issues consistent with how they determine the materiality of other information included in their financial filings,"* and to subject information *"to similar governance processes to those used for existing financial reporting [which] would likely involve review by the chief financial officer and audit committee as appropriate."*

We contend that Chief Financial Officers might interpret this to mean that processes, including

materiality determination, should follow the prescriptions of the IASB. The IASB is the independent standard setting body of the International Financial Reporting Standards (IFRS)[21] Foundation. The IASB sets International Financial Reporting Standards (IFRSs) and other materials for companies to follow when they prepare and publish their financial statements and associated information.
At the time of writing, IFRS standards are required in over 125 jurisdictions and permitted in many more. The IASB 2010 Conceptual Framework for Financial Reporting (Conceptual Framework)[22] sets out the concepts that underlie the preparation and presentation of financial statements for external users, but those concepts also apply to financial reporting more broadly to incorporate the financial statements and accompanying disclosures in notes and management commentary.
Management commentary is where we would expect the majority of information provided in response to the TCFD recommendations to appear. The IASB has issued a Practice Statement on Management Commentary, which confirms that the term materiality used in the Management Commentary Practice Statement has the same meaning specified in the Conceptual Framework.

Although the IASB work might be a point of reference when "determining materiality consistent with the materiality of other information included in financial filings," this might not suffice. This is because the IASB itself recognises that *"there are difficulties applying the concept of materiality in practice when preparing financial statements…[and] these difficulties contribute to a disclosure problem"* In order to address this the IASB is working to advance its "Disclosure Initiative."

A Discussion Paper (DP/2017/1) entitled "Disclosure Initiative – Principles of Disclosure"[23] was issued for public comment by the IASB in March 2017. The Disclosure Initiative seeks to resolve "the disclosure problem" which manifests itself in:

- Not enough relevant information;
- Irrelevant information that clutters financial statements and adds unnecessary ongoing cost to the preparation of financial statements; and
- Ineffective communication that makes financial statements hard to understand and time-consuming to analyse.

One of the projects within the Disclosure Initiative focuses specifically on materiality, aiming to provide guidance on whether information is material, when preparing financial statements, and also to clarify the definition of materiality. As a result of this work, in September 2017 the IASB produced IFRS Practice Statement 2 "Making Materiality Judgements" (PS2). It is designed to *"provide reporting entities with non-mandatory guidance on making materiality judgements when preparing general purpose financial statements prepared in accordance with International Financial Reporting Standards."* However, much of the text is capable by extension of applying to the concept of materiality in relation to other corporate reporting.

The IASB's intention is to provide guidance on applying materiality rather than to change or affect the definition of materiality that is currently in IFRS. In short, PS2 sets out a four-step materiality process as follows:

- Step 1: Identify information that has the potential to be material;
- Step 2: Assess whether the information identified in Step 1 is in fact material. Steps 1 and 2 should take account of the requirements of IFRS Statements particularly as regards quantitative factors and knowledge about the primary users' common information needs in relation to entity specific and external qualitative factors;
- Step 3: Organise the information within the draft financial statements in a way that communicates the information clearly and concisely to primary users; and
- Step 4: Review the draft financial statements to determine whether all material information has been identified and materiality considered from a wide perspective and in aggregate, on the basis of the complete set of financial statements.

If this process is used or considered for identifying material climate-related financial information, companies might also want to take account of what the TCFD states: "*as a non-*

21 International Financial Reporting Standards [Online]. Available from http://www.ifrs.org

22 Note that the Conceptual Framework is under review and the Board expects to publish the revised Conceptual Framework around the end of the first quarter of 2018. An Exposure Draft entitled "Conceptual Framework for Financial Reporting" was published by the IASB in May 2015.

23 International Accounting Standards Board (2017) Disclosure Initiative—Principles of Disclosure. [Online] Available from http://www.ifrs.org/projects/work-plan/principles-of-disclosure/comment-letters-projects/dp-principles-of-disclosure/

diversifiable risk that affects nearly all industries, many investors believe [that climate change risks] require special attention."

As noted previously, the IASB's Disclosure Initiative also considers the definition of "materiality." In the Conceptual Framework Exposure Draft, the proposed definition of materiality reads as follows and similar wording is expected to be used in the revised Conceptual Framework[24] once finalised:

"*Information is material if omitting it or misstating it could influence decisions that the primary users of general purpose financial reports make on the basis of financial information about a specific reporting entity.*"

Information is relevant where it is capable of making a difference to the decisions made by users of information in mainstream reports. This includes where it has value as an input to the predictive processes used by investors to inform their expectations about the future performance of the business and/or where it confirms or changes past or present expectations based on previous evaluations. Materiality is then applied for the purposes of identifying the right type and quantity of relevant information to put in the mainstream report so that the substance of the information is not obscured by immaterial information or what has been described as 'clutter.' In simple terms, the purpose of identifying relevant information is to ensure that the right information is in the report and materiality is then applied as a filter to ensure that the right amount of relevant information is in the report.

The "disclosure problem" identified by the IASB and the development of guidance indicates that materiality as a concept is not yet achieving its objective of producing and effectively communicating enough relevant information and excluding irrelevant information from financial statements. If the application of materiality is not serving its intended objective in relation to financial statements, which are an established form of mainstream disclosure, this raises questions about how companies are to determine what type of climate information is material. This is a clear challenge, as the range of risks and activities that could affect the climate giving rise to economic and financial shocks is wide, and since the timing, scale and pace of climate impacts is uncertain.

24 International Accounting Standards Board (2017) Definition of Material. [Online] Available from http://www.ifrs.org/-/media/project/definition-of-materiality/exposure-draft/ed-definition-of-material.pdf

Selected disclosure frameworks and their approach to materiality

Mainstream reporting extends beyond the financial statements to risk and governance disclosures as well as information about the company's strategy, business model and performance targets. Accordingly, Appendix 4 of the TCFD Final Report lists selected disclosure frameworks and laws that already request some or all of this type of information, including sub-sets of the climate-related information covered in the TCFD recommendations. We focus our analysis on the UK Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

We recognise that climate-related financial disclosure is an international issue and, in subsequent reports, could extend our analysis to other jurisdictions. However, for the purposes of this paper, we have chosen to analyse potential learnings from the Strategic Report Regulations in the UK, because:

- The Strategic Report requirements cover many of the same reporting elements as the TCFD, such as risk, strategy and targets;
- The requirements have recently been updated to reflect the UK Government's implementation of the EU Non-Financial Reporting Directive 2014/95. The Directive requires companies within its scope to report (among other things) on environmental matters and principal risks and therefore covers similar subject matter to the TCFD;
- Guidance on the strategic reporting requirements is under review to provide (inter alia) a greater focus on governance, in particular, on the director's duty to "promote the success of the company" and in doing so "have regard to" the broader matters including the consequences of the directors' decisions in the long term, the interests of employees, the need to foster relationships with suppliers, customers and others, as well as the impact of the company's operations on the community and the environment. Therefore, the Strategic Report also covers similar subject matter to the TCFD recommendations;
- Strategic reports are to be included in annual reports, which in the UK are the same as mainstream annual financial filings as defined by the TCFD; and
- The Strategic Report requirements and

associated guidance influence the way in which organizations determine material issues to be included in their mainstream reports.

The Strategic Report

In the UK, certain companies are required to prepare a Strategic Report[25] as part of their annual mainstream reporting package. The requirements were introduced in regulations[26] with supporting guidance and their purpose is to elicit information from companies, which informs shareholders and other stakeholders about the position and performance of the company and helps them to assess how the directors have performed their duty[27] to promote the success of the company. Subject to certain conditions, the strategic report should include (inter alia) a description of matters that correspond with some of the TCFD disclosure recommendations:

- The main trends and factors likely to affect the future development, performance or position of the business;
- A description of the principal risks and uncertainties facing the entity together with an explanation of how they are managed or mitigated; and
- Information, including any relevant policies, about environmental matters, the entity's employees and social, community and human rights.

In December 2016, the Strategic Report requirements were amended by regulations[28] implementing the EU Non-Financial Reporting Directive (NFR)[29]. As UK law already contained many of the requirements of the NFR, the amendments did not make significant changes to existing provisions on the Strategic Report.

In brief, the amendments require that (in prescribed circumstances), the Strategic Report must include a "non-financial statement", which must contain information, to the extent necessary for an understanding of the company's development, performance and position, and the impact of its activity[30], including environmental information; a description of the policies pursued by the company in relation to environmental matters together with the outcome of those policies; a description of the principal risks relating to environmental matters and how they are managed and a description of the non-financial KPIs relevant to the company's business.

The UK Financial Reporting Council (FRC) is reviewing Guidance on the Strategic Report[31] through publication of an Exposure Draft (referred to in this report as draft guidance). The proposed amendments to the guidance are designed to reflect changes arising from the implementation of the NFR, enhance the linkage between the purpose of the strategic report and directors' duty to promote the success of the company, and to make targeted improvements to certain areas of the Strategic Report guidance to reflect key developments in corporate reporting. An analysis of the proposed updates within the draft guidance is beyond the scope of this paper and CDSB has responded[32] separately to the consultation. However, the FRC draft guidance contains a section on materiality that provides some insights that are potentially useful for the purposes of responses to the TCFD recommendations.

The Strategic Report guidance defines materiality as follows:

"Information is material if its omission or misrepresentation could reasonably be expected to influence the economic decisions shareholders take on the basis of the annual report as a whole. Only information that is material in the context of the strategic report

25 Financial Reporting Council (2017) Guidance on the Strategic Report [Online]. Available from https://www.frc.org.uk/accountants/accounting-and-reporting-policy/clear-and-concise-and-wider-corporate-reporting/narrative-reporting/guidance-on-the-strategic-report

26 The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 resulted in an amendment to existing Company Law requirements and became effective from 1 October 2013.

27 Under section 172 of the Companies Act which requires a director "to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole and in doing so have regard (amongst other matters) to." The likely consequences of any decisions in the long term, the interests of employees, the need to foster business relationships, the impact of the company's operations on the community and environment etc."

28 The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016, which are effective for financial years beginning on or after 1 January 2017

29 European Commission (2016) Non-financial reporting. [Online] Available from https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

30 Here we focus on the environmental requirements as being most relevant to the TCFD recommendations, but the EU NFR is more wide ranging, requiring non-financial statements to include information on the company's employees, social matters, respect for human rights and anti-corruption and anti-bribery matters.

31 Financial Reporting Council (2017) Draft amendments to Guidance on the Strategic Report [PDF] Available from https://www.frc.org.uk/getattachment/9e05c133-500c-4b98-9d76-497172387bea/;.aspx

32 Climate Disclosure Standards Board (2017) CDSB Consultation Response [PDF] Available from https://www.cdsb.net/sites/default/files/cdsb_response_to_draft_uk_frc_amended_strategic_report_guidance.pdf

should be included within it. Conversely, the inclusion of immaterial information can obscure key message and impair the understandability of information provided in the strategic report. Immaterial information should be excluded from the strategic report."

The draft guidance proposes adding the following text to the Strategic Report guidance:

"The strategic report requirements use terms such as 'principal' (e.g. as used in the term 'principal risks and uncertainties'), 'key' (e.g. as used in the term 'key performance indicators (KPIs)' and 'necessary for an understanding of.' These terms serve as a filter to ensure that neither too little nor too much information is included and serve as a guide to the level of detail that should be provided. As materiality is a commonly understood term in financial statements, this guidance uses the term material in conjunction with principle, key or necessary for an understanding of, to help guide entities in making the judgement of what level of disclosure is necessary."

The IASB's Disclosure Initiative and the fact that the FRC has considered it necessary to add further terms, such as "key" and "principal" for the purpose of facilitating materiality judgements suggest that the mainstream reporting model (at least through the work of the IASB and FRC) has not fully solved the problem of how to apply materiality.

The difficulty of making materiality judgements applies widely to financial statements and other reporting vehicles, as well as to climate change disclosures. The analysis in this part of the discussion paper suggests that the reasons include lack of guidance on how management should apply judgement, use of the wrong lens in determining what might be important to investors, over-reliance on quantitative tests and possibly fear of litigation or enforcement from making mainstream disclosures as opposed to voluntary reporting.

Furthermore, disclosure of forward-looking information underpinned by assumptions presents particular difficulties for companies. From the outset, the TCFD has stressed that its recommendations are market-led and need to reflect existing widespread market standards on climate reporting. The above analysis shows that market practice is generally not to report climate information through mainstream channels and that the mainstream is arguably not ready for the integration of climate information albeit that the extension of some of the inner logic from IASB standards and materials might help.

Common themes on the application of materiality: challenges and possible solutions

In this section, we aim to identify and develop some common themes that emerge from the analysis above with a view to considering what it means to "determine materiality for climate-related issues consistent with how [it is] determine[d] [with] other information included in... financial filings."

For the purposes of describing the common themes and how they might help in the course of making materiality judgements on climate disclosure, we have consolidated and condensed aspects of pronouncements made by the IASB, TCFD and FRC. As financial statements, management commentary, the Strategic Report/Non-Financial Statement and disclosures made in response to the TCFD recommendations are all intended for the annual report, we see some merit in integrating the guidance offered on these different elements of the annual report in the form of common themes. However, this necessitates some generalisation about the combined meaning of the IASB, TCFD and FRC's pronouncements. We do not aim to replicate IASB, TCFD and FRC guidance: we want to provide a general sense of how those pronouncements can be applied to help with the implementation of the TCFD recommendations.

We identify common themes of what the IASB, TCFD and FRC say about materiality in mainstream disclosure, together with the challenges they present. Finally, we set out potential solutions for addressing those challenges.

Materiality judgements must take account of the needs of information users

Summary

Information is material if omitting it or misstating it could influence or reasonably be expected to influence the decisions, including the economic decisions, that users of the annual report might make about the company based on the annual report as a whole.
The annual report and its constituent elements, including TCFD disclosures, are designed for an audience of current and potential investors and should therefore contain information material to that audience.

Challenges

Who exactly are the users?

As the TCFD Phase 1 report noted, there is no single representative user of corporate reports, "nor can any single constituency of users be treated as a homogeneous entity." Even within the community of investors, the TCFD identifies asset owners, sell-side analysts, investment consultants, proxy advisers, index providers, beneficial users, individual investors in fund structures, banks, credit rating agencies and so on. The challenge is to determine materiality by reference to a multiplicity of users even within the single category of investors.

IAS 1 says: "assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users...Users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions."

The FRC draft guidance also notes that the shareholder base may comprise groups with different needs and interests and that the needs of all significant shareholder groups should be taken into account when determining whether a matter is material including those who take a long-term view on investment.

How do you incorporate feedback from stakeholders beyond the primary user?

Although current and potential investors are the primary audience for and users of the annual mainstream report and TCFD disclosures, many companies engage with a wide range of stakeholders, including customers, suppliers, community groups and NGOs to help identify which issues are most material. Where there are conflicts between the views of investors, other stakeholders and management, dilemmas will arise about what to disclose as material information. In practice, companies find it difficult to ignore the views of their stakeholders even where they are divergent with what management considers to be material. However, the primary users of financial and annual reports as specified by the IASB, the FRC and the TCFD are investors and should form the single organising focus in determining what and how to report. Other mechanisms can be used to address the specific interests of individual stakeholder groups, consistent with their needs and objectives, rather than "forcing" the information into the mainstream report.

Leave out immaterial information and don't obscure material information

Summary

The TCFD states that disclosures should be "eliminated if they are immaterial or redundant to avoid obscuring relevant information." Both the IASB and the FRC seems to recognise that immaterial information might sometimes be included in a mainstream report but stress that in doing so management should ensure that material information is not obscured.[33]

The IASB Principles of Disclosure discussion paper identifies difficulties in applying judgement when deciding what information to disclose in financial statements as the main cause of the "disclosure problem". Based on feedback, the IASB contends that the difficulties are often behavioural and attributable to many companies following a mechanical and checklist approach to reporting rather than applying judgement to determine what information is relevant to users and how best to communicate it.

Challenges

With the introduction of the Paris Agreement, the UN Sustainable Development Goals and the TCFD recommendations, it can be difficult for companies to report that climate change does not present them with material risks and/or opportunities, even where that is management's conclusion over the period for which material issues are determined. Principle 1 of the TCFD recommendations suggests that at least something should be entered in the mainstream report on the subject of climate change as follows: *"when a particular risk or issue attracts investor and market interest or attention, it may be helpful for the organization to include a statement that the risk or issue is not significant. This shows that the risk or issue has been considered and has not been overlooked."*

Special note

As noted above, the TCFD has indicated that their recommended disclosures on governance and risk should be regarded as material in all cases as they provide context against which investors can assess other information. In other words, climate change should be regarded as material not just to the company but also for investors in understanding the impact of climate risks on their entire portfolio. However, we wonder how, in practice, companies will square this with their materiality judgement processes.

Materiality is entity specific

Summary

Materiality is an entity specific aspect of relevance based on the nature and magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.

Challenges

The IASB refers to the possibility of materiality being interpreted to mean that a disclosure is necessary only in the event that the matter in question is material to the entity and that this "creates the illusion that materiality is not necessary in other instances." In their staff paper on materiality, the IASB says that relevant sources of information on which management should draw in order to make their judgement include *"macroeconomic information about the economy and the industry sector in which the entity operates. Although materiality is an entity-specific assessment, general economic and industry sector data can shape primary users' expectations."* Therefore, *"in making the materiality assessment, management would need to not only draw on their knowledge of the entity but also to consider the potential impact of broader environmental factors. Those factors could include changes in the entity's industry sector, the macro-economic environment and the impact of climate change."*

It is clear that general economic and industry sector data can shape primary users expectations. The challenge for management is to identify how much (if any) information to include in the mainstream report about the impact of climate change on their business when the risk is unlikely to be measurable and any disclosure will necessarily be qualitative or quantified based on subjective or restricted bases.

Materiality should be assessed over appropriate time horizons

Summary

In his Tragedy of the Horizons speech, Governor Mark Carney commented that "once climate change becomes a defining issue for financial stability, it may already be too late." Possibly, for that reason, the TCFD puts a great

33 The IASB states that "IFRS does not prohibit entities from disclosing immaterial information. Nevertheless, it requires them to consider whether disclosure of immaterial information results in material information being obscured.". IFRS (2017) Materiality Practice Statement [Online] Available from: http://www.ifrs.org/projects/2017/materiality-practice-statement/

deal of emphasis on forward-looking information and encourages companies to consider climate risks and opportunities over the short, medium and long term. Whilst encouraging companies to determine materiality based on the approach they use for their financial filings, the TCFD Final Report *"cautions organizations against prematurely concluding that climate-related risks and opportunities are not material based on perceptions of the longer-term nature of some climate-related risks."*

The FRC also states that a strategic report should have a forward-looking orientation. Regarding the materiality of an item in the financial statements, the FRC's draft guidance states that determination may be based on its magnitude relative to other items included in the financial statements in the year under review, but may also be based on the potential effect over the longer-term. Certain international accounting standards take a longer-term view. Whilst for IAS 1 the going concern assumption has a relatively short look out period of the next twelve months, from an IAS 12 perspective deferred tax could go out for many years. Similarly, IAS 36 impairment testing can have a very long look out period.

Challenges

The TCFD does not specify what is meant by short, medium and long term because the timing of climate-related impacts on organizations will vary. The challenge for management is to determine the appropriate time frames for the assessment of climate-related risks and disclose the results as part of their response to recommended disclosures on Strategy which ask organizations to provide a description of:

- What they consider the relevant short, medium and long-term time horizons, taking into consideration the useful life of the organization's assets or infrastructure and the fact that climate-related issues often manifest themselves over the medium and longer terms; and
- The specific climate-related issues for each time horizon (short, medium and long term) that could have a material financial impact on the organization.

Assessing materiality involves taking account of the nature and magnitude of issues, not just quantitative thresholds

Summary

Materiality is an entity-specific aspect of relevance, based on the nature or magnitude or both of the items to which the information relates in the context of an individual entity's financial report. The IASB does not specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation. The materiality of an item in the financial statements may be based on its magnitude relative to other items included in the financial statements, but may also be based on the potential effect over a longer term. Both the FRC and IASB caution management against relying solely on quantitative thresholds when making their materiality judgements. The FRC's draft guidance says: "the disclosure of the auditing materiality figures in the audit report may focus attention on materiality as a number. In the context of qualitative information in general and non-financial information in particular, however, a numerical materiality figure is of less importance and a separate assessment may be required."

Challenges

The challenge for companies is how to assess the materiality of non-financial items which are difficult to assess other than on a qualitative basis.

Choosing material key performance indicators (KPIs), metrics and targets

Summary

The TCFD recommended disclosures on metrics and targets encourage companies to disclose "the key performance indicators used to assess progress against targets."
Tables 3 – 6 in the Annex to the Final Report set out illustrative metrics for use by the four non-financial industry groups identified by the TCFD. Other organizations, such as the SASB, have developed standards and material indicators at sector level. The Strategic Report also requires disclosure of KPIs. The FRC states that the KPIs used will generally be the performance measures and risks considered by the board for management and oversight of the entity, and that the number of items disclosed should be relatively small rather than a comprehensive list of all performance measures used within the business.

Challenges

Given the multiple indicators offered by the TCFD and other organizations, the challenge for companies is how to identify the indicators, metrics and targets that reflect their own materiality judgements rather than the expectations of multiple audiences, stakeholder groups and peers.

Possible strategies for materiality determination

3

Possible strategies for effective materiality determination

In this section we offer a range of possible approaches that might help companies in their materiality judgement process and presentation of the results of that process when responding to the TCFD recommendations.

Develop a climate reporting strategy

The themes identified in the previous section apply to and present their own challenges for mainstream reporting generally. However, they present specific challenges for climate reporting in response to which it may be appropriate to develop a strategy on how those challenges will be addressed. This is likely to entail an internal process, involving cross-departmental experts, to make decisions about:

- Which significant audiences information disclosures will be directed at;
- What processes, criteria, timescales and sign-off processes will be used for identifying climate-related information and whether they are the same as processes and criteria used for other mainstream reporting practices; and
- What is the scope of information that will be used to inform materiality determination decisions, including internal feedback, external stakeholders and macro-economic trends.

Disclose the company's climate reporting policy

Financial statements open with a description of the way in which financial reporting standards have been applied in preparing the statements, the decisions management has taken - for example on the inclusion or not of acquired entities - and general commentary about the basis on which information has been prepared. Whilst the approach to reporting climate information should be the same or substantially similar to that used for mainstream reporting generally, we suggest that where adaptations for climate disclosure have been made, they should be described in an opening statement of reporting policy to explain the basis on which climate disclosures have been prepared. This will draw on conclusions reached from the development of a reporting strategy and might include details of:

- The materiality determination process and criteria, including the timescales over which the process has been conducted. TCFD Recommendations for strategy disclosure states *"organizations should provide a description of the process(es) used to determine which risks and opportunities could have a material financial impact on the organization."* The Task Force also recommends the process should be the same or substantially similar to that used for mainstream reporting. Any adaptations should be reported to assist readers. For example, given the nature of climate change, a longer time horizon for the assessment of risk might be appropriate for certain industries with longer asset lifetimes. We recommend that the frequency of materiality determination is also disclosed in the reporting policy. This is because there are some material climate risks that are inherent to the business and will not change from year to year, therefore it will help readers to understand the frequency of materiality testing and how the company deals with emerging or new risks in their reporting practice; and
- The organizational reporting boundaries and scope. For clarity, the reporting policy should describe the entities, operations and activities about which information is reported where they differ from the boundaries used for the mainstream report generally.
  As climate risks and opportunities can manifest in the supply and value chains of organizations, the reporting policy might need to describe the extent to which the boundaries of the organization have been extended for climate risk materiality determination. Furthermore, the policy should explain any entities, operations or activities that have been left out of the scope of climate reporting and why, such as lack of or unreliable data from subsidiaries.

The Audience

As noted above, the audience for climate information – even within the community of investors – can have diverse interests and information needs.

The IASB October 2015 ED states that "if an entity has many classes of primary users, the financial statements should present and disclose information so as to meet the common information needs of a broad range of those classes." An [IASB Staff Paper](http://www.ifrs.org/-/media/feature/meetings/2016/july/asaf/meeting-summary/meeting-summary-july-2016.pdf)[34] advises management to draw on its knowledge of the primary users' information needs and expectations, including how past communications by the reporting entity have been received. A [Harvard Business School study](http://www.hbs.edu/faculty/Publication%20Files/16-023_f29dce5d-cbac-4840-8d5f-32b21e6f644e.pdf)[35] considers what it means for companies in operational terms to determine the relative importance of different providers of financial capital and other audiences. The study suggests that annually, the board issues a forward-looking "Statement of Significant Audiences" that will inform readers of the audiences the board believes to be important

Material metrics

Most commentaries seem to agree that material metrics should reflect the indicators, targets and metrics used by management for running the business on the basis that what is relevant for the business will be material for the audience. The TCFD, SASB and others have published lists of indicators that are considered to be most material at sector level. In order to be useful and coherent over time, metrics should conform with certain characteristics. The FRC's draft guidance sets out useful guidance on the characteristics of "Alternative Performance Measures" based on [ESMA Guidelines](https://www.esma.europa.eu/press-news/esma-news/esma-publishes-new-qa-alternative-performance-measures-guidelines)[36] as does IFAC's Guidance on Developing and Reporting Supplementary Financial Measures.

It might also be useful to distinguish the types of metrics used for climate disclosure. For example, ISO 14031 describes three main types of indicators:

- Indicators of business-induced environmental change (e.g. impact or pressure indicators);
- Process-based indicators (e.g. the degree of implementation of environmental management systems or action plans); and
- Results or performance based metrics (e.g. the ratio of product or service value to its environmental effect on energy, material and water consumption).

Presentation and disaggregation

As noted previously, climate information may serve multiple audiences (within the investor community), represent risks over different timeframes (short, medium and long term), and at entity specific and systemic levels. Different issues might also be material for different business divisions. The type, quality and verifiability of information reported about material issues could therefore differ depending on the division to which it relates, the timeframe concerned and whether the risk manifests at entity specific or systemic level. We suggest that for the purposes of presenting climate related information a distinction is made between:

1. Reporting content that is material to the performance and prospects of the reporting company, such as entity specific information;
2. Reporting content that is material because at aggregate/system wide level, it has a material impact on the climate and therefore affects the context in which management and others assess the company's performance and prospects;
3. Representative and specific risks. Some climate risks are likely to be shared by all sectors, whereas the TCFD, SASB and others have identified risks that are likely to affect particular sectors, facilities and industries. Specific risks should be distinguished for clarity; and
4. Inherent and new risks. This enables "standing information", such as information that does not change year on year to be distinguished from new or emerging risks.

Communicating a decision that climate change is not material and what to do with information that is not material yet

What should companies do when climate change is not considered material?

1. Record this in the mainstream report to show that it has been at least considered.
2. Put the information in other reports. Both the FRC and the TCFD advise companies to put complementary information that is not required to be included in the mainstream report elsewhere in the public domain. Possible reasons for concluding that climate information is not material and does not

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34 International Accounting Standards Board (2016) Summary note of the Accounting Standards Advisory Forum [PDF] Available from http://www.ifrs.org/-/media/feature/meetings/2016/july/asaf/meeting-summary/meeting-summary-july-2016.pdf

35 Eccles, R.G. and Youmans T. (2015) Materiality in Corporate Governance: The Statement of Significant Audiences and Materiality, Harvard Business School [PDF] Available from http://www.hbs.edu/faculty/Publication%20Files/16-023_f29dce5d-cbac-4840-8d5f-32b21e6f644e.pdf

36 European Securities and Markets Authority (2017) ESMA publishes new Q&A on alternative performance measures guidelines. [Online] Available from https://www.esma.europa.eu/press-news/esma-news/esma-publishes-new-qa-alternative-performance-measures-guidelines

warrant disclosure in the mainstream report could include:

- It is not material yet - the Task Force encourages organizations where climate-related issues could be material in future to begin disclosing climate-related financial information outside financial filings to facilitate the incorporation of such information into financial filings once climate-related issues are deemed to be material; and
- It is not in line with the objectives or context of the mainstream report.

3. Where climate information is published outside the mainstream report, the following steps should be taken:

- Inform readers of management's decision. Relevant advice appears in in paragraph 36 of the IASB Practice note "in some cases it might be helpful to disclose the fact that a particular issue is immaterial to the entity. For example, management may wish to inform the primary users that the entity is not exposed to a particular risk normally associated with an item that is of particular interest to market participants."
- Use consistent internal processes. The TCFD advises companies that where information is published in "other" official company reports, it should be "subject to internal governance processes that are the same or substantially similar to those used for financial reporting."
- Cross reference from the mainstream report to the other report or location where climate change information may be found. The IASB's Principles of Disclosure discussion paper sets out conflicting views on the role of cross-referencing and we wonder whether any guidance emerging from the Initiative will inform future practices on cross referencing. The Principles of Disclosure discussion paper also expressed concerns that excessive cross-referencing can make reports fragmented and difficult to understand. It can also make it difficult to identify which information forms part of the annual report and what has been audited, and find the cross-referenced information.

Some acid tests

It is difficult and arguably dangerous to specify acid tests for the identification of material climate-related issues. However, the following list is designed to summarise what we have learnt from a review of mainstream reporting guidance and associated literature. In summary, climate issues should be treated as materiality "alerts" where they:

- Give rise (now or in the timescales over which materiality is determined) to financial impacts;
- Threaten the resilience of the company's strategy or business model;
- Affect the ability of the company to generate or preserve value; or
- Keep the directors awake at night.

CDSB's Framework on Environmental Information and Natural Capital

Principle 1.1 of the CDSB Framework states that environmental information is relevant where it:

- Is capable of making a difference to the decisions made by users of information in mainstream reports, including where it has:
  - Value as an input to predictive processes used by investors to inform their own expectations about the future performance of the business. This includes information that, while not currently affecting the organization or its strategy, is expected to have an impact over the period management considers for the purposes of assessing the prospects of the business;
  – Confirmatory value, i.e. where it confirms or changes past or present expectations, based on previous evaluations.
- Reflects the information that is important to management in managing the business and assessing how environmental impacts and results actually or potentially affect the organization's strategy;
- Complies with mainstream corporate requirements or compliance requirements on the disclosure of environmental information;
- Reflects the reality of the organization's business;
- Promotes an understanding of how dependence on natural capital, actual and potential environmental impacts and the organization's environmental results and policies contribute to its financial condition;
- Takes account of stakeholder views; and
- Takes account of the specific requirements of the CDSB Framework.

Principle 1.2 of the CDSB Framework states that environmental information is material[37] if:

37 Materiality has been further defined by the Natural Capital Protocol as "an impact or dependency on natural capital is material if consideration of its value, as part of the set of information used for decision making, has the potential to alter that decision".

- The environmental impacts or results it describes are, due to their size and nature, expected to have a significant positive or negative impact on the organization's financial condition and operational results and its ability to execute its strategy;
- Omitting, misstating or misinterpreting it could influence decisions that users of mainstream reports make about a specific reporting organization. Indicators, measures, quantitative and qualitative information should therefore be treated as material and reported to reflect the extent to which the organization has:
- Undertaken activities that actually or potentially give rise to environmental outcomes and/or impacts that have an actual or potential effect on the organization's ability to operate its business model and execute its strategy over the period management considers for the purposes of assessing the prospects of the business through changes in:
- Resource availability, supply, pricing, degradation, policy/regulatory constraints – particularly resources on which the organization is dependent;
- Relationships on which the organization is dependent (for example, the extent and probability that an organization's business activities may cause stakeholder actions to protect environmental resources, benefits and ecosystem services);
- The organization's capacity to innovate (for example, whether a renewable alternative offers opportunities to the organization in maximising its ability to create value);
- The organization's ability to influence natural capital, for example through its supply chain, procurement of resources from sustainable sources and impacts associated with the use of the organization's goods and services; and
- Brand and reputational consequences. For the purposes of conformance with REQ-04, GHG emissions as a contributor to climate change shall be treated as material and reported in all cases. However, this does not mean that GHG emissions are prioritised over other forms of natural capital impacts.

Conclusion

Hundreds of articles have been written about the efficacy of materiality in corporate reporting, ranging from the comparison with packing a backpack for a hike (you can only take supplies that are crucial otherwise the weight will slow you down) to a study on the genealogy of accounting materiality which traces its roots in philosophy, theology, social anthropology, and everything in between. Problems associated with the application of materiality in corporate reporting are a widely acknowledged problem and specifically recognised by the TCFD as being a subject of "considerable disagreement", but necessary for incorporation into its work. However, rather than addressing the issue for climate disclosure purposes, the TCFD simply advises reporters to use the approach to materiality that applies to their other mainstream reporting. Whilst we fully support the integration of climate information, in the context of material natural capital and other environmental impacts, into mainstream reports and agree that, by definition, the same (or substantially similar) processes should apply. As we have shown, the mainstream model itself continues to evolve to address the limitations of current materiality approaches. The intentions of climate-related financial disclosures could be frustrated where they are not catered for in the mainstream reporting model. We believe that more detailed and far-reaching work needs to take place if mainstream reporting infrastructure is to effectively integrate climate change-related reporting.

Other reporting guidance

CDSB has previously published the paper "Positions on relevance & materiality, organizational boundaries and assurance". The CDSB Framework is designed for the purpose of reporting climate change-related and environmental information in mainstream reports. The paper details the materiality position adopted by CDSB in relation to the three key themes in the CDSB Frameworks for Reporting Climate Change and Environmental Information and Natural Capital. Please see guidance at www.cdsb.net.

Invitation to comment

CDSB welcomes discussion about and input to our work. If you would like to comment on the positions above or on the CDSB Framework, please contact us at info@cdsb.net. For further information, please consult www.cdsb.net.

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