Blogs
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Public Chatter

The SEC’s Climate Proposal: Impact on Financial Statements

Digging further into the **SEC's proposing release for climate disclosure,** the SEC's proposal would expand Regulation S-X and create specific requirements for a note to financial statements addressing climate change issues in a number of ways. This is a big deal. By requiring this type of disclosure in the financial statements, the SEC's rules would be directing independent auditors to get more involved with climate change matters during the auditing process. It also means that these climate disclosures would fall within the purview of a company's internal controls. The result would be quite a significant extension from what is required now during the preparation, and audit, of financial statements. Both **FASB** and **IFRS** have previously put out guidance regarding the ways in which climate-related matters may require disclosure in financial statements. But the proposed rules go far beyond that guidance, and the proposing release notes that the rules would increase consistency and comparability of such disclosures.

The Disclosure Requirements Starting on page 110, the proposing release outlines the ways that metrics would be laid out in a company's financial statements. Proposed Item 14-02 of Regulation S-X would require disclosure about climate metrics in the notes to financial statements about certain disaggregated climate-related metrics that are mainly derived from existing financial statement line items. The types of note disclosure would fall into these three categories: 1. Financial Impact Metrics – Companies would be required to disclose the financial impacts of severe weather events and other natural conditions; transition activities; and identified climate-related risks on line items in the financial statements - unless the sum of the absolute values of the impacts on the line item is less than 1% of the total line item for the relevant fiscal year (so this 1% threshold is akin to a "materiality" qualifier). 2. Expenditure Metrics – Companies would be required to disclose expenditure metrics, which are the positive and negative impacts associated with the same climate-related events, transition activities, and identified climate-related risks as the financial impact metrics that companies identified in #1 above (including the 1% threshold). Companies would need to separately aggregate the amounts of expenditure expensed and capitalized costs incurred during the fiscal years presented. 3. Financial Estimates & Assumptions – Companies would be required to disclose whether the estimates and assumptions used in their financial statements were impacted by exposures to risks and uncertainties associated with - or known impacts from - climate-related events, such as flooding, drought, wildfires, extreme temperatures, and sea level rise.

Putting the Disclosure in Context These financial statement metrics would involve estimation uncertainties that are driven by the application of judgments and assumptions – just like any other financial statement disclosures (e.g., estimated loss contingencies, fair value asset measurements, etc.) – and proposed new Item 14-02(a) of Regulation S-X would require companies to disclose contextual information to enable an investor to understand how it derived the metric, including a description of significant inputs and assumptions used, and if applicable, policy decisions made by the company to calculate the specified metrics.

Examples of What Might Need to Be Disclosed As noted on pages 124-125 of the proposing release, the SEC's proposed rule includes specific examples of severe weather conditions and other natural conditions events – as well as transition activities – to help provide guideposts to companies about what they should be considering, including:

- Changes to revenue or costs from disruptions to business operations or supply chains

- Impairment charges and changes to the carrying amount of assets (such as inventory, intangibles, and property, plant and equipment) due to the assets being exposed to severe weather, flooding, drought, wildfires, extreme temperatures, and sea level rise
- Changes to loss contingencies or reserves (such as environmental reserves or loan loss allowances) due to impact from severe weather events
- Changes to total expected insured losses due to flooding or wildfire patterns
- Changes to revenue or cost due to new emissions pricing or regulations resulting in the loss of a sales contract
- Changes to operating, investing, or financing cash flow from changes in upstream costs, such as transportation of raw materials
- Changes to the carrying amount of assets (such as intangibles and property, plant, and equipment), for example, due to a reduction of the asset's useful life or a change in the asset's salvage value by being exposed to transition activities
- Changes to interest expense driven by financing instruments such as climate-linked bonds issued where the interest rate increases if certain climate-related targets are not met

The proposing release also highlights that some of these might pose opportunities for companies – positive impacts. A company may disclose the impact of opportunities in the note to financial statements as well, and if it does so, it must do so consistently (e.g., for each fiscal year presented, for each financial statement line item, and for all relevant opportunities identified).

Presentation of the Disclosure - Financial Impacts As noted on pages 121-122 of the proposing release, for purposes of the financial impacts disclosure, within each category (i.e., climate-related events or transition activities), impacts would, at a minimum, be required to be disclosed on an aggregated, line-by-line basis for all negative impacts - and, separately, on an aggregated, line-by-line basis for all positive impacts. However, for purposes of determining whether the disclosure threshold has been met, a company would be required to aggregate the absolute value of the positive and negative impacts on a line-by-line basis. On pages 122-123 of the proposing release, the SEC provides an example of what a disclosure might look like (excluding the required contextual information).

Presentation of the Disclosure - Expenditure Metrics As noted on pages 132-133 of the proposing release, the expenditure metrics would require disclosure of expenditures expensed and capitalized costs incurred within the fiscal years presented, with separate disclosure of impacts within the two categories (climate-related events and transition activities). However, for purposes of determining whether the disclosure threshold has been met, a company would be required to aggregate expenditure related to climate-related events and transition activities within the two expenditure metrics (amount capitalized and amount expensed). On pages 133-134 of the proposing release, the SEC provides an example of what a disclosure might look like (excluding the required contextual information).

Here are our other blogs about the SEC's climate proposal so far: 1. **SEC Proposes Climate Disclosure Rules: 9 Things to Know** 2. **"How Much Is This Gonna Cost Us?" The SEC's Climate Economic Analysis** 3. **The SEC's Climate Proposal: Where Did We Wind Up With "Materiality"?** 4. **The SEC's Climate Proposal: When Should Scope 3 Emissions Be Considered "Material"?** 5. **The SEC's Climate Proposal: Assessing "Physical Risks"** 6. **The SEC's Climate Proposal: Assessing "Transition Risks"** 7. **In-House Corner: Climate Disclosure Bracketology"** 8. **The SEC's Climate Proposal: Disclosing Carbon Offsets** 9. **The SEC's Climate Proposal: Disclosing Internal Carbon Pricing**

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