

ANALYSIS OF IMPACT OF CLIMATE-RELATED DISCLOSURE ON FINANCIAL REPORTING

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Abstract: According to the International Financial Reporting Standards (IFRS) there is no obligation of disclosure climate-related information in the financial statements, although climate-related risks considerably affect decision-making of different stakeholders. The information is considered as material if its omitting or misstating significantly influence users of financial information – investors, creditors and other stakeholders. An assessment of materiality of climate-related information should be done by combining quantitative and qualitative factors, keeping in mind industry within a business entity operates and expectations of relevant stakeholders. The aim of the paper is to give a review of the most common climate-related risks that are non-financial companies exposed to, and to list potential financial impacts of those risks, manifested in the change of revenue, costs, liabilities, cash flows, and assets value. For the application case will be used the framework “Task Force on Climate-related Financial Disclosures (TCFD)” developed by The Financial Stability Board, to enhance investment decisions more focused on climate-related issues and risks.

Key words: *climate-related risks, financial reporting, investments, stakeholders*

1. INTRODUCTION

The business environment has been changed radically in the last 10-15 years, which requires identification and managing of new risks, threats, but opportunities too, which should be implemented in the company's business model and strategy, resetting missions and basic values. Climate change as recognized as one of the top global risks, and the climate-related disclosure of companies does not provide investors and other stakeholders enough information to make investment decisions. Climate risks are financial risks and have key impact on financial decisions.

Numerous researches indicate rising interest of companies for climate changes and actions, emphasizing that increasing number of companies join different global initiatives - The World Economic Forum's First Movers Coalition or Science Based Target Initiative – SBTi, United Nations' "Race to Zero" campaign, etc. (Jastrzebska, 2023; Principale & Pizzi, 2023; Chua et al., 2022; Hain et al., 2022). The trend of non-financial reporting, with the focus on climate-related information, has been accepted by the increasing number of companies worldwide. Climate-related disclosure in the form of sustainability report, ESG (Environment, Social, Government) report, Corporate social responsibility (CSR) report, present a part of an integrated report, together with mandatory financial report.

Stakeholders, such as consumers, markets and value chain partners have expectations and demand proactive behavior of companies directed toward mitigation of climate changes, as a tradeoff in the purchase of companies' goods and services, capital investments or partnership. In addition, there are rising pressures from the regulatory global and national institutions, as well as natural environment (Galeone, 2023).

In the empirical part of the paper will be used Task Force on Climate-related Financial Disclosures (TCFD) framework or recommendations, set up in 2015 by the Financial Stability Board, and published in 2017. TCFD represents fundamental guidelines for assessing and managing climate-change-related risks. Applying TCFD recommendations contributes to protection of interests of investors and other stakeholders, through the more transparent disclosure of climate-related risks. TCFD framework enables integrated risk management. TCFD recommendations have been adopted in the UK and the EU as the

standards for the disclosure of climate change-related risks, and many companies have already voluntarily adopted the TCFD recommendations as part of their sustainability reporting.

The main objective of this research is to give a review of the most common climate-related risks that are non-financial companies exposed to, and to list potential financial impacts of those risks, manifested in the change of revenue, costs, liabilities, cash flows, and assets value.

The paper is structured as follows: after introduction and literature review, research methodology has been presented. After that results of research has been discussed. The next part of the paper is conclusion, followed by the list of references.

2. LITERATURE REVIEW

Jastrzebska (2023) researched the scope of reporting climate-related information of 20 companies considered as CSR leaders in Poland, by employing a climate-related disclosures index, covering 18 indicators, recommended by TCFD. The study showed that all climate-related disclosure initiatives of researched companies are in compliance with TCFD recommendations, but the value of index indicates that companies perceived as CSR leaders in Poland do not have high awareness of climate changes. The similar conclusion is also found in the other Polish studies on climate-related reporting.

According to the research of Galeone et al. (2023) sustainability and climate change issues should be included in the business model and reporting, allowing stakeholders to participate in the actions of mitigating of limiting climate challenges.

The 2021 Ernst & Young (EY) Global Climate Risk Disclosure Barometer indicated that companies should accelerate the implementation of climate strategies and adapt their business models to climate changes and increasing climate risks. The EY researched the disclosures of more than 1,100 companies across 42 countries and found that although companies continuously improve the quality and coverage of climate risk disclosure reporting, with an average coverage of 70% of the TCFD recommendation, only 41% of the companies in the sample apply scenario analysis, and only 15% feature climate change in their financial statements. EY recommended that climate risks and opportunities should be the central part of companies' growth strategies.

Braasch and Velte (2022) investigated the quality of climate reporting by German DAX30 companies, from 2018 to 2020, related to the recommendations of TCFD, and found that companies showed poor reporting rates in the corporate governance domain, using climate reporting symbolically to present themselves in a favorable light and to gain legitimacy in society, i.e. using „greenwashing“ practices through intentionally disclosing mainly positive information. Companies from less carbon-sensitive industries already have a lower carbon impact, and therefore their management might be less concerned with identifying and managing climate risk. On the other hand, carbon-sensitive firms face greater pressure from stakeholders to disclose their efforts and actions related to climate issues. This might lead to „window dressing “climate reporting and „greenwashing“ practice.

Wedari, Jubb, and Moradi-Motlagh (2021) also found that potential “greenwashers” are companies that have poor environmental indicators, and strive to change negative perceptions by stakeholders. Researchers found no evidence of greenwashing among companies that mark decrease in GHG emissions from year to year.

Andersson and Arvidsson (2022) emphasized that although most firms map and report climate-related risks, the understanding of the nature and impact of these risks, differs across firms and industries. Policymakers have to support firms in mapping, understanding and strengthening capacity to manage climate-related risks.

Principale and Pizzi (2023) analyzed the non-financial statements (NFSs) of 122 Italian companies, and found that company size, board size, and the integration of ESG risks into risk-management systems positively contribute to the compliance of NFSs with the recommendations of climate experts. The results of the study also showed that larger companies exposed to higher environmental risk are more likely to

disclose climate-related information, and have resources to comply their corporate behavior and disclosures with TCFD framework. But generally, the majority of Italian companies have decided not to align corporate disclosure with the TCFD recommendations, and one of the reasons could be the complex scenario analysis.

Bingler, Senni, and Monnin (2022) found that complexity of assessing climate risks impose the heterogeneity of risk metrics of different providers, methodologies, and data underpinning these metrics. According to Hain et al. (2022) some commercial providers and large credit-rating agencies have started developing of climate risk scores to provide investors with firm-level indicators of physical climate risk, aiming to set climate risk assessment and scoring as a standard procedure, like evaluating financial performances of a company.

Research of Amel-Zadeh (2023) emphasized information asymmetry between investors and companies in terms of exposure to climate-related risks and the types of risks, which have considerable impact on investors' making decisions. The findings indicate that current disclosure practices do not support investors with adequate information about climate-related financial risks.

Pavlovic and Miler (2022) investigated non-financial reporting practices of Croatian companies and found that key weaknesses of current practice in the communication and disclosure of climate related information are: „climate change is not perceived as significant as other business risks; companies are not applying the concept of “double materiality”; they are (still) not combining qualitative and quantitative information; they are not putting this information in the context of the goals set by the Paris Agreement; and they are not prepared to develop various climate-related scenarios.“

Companies should consider and disclose an emerging risk, including climate related risk, if that risk could affect amount reported in the financial statements and could have impact on the investors' decision making. Climate-related risks are derived from potential natural disasters, change in climate patterns and the related technology, market, legal and changes in government policies risks (AASB, 2019, p. 4).

Table 1: Climate related disclosure and IAS/IFRS

IAS/IFRS	Potential financial impact
IAS 1 - Presentation of Financial Statements	Companies must consider all the circumstances related to the going concern principle. If climate-related matters create material uncertainties related to events or conditions that cast significant doubt upon a company's ability to continue as a going concern, IAS 1 requires disclosure of those uncertainties. (IFRS, 2020, 2).
IAS 2 - Inventories	Inventories can become obsolete. In that case companies must reduce the value of the inventory to net realizable value. (IAS 2). Inventory impairment will increase the company's costs and decrease company's profit. In accordance with Serbian Income Tax Law that costs cannot be recognized before those inventories are sold.
IAS 16 refers to the recognition, valuation and disclosure of Property, Plant and Equipment (PP & E)	Climate-related risks can affect whether some costs relating to real estate, plant and equipment can be recognized in their purchase value. (Vicentijevic & Markovic, 2023). Also, climate change may have impact on how long items of PP&E are used. (EY, 2023, 13). Shorter useful life will have impact on amortization and depreciation costs.
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	Climate -related risks can increase provisions for rehabilitation of environmental damage and onerous contracts. (Anderson, 2019). That means that companies will have lower profits. Also, some expenses might not be tax-deductible.
IFRS 9 Financial Instruments	IFRS 9 requires companies have to recognize expected credit losses in their statements. Potential impact refers especially to the banks that lend money to the different sector. Banks have to consider increase in credit risk of the borrowers. If there is increase in credit risk, bank will increase their expenses and decrease profit. On the other hand, borrowers might not be able to lend money.

3. RESEARCH METHODOLOGY

In this research were used different methods, including questionnaire fulfilled by company's management, the data presented on the websites of the analyzed company, and in the company's Sustainability report, prepared according to the standards of the Global Reporting Initiative (GRI).

The literature review analysis was done within Scopus database, including the following keywords: climate-related disclosure, financial reporting, and 46 documents were found. Firstly, the title, abstract and keywords were analyzed, and in the second phase, 31 complete papers were chosen and analyzed. The papers were selected according to the relevance of climate-related financial disclosure for decision making of investors and other stakeholders. After detailed literature review, the TCFD framework developed by The Financial Stability Board, was chosen for assessment of climate-related risks and opportunities and their impact on financial performances of a company. The TCFD conceptual framework was used for this research because of detailed overview of climate related risks and opportunities whose disclosure considerably impacts key financial indicators. To assess exposure to climate-related risks, listed in the TCFD conceptual framework, a questionnaire to be fulfilled by the company's management was prepared.

The researched company is a leading Serbian manufacturer of printed and laminated cardboard packaging and blister cards board. Company use responsibly raw materials, energy and water, striving to reduce GHG emission. Analyzed company respects the principles of socially responsible business, management systems, the environment, safety and health of employees, forest protection, and is certified according to the requirements of ISO 9001, ISO 14001, ISO 45001, FSC™. The basis of rapidly growing business is a constant investment in development. It is the only domestic company that is indexed on the first Serbian CSR index list for all six areas of socially responsible business. That means that the company is committed to employees, the local community, and the environment. Company's CSR strategy supports the UN SDGs. Company is rated as a Supplier on *Smeta Sedex* platform, and on *Eco Vadis* ratings platform as a Platinum Supplier (among the top 1% out of 100,000 companies). Eco Vadis is platform for assessment of CSR and sustainable procurement which rates companies in all categories of CSR.

The researchers read the company's Annual Sustainable Report, and the Sustainable Development Goals (SDG) Progress Report, and discussed relevant topics with the company's Chief Business Sustainability Officer and her assistants. The questionnaire has been fulfilled by the company's Chief Business Sustainability Officer.

In the research was used a five-point Likert scale to measure and to express the attitudes of respondent about a certain phenomenon. The numbers were added to certain characteristics of the observed phenomenon, and then scaling has been carried out. The phenomena were positioned on a certain scale depending on how many characteristics the variables had, determined via a five-point Likert scale. The Chief Business Sustainability Officer had to express the degree of agreement or disagreement for each individual statement, on a five-point scale (1. "Very low", 2. "Low", 3. "Medium", 4. "High", 5. "Very high"). Each respondent's answer was scored, and calculated the average value of points for each statement.

Analyzed company has been calculating its GHG emissions for several years, and from 2020 they also prepare annual GHG emissions report according to the international GHG Protocol standard. GHG emissions report contains SCOPE 1 (direct GHG emissions from company-owned and controlled resources, released into the atmosphere as a direct result of a company's activities); SCOPE 2 (indirect GHG emissions released in the atmosphere from the consumption of purchased electricity, steam, heat and cooling), and SCOPE 3 (all indirect emissions not included in Scope 2, that occur in the value chain of the reporting company, including both upstream and downstream emissions).

4. RESULTS AND DISCUSSION

In this section, the results of this research are reported.

The TCFD conceptual framework developed by The Financial Stability Board (2017) was used for assessment of climate-related risks and opportunities and their potential impact on financial

performances. The TCFD framework covers (1) risks related to the transition to a low-carbon economy, and (2) risks related to the physical impacts of climate changes. In terms of transition risks, exposure to policy and legal, technology, market, and reputation risks, were assessed. Regarding physical impacts of climate changes, exposure to acute and chronic risks were assessed. Different climate related risks have been listed in the above-mentioned categories and their potential financial impacts have been assessed, and on the base of the company's answers and data availability, risk exposure has been measured.

The Task Force divided climate-related risks into two major categories: transition risks and risks related to the physical impacts of climate change. The Task Force identified certain subcategories under each of these categories.

In TCFD framework, the main risks to be assessed are detailed in Table 2:

Risks related to the transition to a low-carbon economy

- Exposure to Policy and Legal risks with the focus on possible Increased pricing of GHG emissions; Enhanced emissions-reporting obligations; Mandates on and regulation of existing products and services; Exposure to litigation;
- Exposure to Technology risks with the assessment of possible Substitution of existing products and services with lower emissions options; Unsuccessful investment in new technologies; Costs to transition to lower emissions technology;
- Exposure to Market risks with the focus on possible Changing customer behavior; Uncertainty in market signals; Increased cost of raw materials;
- Exposure to Reputation risks with the focus on possible Shifts in consumer preferences; Stigmatization of sector; Increased stakeholder concern or negative stakeholder feedback.

Table 2: Assessment of exposure to climate-related risks

Risk type	Climate related risks	Exposure to risk	Score
Transition risks	1. Policy and Legal risks	1.1. Increased pricing of GHG emissions	2
		1.2. Enhanced emissions-reporting obligations	1
		1.3. Mandates on and regulation of existing products and services	2
		1.4. Exposure to litigation	1
		Average value	1,50
	2. Technology risks	2.1. Substitution of existing products and services with lower emissions options	2
		2.2. Unsuccessful investment in new technologies	3
		2.3. Costs to transition to lower emissions technology	2
		Average value	2,33
	3. Market risks	3.1. Changing customer behavior	3
		3.2. Uncertainty in market signals	2
		3.3. Abrupt and unexpected shifts in energy cost	3
		3.4. Change in revenue mix and sources, resulting in decreased revenues	3
		3.5. Re-pricing of assets (e.g., fossil fuel reserves, land valuations, securities valuations)	1
		Average value	2,40
4. Reputation risks	4.1. Shifts in consumer preferences	1	

		4.2. Stigmatization of sector	1
		4.3. Increased stakeholder concern or negative stakeholder feedback	2
		Average value	1,33
Physic risks	1. Acute risks	1.1. Increased severity of extreme weather events such as cyclones and floods	4
		Average value	4,00
	2. Chronic risks	2.1. Changes in precipitation patterns and extreme variability in weather patterns	3
		2.2. Rising mean temperatures	3
		2.3. Rising sea levels	1
		Average value	2,33

In terms of Transition risks, Policy and Legal risks, there is a very small chance that there will be an increase in GHG prices, especially for analyzed company, and its industry in Serbia, in the next few years; the current price is 0. Regarding Enhanced emissions-reporting obligations it has to be noted that analyzed company has been rated by *EcoVadis* sustainability rating platform as a Platinum supplier.

Regarding Technology risks, analyzed company consider costs to transition to lower emissions technology through the cost of investing in solar panels.

In terms of Market risks and Changing customer behavior, it has to be added that market conditions and competition force customers to think primarily profit-oriented, and to use packaging that is less “green”. Uncertainty in market signals comes from the chain value, having in mind that the majority of analyzed company’s suppliers are subsidiaries of multinational companies.

Analyzed company is a leader in the packaging industry in terms of circular business model, implementing ESG principles and CSR, and it is not expected higher exposure to the Reputation risk.

Regarding Physic acute risks, there is a flood risk in the closer area of analyzed company. In terms of Physic chronic risks extreme variability in weather patterns and rising mean temperatures could cause forest fires, which could affect supply chain, primarily suppliers of a paper.

Table 3: Assessment of potential financial impacts of climate-related risks

Risk type	Climate related risks	Potential financial impact	Score
Transition risks	1. Policy and Legal risks	1.1. Increased operating costs (e.g., higher compliance costs, increased insurance premiums)	2
		1.2. Write-offs, asset impairment, and early retirement of existing assets due to policy changes	2
		1.3. Increased costs and/or reduced demand for products and services resulting from fines and judgments	1
		Average value	1,67
	2. Technology risks	2.1. Write-offs and early retirement of existing assets	2
		2.2. Reduced demand for products and services	3
		2.3. Research and development (R&D) expenditures in new and alternative technologies	2
		2.4. Capital investments in technology development	4
		2.5. Costs to adopt/deploy new practices and processes	4
		Average value	3,00
3. Market risks	3.1. Reduced demand for goods and services due to shift in consumer preferences	2	

		3.2. Increased production costs due to changing input prices (e.g., energy, water) and output requirements (e.g., waste treatment)	3	
		3.3. Increased cost of raw materials	4	
		Average value	3,00	
	4. Reputation risks	4.1. Reduced revenue from decreased demand for goods/services	1	
		4.2. Reduced revenue from decreased production capacity (e.g., delayed planning approvals, supply chain interruptions)	1	
		4.3. Reduced revenue from negative impacts on workforce management and planning (e.g., employee attraction and retention)	2	
		4.4. Reduction in capital availability	1	
		Average value	1,25	
	Physic risks	1. Acute risks	1.1. Increased severity of extreme weather events such as cyclones and floods	4
			Average value	4,00
2. Chronic risks		2.1. Changes in precipitation patterns and extreme variability in weather patterns	3	
		2.2. Rising mean temperatures	3	
		2.3. Rising sea levels	1	
Average value		2,33		

Assessment of financial impacts of climate-related risks indicate that in terms of Technology risk pressure by competitors who have adopted new technology, is expected, which could reduce demand for products and financial impact is assessed as “medium”; R&D expenditures in new and alternative technologies are covered by all participants in the chain value, which reduces financial impact of that risk; Need for trained and specialized employees could have significant impact on the increase of Costs to adopt/deploy new practices and processes.

Regarding Market risks Energy price increase is expected and planned, and measures are taken to reduce that impact (solar panels). But, considering global disruptions the risk of a catastrophic disruption of energy supply is greater than a few years ago. Financial impact of market risks to the Change in revenue mix and sources, resulting in decreased revenues is assessed at the medium level, having in mind that competition has attacked some of company’s production segments by using different production technology, and company adapt by deploying new product and market niches.

Financial impact of Reputation risk is not expected at the higher level, having in mind company’s effort to attract and retain qualified workforce, and that company fulfills majority of the ESG requests by banks in the case of borrowing capital.

The possible financial impact of exposure to Physic acute risk is assessed as high because of possible supply chain interruptions. Significant financial impact of exposure to physic chronic risks is not expected.

Sustainability manager assessed each type of climate related risk exposure and assigned a score in the 5-point Likert scale. The average value was calculated for each group of transition risks and physic risks. Results are graphically presented in the radar chart shown in Figure 1.

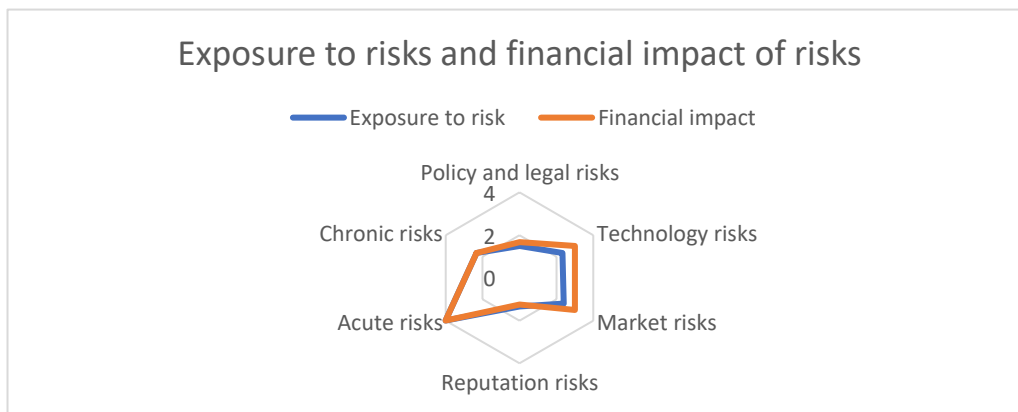


Figure 1: Exposure to risks and financial impact of risks

Data on radar chart indicate that regarding Transition risks, the exposure of analyzed company to the Technology and Market risks are between low and medium. Below that is the exposure to Policy and legal, and Reputation risk. In terms of Physic risks, company is more exposed to Acute, than to Chronic risks. Similar situation is with the financial impact of the exposure to the abovementioned risk groups. Financial impacts of Market and Technology risks are assessed at the medium level. That means that Market and Reputation risks, as well as Physic acute risk, and their financial impact, should be considered as material, and disclosed in annual reports.

5. CONCLUSIONS

Climate change is a global phenomenon and the solution for rising climate risks, and their impacts should be considered at the global level, through the integration of climate-related disclosure in the mandatory corporate reporting.

Although climate related disclosure is not mandatory for companies, they should monitor climate risks because of rising impact of those risks on the business and infrastructure, but what is more important is the way to show their CSR. Company's success and progress are considerably determined by the way how investors and other stakeholders perceive the company, having in mind their continuous pressure on the company to disclose real and objective environmental indicators, in the terms of global climate crisis. Existing and potential investors are especially interested in company's exposure to climate related risk and the managing of these risks, but that information is usually not disclosed in annual reports, although those risk have material significance for making decisions.

Research results were presented for only one company, although this company is a leader in the paper packaging industry of Serbia. The company selection could also be seen as one of the limitation factors of this research. Also, research results based on the subjective assessment of the respondent should be treated with caution. This article could be the basis for further research in the manufacturing industry of a developing country.

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