

Hot Topic

Update on major accounting
and auditing activities

SEC issues guidance on climate change disclosures

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Introduction

On 2 February 2010, the US Securities and Exchange Commission (SEC) published interpretive guidance¹ (the Guidance) regarding how its current disclosure requirements apply to climate change matters. The Guidance does not amend existing SEC rules or create additional disclosure requirements. Instead, the Guidance provides an overview of existing SEC rules that might require disclosure related to climate change. The Guidance identifies several considerations when assessing whether climate change disclosure is needed, including:

- ▶ Legislation and regulation
- ▶ International accords
- ▶ Indirect consequences of regulation or business trends
- ▶ Physical effects of climate change

The Guidance is effective upon publication in the Federal Register, which is expected shortly. Calendar year-end companies should consider the Guidance when preparing disclosures for inclusion in their 2009 Form 10-Ks.

The Guidance states the SEC is planning to hold a public roundtable on disclosure regarding climate change matters in the spring of 2010. In addition, the SEC's Investor Advisory Committee is considering climate change disclosure issues as part of its mandate to provide advice and recommendations to the SEC. The Guidance also states that the SEC will monitor disclosures related to climate change as part of its ongoing disclosure review program.

Background

In January 2010, the SEC voted to issue the Guidance by a contentious 3-2 vote. SEC Chairman Mary Schapiro stated that the Guidance should not be construed as the SEC "weighing in" on the topics of climate change or global warming. Instead, Chairman Schapiro explained that the Guidance is intended to help ensure that the SEC's disclosure rules are "consistently applied, regardless of the political sensitivity of the issue at hand, so that investors get reliable information."² The Guidance responds to petitions from several large institutional investors and investment groups requesting that the SEC provide additional guidance regarding climate-related disclosures.

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¹ SEC Release No. 33-9106, *Commission Guidance Regarding Disclosure Related to Climate Change*.

² See the 27 January 2010 statement of SEC Chairman Mary Schapiro at <http://www.sec.gov/news/speech.shtml#chair>.

Existing SEC disclosure requirements

Regulation S-K currently includes a number of items that would require disclosure if climate change has a material effect on a company's business.³ These non-financial statement items are discussed below. In addition, Securities Act Rule 408 and Exchange Act Rule 12b-20 require a company to disclose, in addition to the information expressly required by Regulation S-K, any material information necessary to make the financial statements not misleading.

Description of business

Item 101 of Regulation S-K requires a company to provide a description of its business. Item 101(c)(1)(xii) specifically requires disclosure regarding the material effects that compliance with federal, state and local regulations regarding the discharge of materials into the environment may have on a company's business.⁴ Among other things, a company is required to disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year, its succeeding fiscal year and additional periods that the company considers material.

Legal proceedings

Item 103 of Regulation S-K requires a company to describe any material pending legal proceeding to which it is a party.⁵ Instruction 5 to Item 103 addresses the disclosure of certain environmental litigation.

Risk factors

Item 503(c) of Regulation S-K requires a company to discuss the most significant factors that make an investment in the company speculative or risky, including risks associated with environmental factors.⁶ Item 503(c) specifies that risk factor disclosure should clearly describe the risk and how it affects the reporting company.

Management's discussion and analysis

Item 303 of Regulation S-K includes a broad range of disclosure items that address a company's liquidity, capital resources and results of operations.⁷ The Guidance notes that Item 303 requires a company to disclose, if material, any difficulties involved in assessing the effect of the amount and timing of uncertain events, and to indicate the time periods in which it anticipates resolution of the uncertainties. The Guidance also notes that the SEC has not quantified a specific future time period to consider in assessing the effects of a known trend or uncertainty that is reasonably likely to occur.

Climate change considerations

Depending on a company's particular facts and circumstances, the Guidance indicates that each of the items discussed above may require disclosure regarding climate change matters. The Guidance identifies several considerations when assessing whether disclosure regarding climate change is appropriate.

Legislation and regulation

Significant developments in federal and state legislation and regulation regarding climate change could trigger disclosure obligations under Items 101, 103, 503(c) and 303 of Regulation S-K.⁸

Existing regulations regarding greenhouse gas emissions could trigger a disclosure requirement under Item 101 of Regulation S-K. Item 101 requires disclosure of any material estimated capital expenditures necessary to comply with emissions laws and regulations.

Item 503(c) may require risk factor disclosure regarding existing or pending legislation or regulation that relates to climate change. The Guidance indicates that a company should consider specific risks it faces as a result of climate change legislation or regulation and avoid generic or boilerplate risk factor disclosure. For example, a company that is particularly sensitive to greenhouse gas legislation or regulation, such as companies in the energy sector, may face significantly different risks from climate change legislation or regulation compared to companies that currently rely on products that emit greenhouse gases, such as companies in the transportation sector.

Item 303 requires a company to assess whether any enacted climate change legislation or regulation is reasonably likely to have a material effect on its financial condition or results of operations. In the case of a known uncertainty, such as proposed legislation or regulation, the Guidance indicates that assessing potential MD&A disclosure requirements consists of two steps. First, management must evaluate whether the proposed legislation or regulation is reasonably likely to be enacted. Unless management determines that it is not

³ The disclosure obligations of foreign private issuers (FPIs) are governed primarily by Form 20-F, not Regulation S-K. However, most of the disclosure requirements of Regulation S-K have equivalents under Form 20-F, albeit not always as prescriptive as those applicable to domestic issuers.

⁴ Item 4.B.8 of Form 20-F requires disclosure of material effects of government regulation on an FPI's business and identification of the particular regulatory body.

⁵ Item 8.A.7 of Form 20-F requires disclosure regarding any legal or arbitration proceedings, including governmental proceedings, with a significant past or future effect on the FPI's financial position or profitability.

⁶ Item 3.D of Form 20-F requires disclosure of material risks. Similarly, Forms F-1 and F-3 require an FPI to disclose risk factors required under Item 503 of Regulation S-K.

⁷ Item 5 of Form 20-F requires a discussion of factors that management believes have or are anticipated to have an effect on the FPI's financial condition and results of operations. Item 4.D of Form 20-F requires disclosure of any environmental issues that may affect the company's utilization of its assets.

⁸ In addition to the requirements of Regulation S-K, the Guidance includes a reminder that a company also must consider any financial statement implications of climate change issues under applicable accounting standards, including Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 450, *Contingencies*, and FASB ASC Topic 275, *Risks and Uncertainties*.

reasonably likely to be enacted, management must proceed on the assumption that the legislation or regulation will be enacted. Second, management must determine whether the legislation or regulation, if enacted, is reasonably likely to have a material effect on the company's business. Unless management determines that a material effect is not reasonably likely, disclosure is required in MD&A regarding the legislation.

In addition to disclosing the potential effect of proposed legislation or regulation, the company also would have to consider disclosure, if material, of the difficulties involved in assessing the timing and effect of the proposed legislation or regulation.

The Guidance states that a company should not limit its disclosure of the reasonably likely effects of a proposed law to potential negative consequences. The Guidance observes that changes in laws or in business practices of some companies in response to those changes may provide new opportunities. For example, if a "cap and trade" system is enacted, some companies may be able to profit from the sale of allowances if their emissions levels are below their emissions allotment. Likewise, companies that are not covered by statutory emissions caps may be able to profit by selling offset credits.

The Guidance identifies several examples of possible consequences of proposed legislation and regulation related to climate change, including:

- ▶ Costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system
- ▶ Costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime

- ▶ Changes to operating profitability arising from increased or decreased demand for goods and services produced by the company arising directly from legislation or regulation, and indirectly⁹ from changes in costs of goods sold

International accords

The Guidance indicates that, if material, companies should disclose the effect on their business of treaties or international accords relating to climate change. The Guidance suggests that companies reasonably likely to be affected by such agreements should monitor the progress of any potential agreements and consider the potential effects.

Indirect consequences

Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies. The Guidance identifies the following potential indirect consequences or opportunities:

- ▶ Decreased demand for goods that produce significant greenhouse gas emissions
- ▶ Increased demand for goods with lower emissions than competing products
- ▶ Increased competition to develop innovative products
- ▶ Increased demand for generation and transmission of energy from alternative sources
- ▶ Decreased demand for services related to carbon based energy sources, such as drilling services or equipment maintenance services

These business trends or risks may require disclosure as risk factors or in MD&A. In some cases, these developments could have such a material effect on a company's business to require disclosure in its business description under Item 101. For example, a company that plans to reposition itself to take advantage of potential opportunities, such as through material acquisitions of plants or equipment, may be required by Item 101(a)(1) to disclose this shift in its plan of operation.

The Guidance also states that the effect on a company's reputation also must be considered as a potential indirect risk from climate change. Depending on the nature of a company's business and its sensitivity to public opinion, the company may have to consider the implication of reputational damage. For example, the public's perception of any publicly available data relating to the company's greenhouse gas emissions could expose it to potential adverse consequences to its business operations or financial condition.

Physical effects

The Guidance indicates that significant physical effects of climate change, such as the severity of weather (e.g., floods or hurricanes), sea levels, the arability of farmland, and water availability and quality, have the potential to affect a company's operations and results. For example, severe weather can cause catastrophic harm to physical plants and facilities and can disrupt manufacturing and distribution processes.

The Guidance states that companies whose businesses may be vulnerable to severe weather or climate related events should consider disclosing material risks of, or consequences from, such events in their SEC filings.

⁹ For example, an increase in supplier's costs related directly to climate change could have a significant indirect effect on its customers if those costs are passed through.

The Guidance identifies possible consequences of severe weather, including:

- ▶ For companies with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products
- ▶ Indirect financial and operational effects from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods
- ▶ Increased insurance claims and liabilities for insurance and reinsurance companies
- ▶ Decreased agricultural production capacity in areas affected by drought or other weather-related changes
- ▶ Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for companies with plants or operations in areas subject to severe weather

Voluntary reporting initiatives

The Guidance indicates that although some information relating to climate change is currently disclosed in SEC filings, much more information is disclosed outside of SEC filings as a result of voluntary disclosure initiatives. For example, the Global Reporting Initiative (GRI)¹⁰ has developed a sustainability reporting framework that sets out principles and indicators that companies can use to measure and report their economic, environmental and social performance, including issues involving climate change. The Guidance identifies similar voluntary initiatives such as the Carbon Disclosure Project¹¹ and the Climate Registry.¹²

The Guidance reminds companies that some of the information reported under these voluntary initiatives also may be required to be disclosed in SEC filings in response to the SEC's existing disclosure requirements discussed above.

Implementation considerations

The Guidance signals that companies should have a heightened awareness of climate change considerations when preparing disclosures for their SEC filings.

Despite its timing in relation to upcoming annual reporting deadlines, the Guidance likely will prompt many companies to reassess the sufficiency of their climate change disclosures. At a minimum, companies should assess whether their disclosure controls and procedures are sufficient and effective in identifying relevant information related to the climate change matters identified in the Guidance. Companies also should consider documenting the consideration of climate change matters and their materiality in determining whether related disclosures are required.

¹⁰ The GRI's website can be located at www.globalreporting.org.

¹¹ The Carbon Disclosure Project's website can be located at www.cdproject.net.

¹² The Climate Registry's website can be located at www.theclimateregistry.org.

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