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ESG and IFRS

When sustainability and accounting get together

Environmental, social and governance (ESG) aspects are becoming more and more important for companies. Investors and the public increasingly expect companies to address these issues and align their business models to sustainable goals. At the same time, there are numerous initiatives aimed at enabling transparent, reliable and comparable reporting on such aspects, including:

- The Federal Council's consultation on an ordinance on climate reporting by large companies
- The FER Commission's work on sustainability guidelines
- The revision of the EU directive on corporate sustainability reporting and the associated development of European Sustainability Reporting Standard (ESRS)
- The development of standards for accountability on sustainability issues by the International Sustainability Standards Board (ISSB)
- The development of rules on climate-related disclosures by the Securities and Exchange Commission (SEC)

Even though the initiatives mentioned focus primarily on non-financial reporting, companies should be aware of possible effects on the IFRS financial statements. IFRS do not contain a specific standard for such issues, but as a framework IFRS are reflecting all existing circumstances. As a result, there may already be an impact on the IFRS financial statements today – and the expectations placed on companies with regard to their IFRS financial statements are set to increase. For example, the European Securities and Markets Authority (ESMA) has already declared climate-related aspects a priority area for reviews of financial statements for the 2021 financial year. Other regulators are likely to follow suit.

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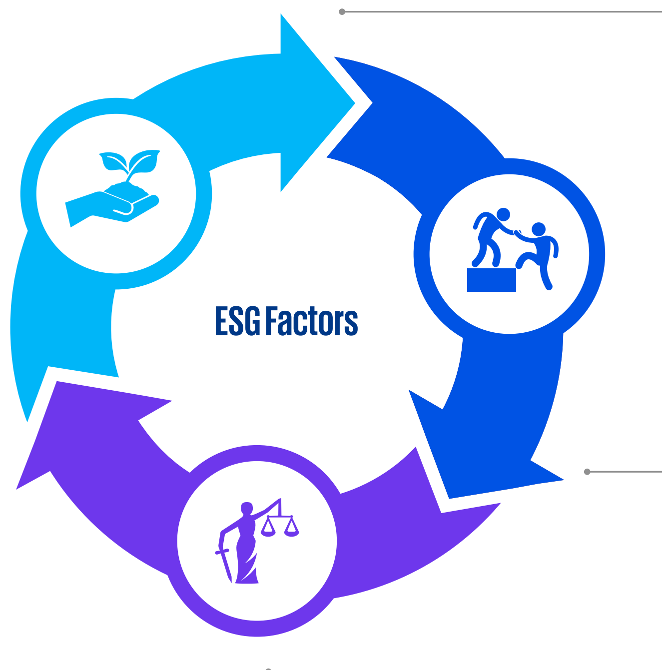

Environmental
- climate change
- greenhouse gas emissions
- resource depletion, including water
- waste and pollution
- deforestation

Social
- working conditions, including slavery and child labour
- local communities, including indigenous communities
- conflict and humanitarian crisis
- health and safety
- employee relations and diversity

Governance
- executive pay
- bribery and corruption
- board diversity and structure
- fair tax strategy

Focus areas for IFRS financial statements

In the medium to long term, sustainability issues could have a variety of effects on IFRS financial statements. The current discussion in the literature and in practice suggests that the focus for IFRS accounting is primarily on climate-related aspects at present, with the following 'near future' topics:

Budgets/business plans
New legal requirements, changes to the business models and shifts in customer and supplier behavior can have a negative or positive impact on income and expense estimates. Against this background, planning assumptions need to be critically reviewed, for example with regard to long-term development. It may be necessary to plan with several scenarios in order to appropriately consider the uncertainty regarding future developments.

Budgets and business plans are used for various purposes, e.g. business valuations, impairment testing and demonstrating the ability of a company to continue as a going concern. This may, in turn, affect various items in the statement of financial position such as intangible assets (including goodwill), property, plant and equipment, and deferred tax assets.

Property, plant and equipment
Certain assets may end up being decommissioned earlier than originally scheduled as a result of new regulatory requirements, technological advances (e.g. for CO_2 savings), changes in customer behavior, voluntary commitments (e.g. net zero targets), or the threat of reputational damage. This may have the following effects:
- Depreciation and amortization: Adjustments may be required as part of the annual review of useful life and residual value.
- Impairment: The aspects flagged above may constitute indications of impairment, which could trigger impairment testing and, accordingly, lead to impairment losses.
- Decommissioning and restoration obligations: Decommissioning earlier than originally planned should be reflected in the measurement of provisions.

Provisions
Decommissioning and restoration obligations often arise due to legal or contractual provisions. In addition, constructive obligations can be triggered by public announcements or industry practice. In this respect, it is particularly important to critically evaluate voluntary commitments by the company as well as any new legal requirements.

If the "damage" has already occurred, provisions must be recognized for its elimination. The valuation is to be reviewed at the respective reporting date and adjusted if necessary (e.g. due to changes with regard to maturity or increased disposal requirements).

Sustainable financing

Sustainable financing (e.g. ESG bonds and loans) will become increasingly important in the coming years. Examples include bonds with interest rates linked to performance against certain sustainability targets or bonds whose issue proceeds are used for pollution reduction projects. In terms of accounting, sustainable financing comes with certain challenges:

- For investors, the question arises in particular as to how the corresponding financial instruments are to be classified and thus valued. For this purpose, it must be determined whether the ESG element is compatible with the solely payments of principal and interest (SPPI) criterion.
- For issuers, the question arises as to whether the financing contains a derivative that must be separated. For this purpose, it must be determined whether the ESG element is closely related to the bond or loan in terms of economic characteristics and risks.

Emission rights

In order to limit harmful emissions, more and more countries are relying on emission rights systems (e.g. CO_2 certificates or caps) for production processes and/or manufactured products. This leads to questions such as:

- How should free allocations, purchases/sales of certificates or obligations to return allowances be accounted for?
- How should government grants be recognized in profit/loss?
- From which point in time should provisions for excess emissions be recognized?

Employee compensation

In order to provide incentives for sustainable behavior, specific sustainability indicators may be included in share-based or other compensation agreements. The design of the sustainability indicators and compensation program affects how they are valued.

Notes to the financial statements

The notes are intended to provide users with additional relevant information about the financial statements. This includes (material) effects of ESG aspects. The disclosures in the notes are thus an important component of transparent, reliable, comparable and consistent reporting on ESG aspects. Of particular importance in this context is information on significant assumptions, estimates and judgments – e.g. on the accounting topics mentioned above.

Conclusion

ESG aspects have an impact not only on non-financial reporting, but also on accounting under IFRS. This means there may already be a need for action regarding accounting and disclosure. Implementing the effects in the financial reporting is much like a journey. Now is the time to "pack your bags and hit the road" if you are to meet the expectations of investors, regulators and the public, and ensure correct accounting and disclosure.

Recommended steps

1. Status quo analysis: How, where and to what extent is the company affected by ESG aspects? Does a (public) sustainability strategy already exist? Have binding commitments (e.g. net zero) been made in this regard?
2. Analysis of the accounting impact: What are the accounting consequences based on the current status?
3. Disclosure: Has all information essential for the understanding of the addressees been disclosed? Is there a common thread running through the disclosures, i.e. are the statements in the notes, sustainability report and other components of the annual report and corporate communications consistent?
4. Implementation of a process for identification and coordination: The area of ESG is developing rapidly and responsibilities in the company are often distributed across several departments. Is there a process in place to identify new aspects regularly and coordinate internally?

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Further information

KPMG on sustainability and ESG – KPMG Switzerland (home.kpmg)
Climate change financial reporting resource centre – KPMG Global (home.kpmg)
IFRS – Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards
ESMA Enforcement Priorities 2021

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