Preparing for year two of mandatory TCFD reporting

January 2023

More remains to be done in year two

With year one of mandatory TCFD reporting behind them, premium-listed companies are now in the process of preparing for year two.

In some cases, having reported that they were largely consistent with the framework in year one, companies might be anticipating relatively little change. Some, for example, are looking at the balance between what's included in the annual report and what's reported elsewhere, such as in a separate sustainability report.

This might be the right approach in some circumstances, but companies should also bear in mind the messages over the summer from the two main regulators, the FRC and the FCA.

Regulator concerns

In its report issued in July 2022, the FCA noted that over 90% of the companies that it reviewed self-reported that they had made disclosures consistent with the TCFD's Governance and Risk Management pillars, but that this dropped to below 90% for the Strategy and Metrics and Targets pillars. And, of the companies reviewed, only 81% indicated that they had made disclosures consistent with the seven recommended disclosures that the FCA expected every company to comply with (see section (c) under Recommendation 2 for more information).

Even more significantly, from its own reviews of 31 companies, the FCA found that a much lower percentage of companies' disclosures were, in its opinion, actually consistent with the TCFD framework.

With the FCA promising to follow up on its findings, and the FRC (through its Corporate Reporting Review Team) already including issues with climate reporting in its letters, we believe that every company should look again at its TCFD reporting.

Climate change and strategic decisions
Some companies are also starting to make significant strategic decisions, including where to allocate capital, based on information disclosed as part of the TCFD requirements. This is when dealing with the TCFD requirements becomes part of core business decision making, as well as a priority for regulators and other stakeholders.

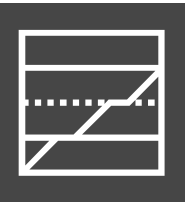
This paper has been developed to help companies to navigate the challenges of year two. It sets out a number of high-level recommendations (summarised below) and specific areas to consider:

Our key recommendations for year two

This paper has been developed to help companies to navigate the challenges of year two. It sets out a number of high-level recommendations (summarised below) and specific areas to consider:

Recommendation 1 – Climate-related judgements

There needs to be a solid basis for the judgements that are made on the relevance and impact of climate change, which should also be reflected in reporting.



Recommendation 2 – Listing Rule reporting requirements

The Listing Rule reporting requirements all need to be appropriately implemented.

Recommendation 3 – Most common areas of inconsistency

The two most common areas where the regulators found companies to be inconsistent with the TCFD framework particularly need to be looked at again.

Recommendation 4 – Climate-related financial disclosures

Companies need to remember that the TCFD framework is looking for climate-related *financial* disclosures.

Recommendation 1 – Climate-related judgements

1

Climate-related judgements

The key message

The ways in which climate change is relevant to companies vary enormously, so a 'one size fits all' approach is not appropriate, either for an individual company's reporting or for the processes that it is based on. The reason why the FCA expects every company to be able to comply with the first seven recommended disclosures of the TCFD is because they are the means by which a company assesses how the issue is relevant, but a checklist approach does not work when dealing with what the risks and opportunities are and how they should be responded to.

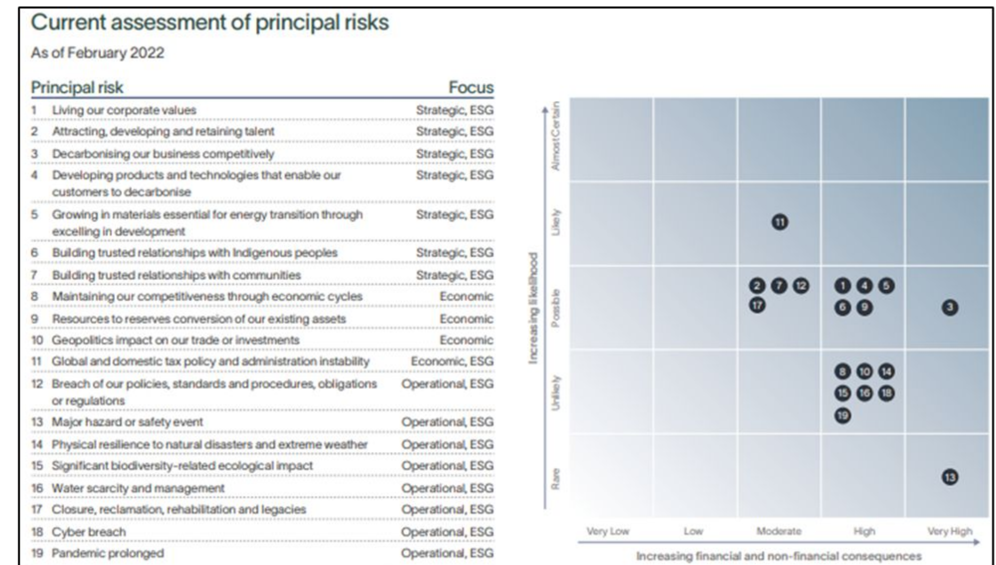
This also makes it inappropriate, in many cases, to give definitive responses to climate-related questions without taking into account all of the specific facts and circumstances.

Specific points to consider

a. *A company's response to the framework should be proportionate and based on a robust assessment*

- The TCFD framework allows companies to make judgements about the relevance of climate change in their own particular circumstances[1].
- However, those judgements need to be based on an appropriately robust assessment of the relevant risks and opportunities.
- So companies should disclose, at the very least, a summary of this robust assessment in their annual report, to allow the reader to understand what judgements have been made and on what basis.

Reporting example - Risk heatmap



Current assessment of principal risks

As of February 2022

	Principal risk	Focus
1	Living our corporate values	Strategic, ESG
2	Attracting, developing and retaining talent	Strategic, ESG
3	Decarbonising our business competitively	Strategic, ESG
4	Developing products and technologies that enable our customers to decarbonise	Strategic, ESG
5	Growing in materials essential for energy transition through excelling in development	Strategic, ESG
6	Building trusted relationships with Indigenous peoples	Strategic, ESG
7	Building trusted relationships with communities	Strategic, ESG
8	Maintaining our competitiveness through economic cycles	Economic
9	Resources to reserves conversion of our existing assets	Economic
10	Geopolitics impact on our trade or investments	Economic
11	Global and domestic tax policy and administration instability	Economic, ESG
12	Breach of our policies, standards and procedures, obligations or regulations	Operational, ESG
13	Major hazard or safety event	Operational, ESG
14	Physical resilience to natural disasters and extreme weather	Operational, ESG
15	Significant biodiversity-related ecological impact	Operational, ESG
16	Water scarcity and management	Operational, ESG
17	Closure, reclamation, rehabilitation and legacies	Operational, ESG
18	Cyber breach	Operational, ESG
19	Pandemic prolonged	Operational, ESG

[Rio Tinto annual report and accounts, pg. 117]

[1] Final report - Recommendations of the Task Force on Climate-related Financial Disclosures, pg.53
[2] CRR Thematic review of TCFD disclosures and climate in the financial statements, pg.56-57

Climate-related judgements (continued)

Specific points to consider

b. It should be clear how 'materiality' has been arrived at

- Part of the assessment of risks and opportunities is to make judgements about the relative importance (or materiality) of the factors considered.
- Where the financial impact of a climate-related issue has been calculated, the level of materiality applied for the rest of the annual report is likely to be a relevant measure.
- Where the financial impact has not been calculated, however, a different approach will need to be used – as is often the case when carrying out a risk assessment exercise. As the FRC noted in its climate change thematic[2] review, this could be done with a risk heat map.

c. The assessment process must be properly documented

- In its capacity as one of the main regulators, the FCA has been clear about the importance of having evidence to support the judgements that have been made: "*there is an expectation that listed companies retain records to support both the statement made in the Annual Financial Report and the detailed assessment of the company's disclosures against the TCFD's recommendations and recommended disclosures.*"[3]
- The FRC[4] has also stated that it will be looking to see evidence for the process that underpins a company's TCFD reporting.
- A summary of the internal process should be included in the annual report to allow users to understand the quality of what has been done.

d. Companies should bear in mind that this will be an ongoing process

- We are only at the start of a process that is likely to go on for many years, over which time companies will need to continue to assess and respond to the actual and potential impacts of climate change on them.
- Judgements and disclosures are therefore also likely to change as time goes on.
- We are in **phase 1** for many companies: getting to consistency with the framework (see next Recommendation) on the basis of the current assessment of risks and opportunities (and based on current available scenarios). **Phase 2** (and beyond) will be an iterative process of monitoring the relevance of ongoing developments and considering how the response/application of the framework (including strategy and metrics and targets) will need to change.

Companies that take these points on board and, where applicable, reflect them in their reporting are likely to be in a stronger position to deal with the issues (and also to generate fewer questions from regulators). They will also be able to demonstrate how and why they might have made strategic decisions related to the climate-related risks and opportunities that have been identified as part of their TCFD disclosures.

[3] Review of TCFD-aligned disclosures by premium listed commercial companies - Getting ready for TCFD-aligned climate-related disclosures

[4] CRR Thematic review of TCFD disclosures and climate in the financial statements, pg.4

Recommendation 2 – The Listing Rule requirements

2

The Listing Rule requirements

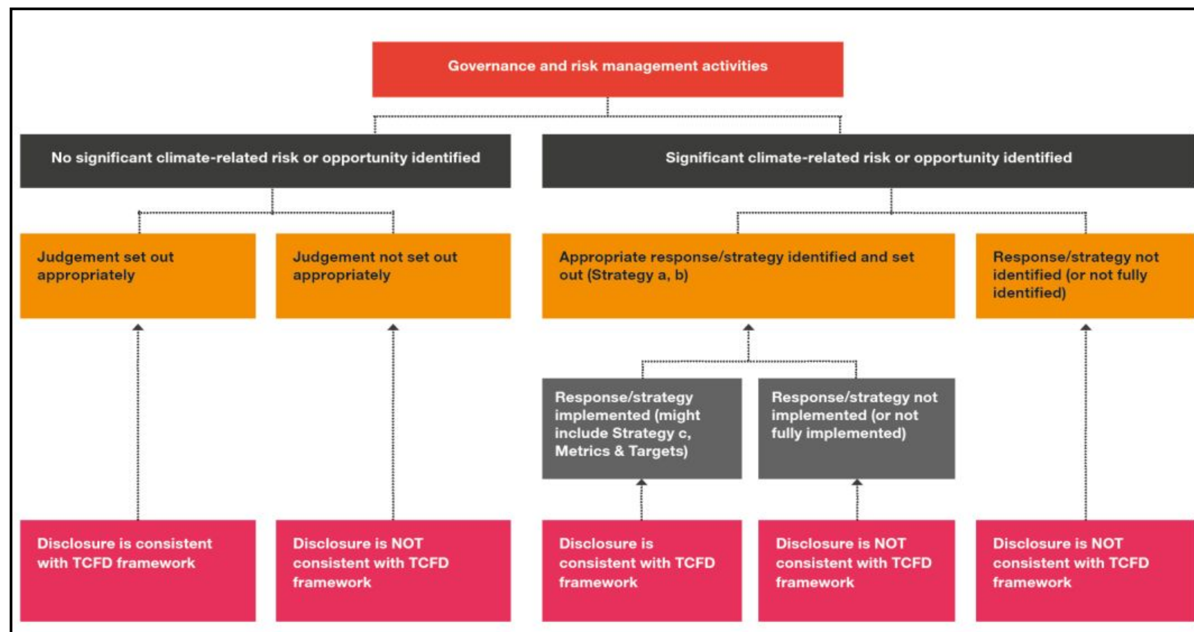
The key message

The FCA recognises that the TCFD framework is not a set of formal reporting standards and that this brings with it a number of challenges, including the need for judgement to be exercised. Companies should, however, take on board the steers from the regulator's reports over the summer.

Specific points to consider

a. Recognise that there is judgement as to what constitutes 'consistency'

- There is often judgement involved in deciding the extent to which a company's processes and reporting are consistent with the TCFD framework.
- For instance, there will sometimes be judgement about whether enough has been done to claim consistency – not every action will have a well-defined endpoint.
- In some cases, the company might have judged that an aspect of the TCFD framework is not necessary in its particular circumstances. Provided that the judgement is appropriately made and evidenced, this can still be consistent with the framework. Where the company believes that an aspect of the framework is relevant but has not been applied, this would of course be inconsistent. See the decision tree below.
- Proper documentation (both internally and externally in the narrative) of the process that led to the related judgements is the key in such cases.



Decision tree on whether disclosures are consistent with the TCFD framework

PwC - climate related financial disclosures - mandatory TCFD requirements - disclosure tool - Figure 1 - pg. 3

The Listing Rule requirements (continued)

Specific points to consider

b. Make sure that the Annex is fully considered

- Judgement might also be needed to assess what aspects of the TCFD Annex are relevant in a particular case, but the regulators have made it clear that it is mandatory to consider[5] the Annex as part of the framework, given the additional detail that it provides.
- Examples of matters raised in the Annex that supplement the Recommended Disclosures include:
  - *"Whether the board and/or board committees consider climate-related issues when reviewing and guiding strategy, major plans of action, risk management policies, annual budgets, and business plans as well as setting the organisation's performance objectives, monitoring implementation and performance, and overseeing major capital expenditures, acquisitions, and divestitures"[6];*
  - *"Organisations should describe the impact of climate-related issues on their financial performance (e.g., revenues, costs) and financial position (e.g., assets, liabilities)"[7];*
  - *"How organisations determine the relative significance of climate-related risks in relation to other risks[8]"; and*
  - *"Where relevant, organisations should provide their internal carbon prices as well as climate-related opportunity metrics such as revenue from products and services designed for a low-carbon economy[9]".*
- Not all disclosures in the Annex will be relevant for each company. However, judgement will be required at any particular point in time to assess which ones are relevant to the company, and this is likely to evolve as a company's assessment of its climate-related risks and opportunities matures.
- Explanations of how a company has considered the Annex will again help the users of the annual report to understand what judgement has been applied and how.

[5] Review of TCFD-aligned disclosures by premium listed commercial companies - What you need to do

[6] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures - Describe the board's oversight of climate-related risks and opportunities - pg.17

[7] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures - Describe the resilience of the organization's strategy, taking into consideration different climate related scenarios, including a 2°C or lower scenario - pg.19

[8] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures - Describe the organization's processes for identifying and assessing climate related risks - pg.20

[9] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures - Disclose the metrics used by the organization to assess climate related risks and opportunities in line with its strategy and risk management process - pg.21

The Listing Rule requirements (continued)

Specific points to consider

c. *Don't omit mandatory elements of the framework.*

- The regulators have been clear that seven of the 11 Recommended Disclosures are expected to be addressed by every company.
- **LR 9.8.6E (G)** states that, "*the FCA would expect that a listed company should ordinarily be able to make disclosures consistent with:*
  - *the recommendation and recommended disclosures on governance in the TCFD Recommendations and Recommended Disclosures;*
  - *the recommendation and recommended disclosures on risk management in the TCFD Recommendations and Recommended Disclosures; and*
  - *recommended disclosures (a) and (b) set out under the recommendation on strategy in the TCFD Recommendations and Recommended Disclosures, to the extent that the listed company does not face … transitional challenges … in relation to such disclosures."*
- If companies are unable to report against these seven disclosures, a detailed explanation (per **LR 9.8.6 (8) (b)**) will be needed to explain why.

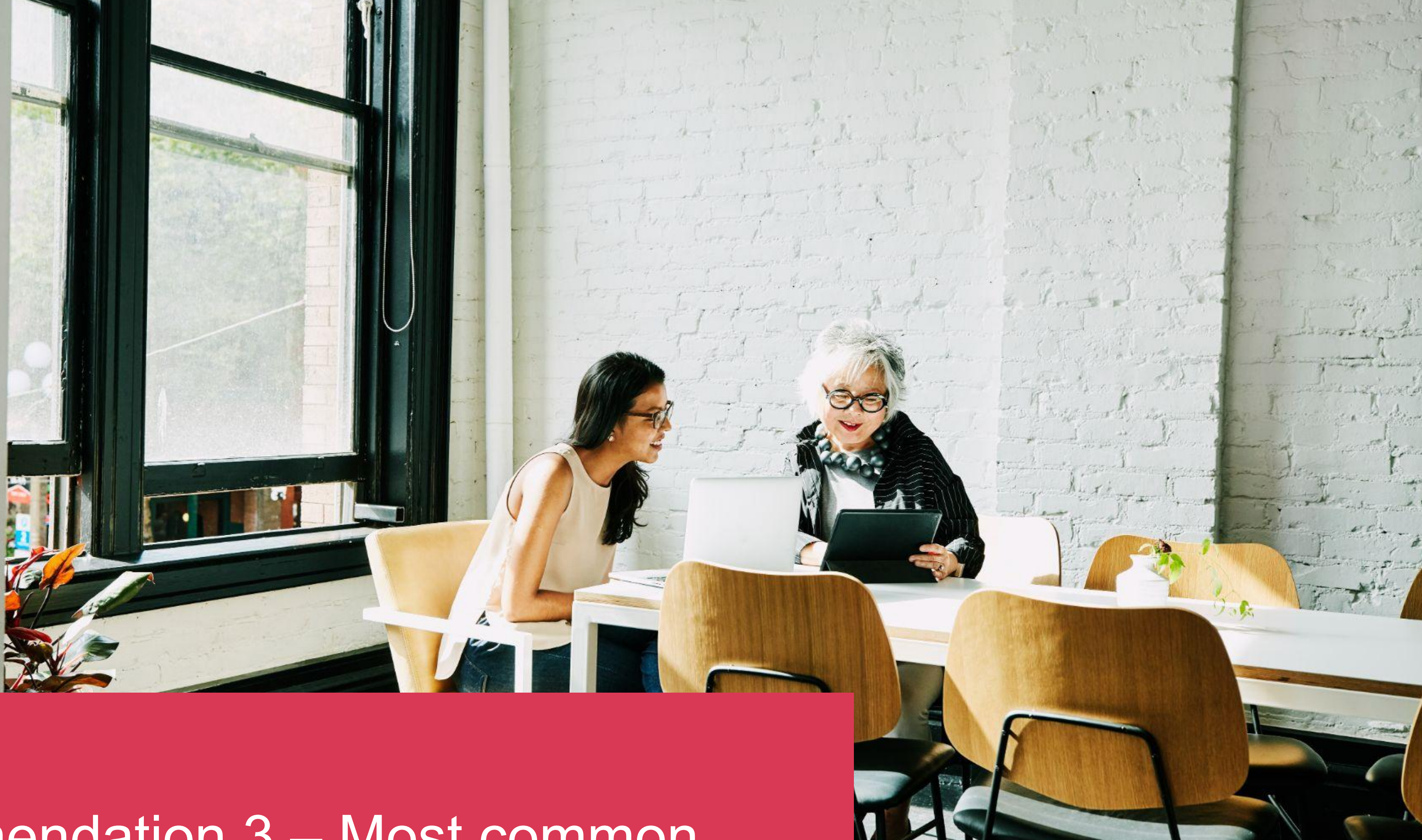
TCFD-related information contained outside the annual report - Listing Rule 9.8.6 (8) (b) (i) requires a company to make a statement setting out *"where the listed company has made climate-related financial disclosures consistent with the TCFD Recommendations and Recommended Disclosures, but has included some or all of these disclosures in a document other than the annual financial report:*

- *the recommendations and/or recommended disclosures for which it has included disclosures in that other document;*
- *a description of that document and where it can be found; and*
- *the reasons for including the relevant disclosures in that document and not in the annual financial report."*

Companies might therefore conclude that it is appropriate to have a separate report, or to use a separate medium of communication for much of their TCFD-related information. However, they also need to consider the general requirement that "*information material to shareholders should be included in the strategic report*"[10].

Therefore, while companies are able to produce a separate report, this must be additional information only and not information material to the annual report. A separate report can be helpful, and it can make the strategically material matters easier to identify in the annual report, but companies should consider on a case-by-case basis how much of the full set of information needs to be in the annual report.

[10] FRC Guidance on the Strategic Report, pg. 4



Recommendation 3 – Most common areas of inconsistency

3

Most common areas of inconsistency

The key message

Judgement, based on a robust assessment of the relevant risks and opportunities, is also key in the two most challenging areas: scenario analysis, and metrics and targets. Companies need to have a thorough understanding of the terminology used around scenario analysis in particular, to make the right judgements about how much work is needed in this area.

Specific points to consider

a.i Is scenario analysis required?

- The TCFD framework calls for two climate scenarios (including one of 2 degrees or lower) to be considered when assessing the resilience of a company's strategy when taking into account different climate scenarios.
- Like the rest of the framework, the appropriate nature and extent of scenario testing depends on the judgements about risks and opportunities – it can be limited or extensive, qualitative or quantitative.
- If, after a thorough risk assessment, a company has concluded that climate-related risks and opportunities are immaterial, performing climate-related scenario analysis is not required in order to be consistent with the framework.
- However, if a company concludes that climate-related risks and opportunities are material or potentially material, performing climate-related scenario analysis is required in order to be consistent with the framework.
- In both cases, the process that has been undertaken to reach this conclusion and the judgements made must be fully documented and set out clearly in the TCFD reporting.

a.ii Should scenario analysis be quantified?

- Climate scenarios need to be applied within a company's own process of assessing risks and opportunities. They are, in essence, inputs into a company's own assessment and, depending on what this shows, it might or might not be appropriate to carry out a full analysis of the financial impact(s).
- In some cases, a qualitative assessment might be the most appropriate approach. In others, a full quantitative assessment will be required.
- There is also growing recognition that it will take time for many companies to perform a quantitative scenario analysis and to calculate the financial impacts arising from it. Scenario analysis is, however, only one tool, and companies must, of course, apply accounting standards for their financial statement disclosures (see also Recommendation 4 below).
- Whatever approach companies take, their narrative reporting should be transparent about why they have undertaken scenario analysis, why it is qualitative or quantitative in nature, and what actions they are taking based on the outcomes.

Most common areas of inconsistency (continued)

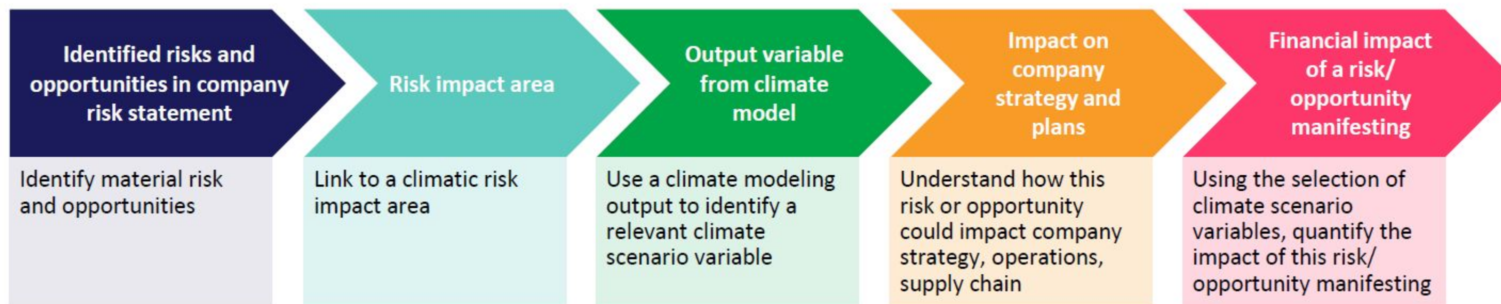
Specific points to consider

a.iii What is the role of scenario analysis in a company's assessment?

- Companies might wish to start by referring to the following recent publication by the World Business Council for Sustainable Development and PwC: Demystifying climate transition scenarios.
- It is important to understand how climate scenarios and climate models can be used by companies and the chart below shows how the overall process should typically work.

An example use case for climate scenario model outputs

The output variables can be the starting point for describing how transition and physical risks and opportunities can link to financial impacts.



Climate scenario outputs can be used as a tool for understanding potential changes to impacts on the balance sheet and market opportunities. This can be done through a 5-step process:

1. Develop an impact pathway linking risk and opportunities to an impact on the balance sheet.
2. Apply normative and explorative scenarios to assess material risks and to set climate related targets.
3. Identify a relevant climate scenario variable.
4. Analyze how a variations in demand, supply, price etc. under different scenarios might affect key parts of the business and its performance.
5. Perform sensitivity analysis on drivers of transition risk, to assess impacts on revenue, costs and profitability. Drivers of transition risk can include policy and legal (e.g. compliance costs and emission pricing), market and economic (e.g. company and asset valuation,) etc.

WBCSD - Demystifying climate transition scenarios - pg. 12

Most common areas of inconsistency (continued)

Specific points to consider

b. Metrics & targets

- The majority of metrics and targets that companies currently report are mostly related to GHG emissions, often reflecting a focus on their 'transition plan' and the associated net-zero or other commitments.
- However, emission related metrics and targets might not be the most relevant with respect to the climate-related risks and opportunities identified.
- There could be more directly relevant metrics and targets that help a company to monitor and address a risk or opportunity. They could, for instance, relate to more direct operational measures, such as new product development or compliance of products with upcoming regulations.

Scope 3 emissions: for unquoted UK companies, there are specific scope 3 reporting requirements under Part 7A of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (Streamlined Energy & Carbon Reporting Regulations – SECR). For TCFD purposes, all companies should be applying the approach discussed under Recommendations 1 and 2 above, to determine whether scope 3 disclosures are appropriate for them to disclose[11]. There will be many cases, for instance, where scope 3 emissions are more significant than scope 1 or 2 and, in these cases, the TCFD framework would require scope 3 emissions to be reported.

[11] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures - Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks. - pg.21

Recommendation 4 – Climate-related financial disclosures

4

Climate-related financial disclosures

The key message

Relatively few of the TCFD reports in year one contained significant information on the actual or potential financial impacts of climate change. The disclosures across the annual report also need to be consistent and to reflect the different demands that apply to the front and back halves of the annual report. Internally, different departments need to work together (particularly finance) to ensure that the financial implications of decisions are considered in the financial statements.

Specific points to consider

a What is meant by financial impact?

- To disclose the actual and/or potential financial impact of climate change is the fundamental objective of the TCFD framework[12].
- In some cases, the financial impact(s) are highly material to the financial statements, and so disclosures should be made (under the relevant accounting standards) within the financial statements and in the TCFD disclosures.
- In others, the financial impact(s) of climate change are more indirect and/or gradual. In these cases, as the climate challenge progresses and the related processes and disclosures develop, it will often become more possible to identify financial impact(s) and ultimately to quantify these.
- Accounting standards drive when and how the impact of climate risk should be reflected in the financial statements.
- Until a company is in a position to quantify the impacts, the output of the assessment of risks and opportunities might be qualitative, focusing on the nature of the financial impact(s) rather than putting a number on them. Typically, this would be in the narrative disclosures in the strategic report rather than the financial statements.
- Both the International Sustainability Standards Board (ISSB) and the FRC have outlined that qualitative disclosures are helpful in the short term, as companies build up the internal capabilities:
  - FRC Thematic, page 47: *"We expect companies to provide discussion and, where practical, quantification of the expected impact of climate-related risks and opportunities on operating costs and revenues, capital expenditures and capital allocation, acquisitions or divestments, and access to capital."*
  - ISSB: *"At a minimum an entity would need to undertake the qualitative form of scenario analysis as a basis for its resilience analysis."*
- This approach also aligns with the Companies Act climate reporting requirements that apply for periods beginning on or after 6 April 2022: *"To meet the requirements of these regulations it is not necessary to produce quantitative scenario analysis, though some companies and LLPs may find it useful to do so to support their strategy and risk management considerations."*

[12] Final report - Recommendations of the Task Force on Climate-related Financial Disclosures, pg. v

Climate-related financial disclosures (continued)

The risk of disclosing quantified climate-related information:
Companies often worry that quantifying a potential future impact could be seen as a forecast. However, a number of leading companies have provided a range of potential impacts relating to risks and opportunities, or have quantified the potential impact from various scenarios. Quantification does not have to be a single figure estimate and could instead be a range.

Reporting examples - Quantification of risks and opportunities and scenario analysis outcomes

1.5°C scenario analysis financial quantification in current money

Financial quantification of the assessed regulatory and market risks

Risk	Potential financial impact on profit in the year if no actions to mitigate risks are taken[a] 2030	2039	2050	Key assumptions
Carbon tax and voluntary carbon removal costs We quantified how high prices from carbon regulations and voluntary offset markets for our upstream Scope 3 emissions might impact our raw and packaging materials costs, our distribution costs and the neutralisation of our residual emissions post 2039.	-€3.2bn to -€2.4bn	-€5.2bn to -€4.8bn	-€6.1bn	• Absolute zero Scope 1 and 2 emissions by 2030 • Scope 3 emissions exclude consumer use emissions • Carbon price would reach 245 USD/tonne by 2050, rising more aggressively in early years in a proactive scenario • The price of carbon offsetting would reach 65 USD/tonne by 2050 • Offsetting 100% of emissions on and after 2039

Unilever annual report and accounts, pg. 61

Summary of GSK's risks and opportunities

Physical risk/ description	Scenario	Risk management	Potential profit impact/ timeframe	Metrics	Targets
Increasing levels of water stress which reduces the availability of water for our operations. GSK uses freshwater as the main source of water to manufacture medicines, vaccines, and consumer health products. If water availability was restricted at a factory then production operations would be interrupted.	BAU and low carbon	We have performed water stewardship risk assessments for all our manufacturing sites and we have identified ten sites in our current network that are currently in areas of high-water risk. We are developing plans for these sites to become water neutral by 2030 and will partner with other organisations to address shared water challenges. We are currently piloting this approach in our Cape Town site working with partners including WWF and the Water Resilience Coalition. The TCFD process has helped us develop a watch list of additional sites potentially under long-term threat and we will monitor changes to the risk levels and update our site water risk assessments appropriately.	Low: <£100m/ Long: 3-10 years	Sites that have achieved water stewardship* Water use in our operations Sites and supplier sites that have achieved water neutrality	Achieve good water stewardship at 100% of our sites by 2025 Reduce overall water use in our operations by 20% by 2030 Be water neutral in our own operations and at key suppliers in water stressed regions by 2030

GSK annual report and accounts, pgs. 50-52

Efficient and effective reporting

- In the recent PwC publication, Drawing a line in the sand - Annual review of the FTSE 350, a set of practical suggestions was outlined for companies to apply to their annual reporting.
- These can often be helpful in TCFD reporting too. For example:
  - *Report smarter not harder* – As set out above, good climate change reporting needs to be based on a thorough assessment of the risks and opportunities, and their significance for a business's strategy. Focusing on the matters that are judged to be material in this way should make for more efficient and effective reporting. It can also allow other mediums to be used for less material information.
  - *Clarity of audience* – A number of different stakeholder groups are often interested in aspects of TCFD and climate reporting, from institutional and retail shareholders through to special interest groups and local communities directly affected by a company's activities. Good reporting will show awareness of who these groups are and address their primary concerns.
  - *Creating a feedback loop* – Where climate-related targets have been set (for instance, net-zero commitments), companies should expect to report on progress against them on an ongoing basis, as well as explaining when and if they are amended.

Further information:

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