CHAPTER 1

Net zero commitments

This article aims to:

Emphasise the principles that should be met for recognising a provision when a company commits to a net-zero target.

Background

When a company pledges to achieve net-zero emissions, such as by the year 2050, it typically signifies a plan to minimise greenhouse gas emissions to the lowest feasible level and to balance out any residual emissions through verified carbon removal methods, like afforestation. Net-zero goals generally encompass emissions across the entire value chain, known as Scope 1, 2, and 3 emissions according to the GHG Protocol[1], although some commitments may only cover direct operational emissions (Scope 1 and 2).

In addition to net-zero, companies may set various related targets:

- **Carbon neutral:** Often an interim milestone towards net-zero, focusing on the acquisition and retirement of carbon offsets.
- **Carbon negative:** A pledge to eliminate more carbon than the company emits annually.
- **Climate positive:** An ambition to go beyond carbon-negative by addressing total emissions across the full value chain, akin to net-zero.

Stakeholders, including users of financial statements, regulators, and the public, are increasingly inquiring about the implications of net-zero commitments on financial reporting, particularly regarding the potential triggering of liabilities. It is crucial for companies to present a cohesive narrative across various reports and forums, encompassing their financial statements, to ensure transparency in their journey towards net-zero.

Recently, the IFRS Interpretations Committee has discussed climate-related commitments based on a specific scenario and published an agenda decision in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

This article highlights the need for companies to carefully evaluate their net-zero commitments to determine the appropriate financial reporting actions. In this article, we will summarise the agenda decision with help of an example.

1. Greenhouse gas emissions are categorized into three groups or 'scopes' by the most widely used international accounting standard, the Greenhouse Gas (GHG) Protocol. Scope 1 is direct emissions, scope 2 covers energy purchases, and scope 3 includes all other indirect emissions in a company's value chain, such as transportation and waste disposal. Scope 3 emissions are critical, as they often represent the majority of organizations' carbon emissions.

Liability recognition

Merely establishing a net-zero target does not inherently result in a liability. Companies must scrutinise the specifics of their net-zero pledges and the strategies for their implementation. According to IAS 37, there are explicit criteria to determine the existence of a liability at the reporting date and whether it should be recognised in the financial statements. Future operating losses cannot be accounted for as liabilities; therefore, a company's commitment must result in a current obligation due to a past occurrence (such as 'environmental impact') to necessitate recognition in the financial statements.

Example

In 2020, a household product manufacturer publicly committed to:

a. Gradually reducing its annual greenhouse gas emissions by at least 60 per cent from current levels by 20X9.

b. Offsetting its remaining annual emissions from 20X9 onwards by purchasing and retiring carbon credits from the carbon market.

To support these commitments, the entity undertook the following actions:

a. Released a transition plan detailing the gradual modification of its manufacturing processes from 20X1 to 20X9 to achieve the targeted emission reduction.

b. The modifications include:

- Investing in more energy-efficient processes
- Sourcing energy from renewable providers
- Substituting petroleum-based ingredients and packaging materials with alternatives that have a lower carbon footprint.

In addition to the transition plan, the entity has taken multiple public actions to reinforce its dedication to fulfilling these commitments.

The IFRS Interpretations Committee has identified two critical criteria (two tests) that must be satisfied for a liability to be recognised. The determination of whether these conditions have been met may involve substantial judgement, taking into account the unique facts and circumstances of each case.

Test 1

Constructive obligation

Do you have a constructive obligation?

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Test 2

Recognition criteria

Are the criteria to recognise a liability met?

=

Liability

Recognise a liability only when both tests are met

Source: KPMG IFRG Limited's Talk book on Net-zero commitments, April 2024

Test 1- Do you have a constructive obligation?

- Has a company made a public statement about its climate-related commitments?
  - No → No liability or contingent liability
  - Yes → Has the public statement created a valid expectation?
    - Consider:
      - Nature of the statement
      - Method of communication
      - Specificity and status of plans
      - Timing of actions to fulfil commitment
      - Publicly available evidence of progress
    - No → No liability or contingent liability
    - Yes → **There is a constructive obligation** — Go to Test 2

Source: KPMG IFRG Limited's Talk book on Net-zero commitments, April 2024

Test 2 – Are the criteria to recognise liability met?

- Does the public statement relate to:
  - Past damage done? → Present obligation
    - Is an outflow of resources probable?
      - No → Disclose contingent liability
      - Yes → Can the amount be measured reliably?
        - No → Disclose contingent liability
        - Yes → Recognise liability
  - Future event? → No present obligation
    - No liability or contingent liability

Source: KPMG IFRG Limited's Talk book on Net-zero commitments, April 2024

Constructive obligation – public statement

The Committee noted that the establishment of a constructive obligation through a company's commitment to reduce or offset emissions creates a valid expectation on the specifics of the commitment and the surrounding circumstances, including any public actions affirming the company's intent to fulfil the commitment. Management must exercise judgement at each reporting date, considering all pertinent facts and circumstances at that time. As these may evolve from one reporting date to another, so might the conclusion regarding the existence of a constructive obligation. In the absence of such an obligation, no provision is recognised. Conversely, if a constructive obligation is present, the next step is to evaluate if it meets the criteria for provision recognition.

An entity should recognise a provision when:

a. It has a present obligation (legal or constructive) as a result of a past event;

b. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

c. A reliable estimate can be made of the amount of the obligation.

Present obligation as a result of a past event

The Committee emphasises two core principles:

1. The mere enactment of a law or the publication of a policy or statement does not, in itself, create a present legal or constructive obligation for an entity. An entity has a present legal or constructive obligation only upon the occurrence of the event to which the law, policy, or statement pertains.

2. Provisions are not recognised for future operational costs that an entity may incur.

By applying these principles to the example mentioned above, the committee analysed that if the commitment described in the fact pattern creates a constructive obligation for the entity:

a. When the entity announced its commitments in 20X0, it did not create a present obligation as a result of a past event. Neither the declaration of a commitment nor actions that demonstrate the entity's intention to fulfil that commitment constitute events that lead to a present obligation. The events that would create such an obligation are those to which the commitment pertains, and these events have not yet occurred at the time of the commitment's declaration. The expenses that the entity will incur to reduce its annual greenhouse gas emissions and to offset emissions in 20X9 and beyond are future operational costs-the obligations for these costs do not exist independently of the entity's future actions.

b. At any given date, the entity does not have a present obligation to reduce emissions beyond that date, as the costs associated with operating at reduced emissions in the future are future operational costs. The entity will eventually incur liabilities for resources it acquires to conduct future operations, such as new plant or equipment, but only upon entering into an exchange transaction for those resources.

c. The entity will only have a present obligation to offset greenhouse gases once it has emitted them as per its commitment. This obligation will arise only if and when the entity emits greenhouse gases in 20X9 and subsequent years.

Probable outflow of resources

The Committee determined that if the commitments outlined in the scenario do create a constructive obligation for the entity, the following would apply:

a. Settling the constructive obligation to reduce the entity's annual greenhouse gas emissions would not necessitate an outflow of resources embodying economic benefits. While the entity will incur costs to modify its manufacturing methods, it will receive resources in exchange—such as property, plant, equipment, energy, product ingredients, or packaging materials—which it can utilise to produce and sell products profitably.

b. Settling the constructive obligation to offset the entity's remaining annual greenhouse gas emissions will require an outflow of resources embodying economic benefits, as the entity will need to purchase and retire carbon credits without receiving any economic resources in return.

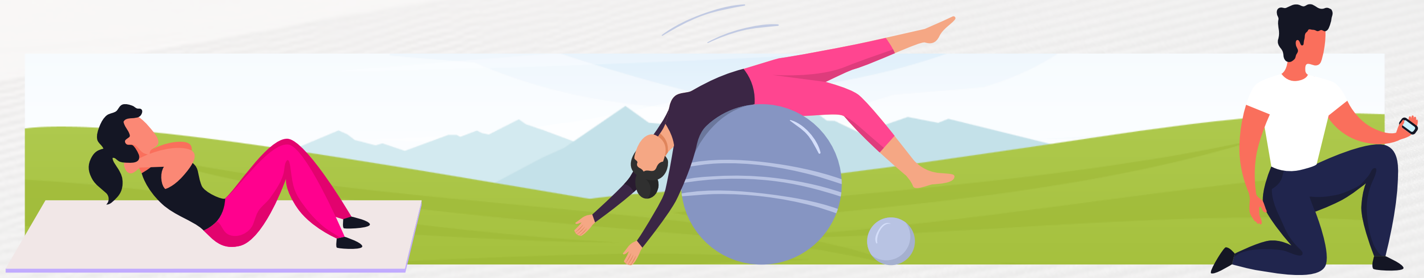
Reliable estimate

The Committee concluded that in the fact pattern described, it is likely that the entity would be able to make a reliable estimate of the amount of a constructive obligation that satisfies the other recognition criteria.

Conclusion

The Committee determined that:

1. The creation of a constructive obligation from the entity's declaration of its greenhouse gas reduction and offset commitments is dependent upon the facts of the declaration and the circumstances surrounding it.
2. Should such a declaration result in a constructive obligation, the following applies:
   a. Upon making the declaration in 20X0, the entity does not recognise a provision, as the constructive obligation does not constitute a present obligation stemming from a past event.
   b. Between 20X0 and 20X9, no provision is recognised because a present obligation due to a past event does not exist until the entity emits the greenhouse gases it has committed to offset.
   c. As the entity emits greenhouse gases in 20X9 and the years that follow, it incurs a present obligation to offset these past emissions. If the obligation remains unsettled and can be reliably estimated, the entity is then required to recognise a provision.



Disclosure requirements

Investors and regulators expect a company's financial statements, management discussion and analysis (MD&A) and sustainability-related disclosures to provide a coherent, connected and integrated picture. To achieve this, companies need to provide enhanced disclosures on the impact of net-zero commitments in their reporting.

- **Specific disclosures in the financial statements:** Once companies have assessed the financial reporting impacts of the individual actions in their net-zero plan, they need to consider the disclosures required by the specific IFRS standards. In some cases, a disclosure may be required even though there is no current-period financial statement impact.
- **Overarching disclosures in the financial statements:** Companies also need to consider the requirements of IAS 1, *Presentation of Financial Statements.* This includes disclosing additional information that is necessary for investors to understand the impact of net-zero commitments on the company's financial position and performance, and information that could influence their decisions.
- **Other disclosures outside the financial statements:** If a planned action does not impact the company's financial position and performance at the reporting date and is not subject to the specific or overarching disclosures – e.g. a commitment to offset emissions after 2030 by purchasing carbon credits – then the company may explain that there is 'no financial reporting impact' as part of the net-zero disclosures outside the financial statements. Disclosing 'no impact' may be specifically required by some sustainability reporting frameworks.