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As the planet becomes warmer, accounting standards are already adapting to the changing environment.

By MASB secretariat

Directors - what's on the weather radar for your company?

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As the planet becomes warmer, accounting standards are already adapting to the changing environment.

In October last year, the Prime Minister announced that Malaysia would establish the National Council of Climate Change Action and that the Malaysian Green Technology Corporation would be renamed the Malaysian Green Technology and Climate Change Centre^[1] with a mandate to undertake, amongst other things, climate change-related risk analytics and policy coordination amongst different levels of government.

Earlier, in May, The Malaysian Chapter of The Climate Governance Initiative (CGI) was established by a group of Non-Executive Directors (NEDs) from Bursa Malaysia listed companies to encourage NEDs to acquire the skills needed to assist their companies through effective climate transition. The Malaysian Chapter was the first country-level chapter established under The Climate Governance Initiative instigated by the World Economic Forum, an international, not for profit organisation which engages the foremost political, business, cultural and other leaders of society to shape global, regional and industry agendas.

Both these recent developments highlight the growing awareness amongst political and business leaders of the need to address climate change in future policy and strategic decision making.

This is likely to lead to greater focus, as is already occurring globally, by investors and other key stakeholders, on climate change risks within investment portfolios.

Consequently, it is timely to remind directors of how climate change risks are dealt with in current accounting standards and guidance.

^[1]<https://www.pmo.gov.my/2019/10/speech-at-the-international-greentech-eco-products-exhibition-conference-malaysia-jgem-2019/> (see paragraphs 13 and 14)

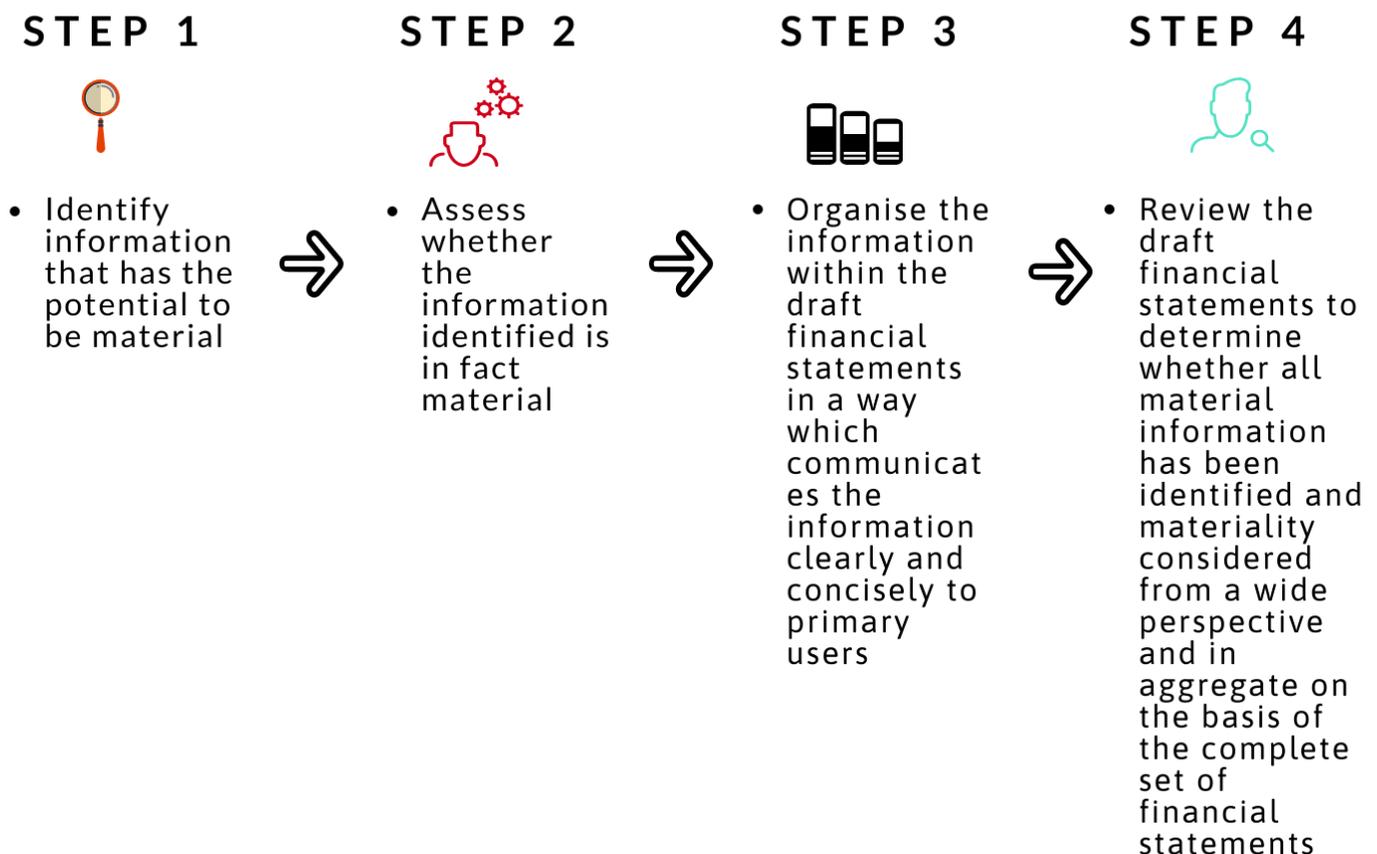
Materiality in financial statements and the impacts

Climate change risks are not covered by a specific accounting standard. However, recent amendments to the Definition of Material in MFRS Standards and consequential amendments to Practice Statement MFRS PS 2 Making Materiality Judgements (MFRS PS 2), which are effective from 1 January of this year, further clarify that materiality needs to be considered in relation to a reporting entity's own circumstances. The amendments also highlight that materiality depends on the nature or magnitude of information, or both and that an entity assess whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole. Applying these words, it would not be appropriate for an entity to rely purely on numerical guidelines or apply a uniform qualitative threshold for materiality.

Although MFRS PS 2 is not mandatory, it provides companies with guidance on how to make materiality judgements when mandatory Standards are applied. It highlights that making materiality judgements involves considering both numerical and qualitative factors.

Qualitative factors would include the industry in which the entity operates and investor expectations, which may lead to qualitative information about risks being regarded as material and warranting disclosure in the financial statements irrespective of the current numerical impact.

MFRS PS 2 sets out a four-step process:



Climate change has the potential to affect the performance of a business, the value of its assets and its exposure to liabilities.

In some cases it may be feasible to measure the impacts on assets and liabilities currently recognised in the financial statements, for example by considering the effect on the useful life and fair value of assets, expected credit losses for loans and provisions for onerous contracts or fines and penalties.

In other cases, it may not be feasible to measure the impacts on assets and liabilities currently recognised in the financial statements or the directors might conclude that the likely impact on existing assets and liabilities is not material in a quantitative respect. Nonetheless, applying MFRS PS 2 may lead them to decide that qualitative information is material and should be disclosed in financial statements when it either:

- (a) explains why assets are not affected and the entity is not exposed to further liabilities; and/or
- (b) there are risks around future exposures, including the potential impacts on future net cash flows.

Existing accounting standards most likely to warrant further consideration

Based on an overview undertaken recently of International Financial Reporting Standards by a member of the International Accounting Standards Board (IASB), specific Malaysian Financial Reporting Standards (MFRS) likely to warrant further consideration in relation to climate change by Directors are:

MFRS 1 *Presentation of Financial Statements* which requires consideration of information that is not presented elsewhere in the financial statements but could be expected to influence decisions by investors. Under the Paris Agreement, Malaysia has undertaken to reduce carbon emissions by 35% over 2015 levels by 2030^[2]. This commitment is being met by a number of initiatives including greater reliance on renewable energy and the use of biofuels. However, it may mean that long term assets within the portfolios of some companies could become impaired as customers switch demand to less carbon intensive energy sources such as wind power and ethanol.

Consequently, it could be necessary for companies which generate and sell energy from the burning of fossil fuels or refine and distribute petroleum products to explain the extent to which climate related risks are a source of estimation uncertainty.

[2] https://www.miti.gov.my/miti/resources/Article_on_Malaysia_UNFCCC-Paris_Agreement.pdf?mid=572 (see last paragraph of page 1)

MFRS 136 *Impairment of Assets* requires an entity to consider evidence of asset impairment. Exposure to climate-related risks could be an indicator of impairment and, consequently, could affect the carrying value of assets such as property, plant and equipment. Expectations about the impacts of climate change might be among disclosures on key assumptions underlying future estimated cash flows on which recoverable amounts have been determined. For example, as more power is generated from renewable resources, reduced demand for energy produced by burning coal may result in lower coal costs but also lower selling prices for the energy generated. The net effect of these changes may reduce future cash flows and hence the recoverable amount of energy generating assets.

MFRS 116 *Property, Plant and Equipment* and MFRS 138 *Intangible Assets* require consideration of the estimated useful lives of assets and therefore the amount of depreciation or amortisation required. For example, reduced demand could lead to some boilers in a coal fired power station being taken out of service earlier than originally anticipated with the result that the useful life of the boilers is reduced.

MFRS 9 *Financial Instruments* and MFRS 7 *Financial Instruments Disclosures* necessitate the use of forward-looking information to consider credit losses and disclose exposure to market risks arising from financial instruments whilst MFRS 13 *Fair value Measurement* requires disclosure of key assumptions used when assets are recognised at fair value. For example, with more laws and regulations to mitigate climate-related risks, financial institutions with loans to companies which are high emitters of carbon dioxide may need to disclose the significance of these loans within the overall loan portfolio.

MFRS 137 *Provisions, Contingent Liabilities and Contingent Assets* requires the disclosure of any contingent liabilities and where practicable, an estimate of their financial effect. With greater regulation, for example, over the emission of carbon dioxide into the atmosphere, there is greater potential for some companies to be exposed to litigation and fines and penalties for accidental breaches of the regulations or the costs of decommissioning assets or rehabilitating environmental damage.

Better information for primary users of financial statements is good practice given the uncertain nature and impact of climate change

As the review of existing standards and practice statements set out above demonstrates, the consequences of climate change likely to have a material impact on an entity's financial position should already be considered by directors when determining the content to stakeholders.

MFRS Practice Statement 1 Management Commentary (MFRS PS 1)

MFRS PS 1 released in February 2013 sets out a non-binding framework for preparing management commentary on financial statements prepared applying MFRS standards. Under MFRS PS 1, the management commentary is viewed in part, as providing additional insights into an entity's long-term prospects. The IASB is currently working on a revision to the IFRS equivalent of MFRS PS 1, an aspect of which will be guidance to support the identification and discussion of matters affecting an entity's future success, including factors such as climate change and related regulation that may affect its long-term sustainability. Once the IASB has completed its revision, the MASB plans to revise MFRS PS 1 accordingly.

In undertaking the review and update of Management Commentary, the IASB and MASB are conscious of the fact that since 2013, there has been a wide variety and range of initiatives in providing additional information about how the entity affects its social and economic environment and how that environment impacts the entity. A common example of this is the inclusion, in a number of jurisdictions, of a sustainability report within the overall annual report.

In its review, the IASB will focus on information about socio economic factors affecting the entity. Whilst the guidance will continue to be principle-based, it will focus on what management needs to consider in order to identify and report on economic, social and governance matters that could affect the entity's future success. Specifically, the economic, social and governance matters should be discussed in management commentary if information about them could affect users' assessments of the amount, timing or uncertainty of the entity's future cash flows, or otherwise affect users' economic decisions.



Avoiding information overload and further prescriptive requirements

With the growth of social media, internet information platforms and a broadening of the stakeholder base, there are increased community expectations regarding accountability and disclosure by economic entities. This is placing more pressure on directors and standard setters to respond accordingly. In so doing, it is important that the response is both measured and appropriate to the circumstances of the individual entity. This review of accounting standards and practice guidance in the context of the increasing global community concern with climate change, is designed to assist directors of Malaysian reporting entities to respond in a timely, effective and proportionate manner based on existing mandatory MFRS and non-binding guidance.

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