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SEC Issues Interpretive Release for Climate-Change Disclosures

A recently issued SEC interpretive release provides guidance for existing SEC disclosure obligations about the impact of climate change and climate-related risks that are material to public companies.¹ The intent of the interpretive release is to clarify the SEC's requirements and promote their consistent application.

Regulatory, legal, and business developments related to climate change and climate-related risks that may have an impact on the financial condition or operating performance of registrants must be disclosed in regulatory reports filed with the SEC. In the United States, legislation has been proposed that would limit greenhouse gas emissions, while the Environmental Protection Agency has taken steps to regulate greenhouse gases. Internationally, governments have adopted directives such as the Kyoto Protocol. Industries also have begun to react. Beginning May 1, 2010, insurance companies will be required to disclose the financial risks posed by climate change and the actions taken to mitigate those risks.²

Those developments prompted the SEC to issue its interpretive release. "The Commission is not making any kind of statement regarding the facts as they relate to the topic of climate change or global warming," said SEC Chairman Mary Schapiro.³ "And we are not opining on whether the world's climate is changing, at what pace it might be changing, or due to what causes."

SEC Reporting Requirements

Regulation S-K requires disclosure of climate-change related matters in narrative form that summarizes the risks, events, or circumstances that are material to an investor's understanding of the registrant's business. The most relevant non-financial statement disclosures that may require disclosure include:

SEC Reporting Requirements	1
Potential Impact of Disclosure Requirements	2
Materiality	4
Foreign Private Issuers	4
Summary	5

¹ SEC Release No. 33-9106, Commission Guidance Regarding Disclosure Related to Climate Change, February 2, 2010, available at www.sec.gov/rules/interp/2010/33-9106.pdf.

² On March 17, 2009, the National Association of Insurance Commissioners adopted a mandatory requirement that insurance companies disclose to regulators the financial risks they face from climate change, as well as actions the companies are taking to respond to those risks. All insurance companies with annual premiums of \$500 million or more will be required to complete annually an Insurer Climate Risk Disclosure Survey, with an initial reporting deadline of May 1, 2010. The surveys must be submitted in the state where the insurance company is domiciled. "See Insurance Regulators Adopt Climate Change Risk Disclosure," available at www.naic.org/Releases/2009_docs/climate_change_risk_disclosure_adopted.htm.

³ SEC Chairman's Speech, Statement Before the Open Commission Meeting on Disclosure Related to Business or Legislative Events on the Issue of Climate Change, January 27, 2010, available at www.sec.gov/news/speech/2010/spch012710mls-climate.htm.

- Item 101, *Description of Business*, requires a narrative description of the business, including disclosure of the costs and effects of compliance with federal, state, and local environmental laws;⁴
- Item 103, *Legal Proceedings*, requires a description of material pending legal proceedings, which includes matters arising from federal, state, or local laws intended to protect the environment;⁵
- Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, requires disclosure of known trends or uncertainties that could have a material impact on the continuing operations of the registrant, as well as known material events and uncertainties that could cause the financial information not to be indicative of future operating results or financial condition;⁶ and
- Item 503(c), *Risk Factors*, requires disclosure of the most significant factors specific to the registrant that make an investment in the registrant speculative or risky.⁷

In addition to the specific information required by SEC regulations, registrants also must disclose any other material information that may be relevant to financial statement users.⁸

Potential Impact of Disclosure Requirements

Registrants' disclosures should focus only on material information and exclude immaterial information that does not promote understanding of their financial condition, liquidity and capital resources, changes in financial condition, and results of operations. While these materiality determinations may limit what is actually disclosed, they should not limit the information that management considers in making its determinations. The SEC staff cited the following areas where climate change may require disclosures.

Impact of Legislation and Regulation. When assessing potential disclosure obligations, a registrant should consider the impact of existing and pending climate-change laws and regulations. The registrant should also consider disclosure, if material, of the difficulties of assessing the timing and effect of the pending legislation and regulation. Both the positive and negative consequences of actual or pending legislation or regulatory actions should be considered. Possible consequences include:

- 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 to comply with regulatory limits or to mitigate the financial consequences of a cap and trade regime; and

⁴ Regulation S-K, Item 101, *Description of Business*, (see 17 CFR 229.101(c)(xii)).

⁵ Regulation S-K, Item 103, *Legal Proceedings* (see 17 CFR 229.103 Instruction 5).

⁶ Regulation S-K, Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (see 17 CFR 229.303.3(ii) and Instruction 3).

⁷ Regulation S-K, Item 503, *Summary Information, Risk Factors and Ratio of Earnings to Fixed Charges* (see 17 CFR 229.503(c)).

⁸ Securities Act of 1933, Rule 408(a), *Additional Information* (see 17 CFR 230.408), and Securities Exchange Act of 1934, Rule 12b-20, *Additional Information* (see 17 CFR 240.12b-20).

- Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.

Impact of International Accords. A registrant should consider the risks or effects of international accords and treaties relating to climate change. The disclosure requirements are the same as those for domestic legislation and regulation and should include both negative and positive consequences.

Indirect Consequences of Regulation or Business Trends. A registrant should evaluate the legal, technological, political, and scientific developments related to climate change or other trends in the business environment that may directly or indirectly pose risks or create new opportunities. For example, indirect negative consequences or opportunities may include:

- Decreased demand for goods that produce significant greenhouse gas emissions;
- Increased demand for goods that result in lower emissions than competing products;
- Increased competition to develop innovative new products;
- Increased demand for generation and transmission of energy from alternative energy sources;
- Decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services; and
- Depending on a registrant's business and its sensitivity to public opinion, reputational damage or gain from the public's perception of any publicly available data related to its greenhouse gas emissions.

Registrants should evaluate where the indirect consequences or opportunities should be disclosed within Regulation S-K. For example, if a registrant plans to take advantage of potential opportunities through material acquisitions of plants or equipment, disclosure may be required in Item 101. The potential impact of business trends or risks may need to be disclosed in Items 303 or 503(c).

Physical Impact of Climate Change. Significant physical effects of climate change, such as effects on the severity of weather (e.g., floods or hurricanes), sea levels, the arability of farmland, or water availability and quality, have the potential to affect a registrant's financial condition and business. Possible consequences of severe weather include:

- For registrants with operations concentrated on coastlines, property damage and disruption to operations, including manufacturing or the transport of manufactured products;
- Indirect financial and operational impacts 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; and
- Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for registrants with plants or operations in areas subject to severe weather.

Registrants should consider both the actual and potential impact of environmental matters stemming from climate change to the company's business and operations, including its personnel, physical assets, and supply and distribution chain.

Materiality

Registrants are required to disclose the impact of climate change and climate-change related risks that are reasonably likely to have a material impact on the registrants' financial condition or operating performance.⁹ The SEC staff said on January 27 that consideration of materiality for non-financial statement disclosures as traditionally understood should be applied when evaluating the potential impact of climate change to the registrant.¹⁰ The materiality evaluation is a two-part process requiring (1) an evaluation of whether the event is reasonably likely to occur, and (2) if so, whether the event is reasonably likely to have a material effect on the registrant's financial condition or operations. The SEC requires that registrants consider a time horizon when assessing materiality and whether that time horizon affects their assessment of whether the impact of climate change is reasonably likely. The interpretive release specified that materiality "with respect to contingent or speculative information or events... 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"

Unless the registrant is able to determine that a material effect is not reasonably likely, disclosure is required. A registrant should ensure that it has an effective system for capturing and collecting data necessary to comply with laws and regulations and be able to assess the materiality of the related impacts.

Foreign Private Issuers

Foreign private issuers are subject to the disclosure requirements of Form 20-F. These requirements are consistent with Regulation S-K, although some requirements are not as prescriptive. Foreign private issuers should consider whether climate change disclosures should be made in these sections:

- Item 3.D, *Risk Factors*, requires disclosure of risk factors specific to the issuer;
- Item 4, *Business Overview*, requires disclosure of the material effects of government regulations on the issuer's business, identifying the regulatory body and the environmental issues that may affect the issuer's utilization of assets;
- Item 5, *Operating and Financial Review and Prospects*, requires disclosure of factors and trends that are anticipated to have a material effect on the issuer's financial condition and results of operations in future periods; and
- Item 8, *Financial Information*, requires disclosure of any material proceeding or any material interest adverse to the issuer.¹¹

⁹ SEC Release No. 33-8056 (Jan. 22, 2002; 67 FR 3746), available at www.sec.gov/rules/other/33-8056.htm, specifies that reasonably likely is a lower disclosure standard than more likely than not.

¹⁰ SEC Issues Interpretive Guidance on Disclosure Related to Business or Legal Developments Regarding Climate Change, January 27, 2010 (see the video link), available at www.sec.gov/news/press/2010/2010-15.htm.

¹¹ SEC Form 20-F, available at www.sec.gov/about/forms/form20-f.pdf.



Summary

The effective date of this interpretive release is its publication in the *Federal Register*. The interpretive release reminds registrants of their obligations under existing financial reporting guidance to consider the impact of climate change and climate-related risks as they prepare filings. The SEC will monitor the impact of the interpretive release on filings as part of its ongoing disclosure review program. The SEC's Investor Advisory Committee also is considering including climate-change disclosure issues in its recommendations to the SEC on matters of concern to investors. The SEC plans to hold a public roundtable on climate-change disclosures in the spring of 2010.

The descriptive and summary statements in this newsletter are not intended to be a substitute for cited or potential SEC regulations. Companies filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

**This is a publication of KPMG's
Department of Professional Practice
212-909-5600**

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