IFRS Today

Our series on the most topical issues in IFRS® Standards and financial reporting

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PODCAST TRANSCRIPT

Climate change – Helping you identify the potential financial statement impacts for your business

Speakers

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Reinhard Dotzlaw
Partner, Global IFRS leader

KPMG in Canada

Introduction

Hello and welcome! I'm Reinhard Dotzlaw, a partner at KPMG in Canada and global IFRS leader.

Faced with the challenges of climate change, companies everywhere are making strategic business and risk management decisions to manage climate-related risks and seize climate-related opportunities. Although companies and their boards are increasingly focused on the issues, the assessments are complex and multi-levelled – and depending on the specific climate risks and opportunities they face, the time horizons range from short to medium and longer-term.

There is a growing focus by investors and other capital markets participants on the impact of climate risks on an entity's business models, its operations and future cash flows and its future viability. They are demanding high quality information that allows them to assess how your company is managing climate-related risks and the

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impact on your long-term prospects. And they are looking to your annual reports, including your financial statements, for that information.

So it's important that the information in the front end and the back end of your annual report is in sync and complements each other. It's also important that the information is specific to your circumstances and provides clear and meaningful insights into the significant judgements and estimates you have made relating to the impact of climate risk.

We've been collaborating remotely on this podcast, wherever we are in the world. Each of our speakers will introduce themselves and then give you a flavour of some of the considerations at stake.

So here goes – Over to our speakers!

Brian O'Donovan
Partner

KPMG International Standards Group

What are the potential impacts of leasing polluting assets?

Hello – I'm Brian O'Donovan. Many businesses lease polluting assets. They may do this explicitly– for example, they may lease transport assets. Or they may have embedded leases – for example a power purchase agreement might contain a lease of coal-fired generating plant. These leases can be material. They can be very long term.

Changes in how you expect to use polluting assets in the future can affect how you account for leases of those assets today. The financial statement impact will often depend on how flexible your lease agreements are – for example, whether you can exit them early. And there can be other financial statement impacts too – for example, there are often associated restoration and environmental obligations.

So what should you be doing now?

- Firstly – Identify your leases of polluting assets and document the main terms. I would focus particularly on termination options and associated obligations.
- Secondly – Really challenge whether the current accounting captures the changing economic incentives that will impact how you will use these assets. Is the right-of-use asset impaired? Is the lease term correct? Have you captured all the associated liabilities?
- Thirdly – Provide clear and meaningful disclosure about the key judgements and estimates made around these often material contracts.

Eiichi Fujita
Head of DPP Accounting

KPMG in Japan

What's the impact on useful lives and residual values of PP&E and intangible assets?

Hi – I'm Eiichi Fujita. I want to talk about how climate-related risks, in particular those arising from transitioning to a lower-carbon economy, could significantly impact the useful lives and residual values of the company's assets, as well as the depreciation or amortisation methods.

Climate-related regulations might mean restrictions on assets such as exploration licenses. Technological advances may lead you to retire some of your production equipment sooner than planned. Changes in the market might cause the obsolescence of that equipment too. And then there is potential reputational damage to consider.

If all of this means there is a significant risk of a material adjustment to the carrying amounts of your property, plant and equipment, or your intangible assets within the next financial year, then you will have to disclose this – both the assumptions you have made to estimate the useful lives and residual values of those assets and the nature and carrying amounts of those assets.

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And remember, significant exposure to climate-related risks might lead to much higher estimation uncertainty.

Irina Ipatova
Director

KPMG International Standards Group

How do you account for emissions or 'green' schemes?

Governments around the world are introducing schemes designed to encourage a shift to greener sources of energy and reduce emissions of pollutants.

I'm Irina Ipatova and I'd like to share some considerations that you might find helpful in accounting for various emissions or 'green' schemes.

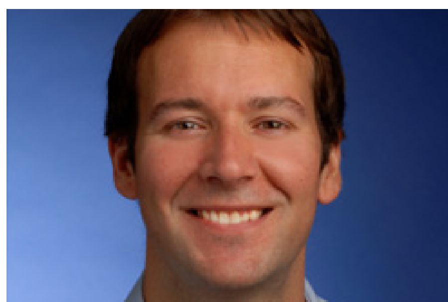
There are a number of different schemes and your company may be subject to more than one. To determine how to account for a scheme, it is critical to understand its terms and the company's obligations and rights.

So, what are the key questions to ask?

– What are the terms of the scheme?
– What is the company required to do and when does that obligation arise?
– Is an outflow of resources probable and what is the cost of settling the obligation?
– Do any rights held by the company under the scheme meet the definition of an asset?

These are just some of the questions you'll need to think about in determining the appropriate accounting treatment.

And don't forget about meaningful disclosures of judgements and estimates made in recognising and measuring liabilities and assets related to the scheme – these are essential for your effective communication with stakeholders.



Anthony Voigt
Director

KPMG International Standards Group

Have you recorded all of your environmental and decommissioning obligations?

Hello – I'm Anthony Voigt – I'm here to talk about the increase in environmental and decommissioning obligations placed on companies due to new legislation from governments and their own public commitment to climate change.

It goes without saying that the level of obligation varies a lot between sectors. If a company is seen to cause environmental damage when installing assets (such as an oil rig) and/or in its day-to-day operation (say nuclear contamination) then it will face particular challenges. But the net has been cast wider than you might think.

As governments take action to combat climate change, new legislation or a company's public commitment on climate change is generating additional environmental and decommissioning obligations. These affect everyone. No matter which sector you operate in, you will need to make the right preparation to ensure that any new or enhanced obligations are properly met, and reported appropriately in your financial statements.

What can you do to get ready?

– Consider if there are any changes in legislation that may result in new obligations or changes to existing obligations.
– Review your recent company announcements on climate change and assess if they have created a constructive obligation.
– Assess whether the expected timing and amount of remediation costs needs adjustment.

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Gabriela Kegalj
Partner

KPMG in Canada

The impact of climate change on the going concern assessment

I'm Gabriela Kegalj, and I want to talk about how, for some companies, climate-related risks could give rise to events or conditions that may cast significant doubt on their ability to continue as a going concern. These may be physical risks such as the destruction of a manufacturing facility in a hurricane, or crop devastation due to fire, flood or drought or some other climate event. These risks may also stem from a company's large carbon footprint, which may trigger, for instance, litigation resulting in significant penalties for exceeding emission targets or a shift in customer preferences resulting in the loss of a major customer.

When you consider climate-related risks in your going concern assessment, make sure you look at different possible scenarios – including at least one severe but plausible downside scenario. Look at your plans for future actions – do they provide sufficient mitigation for these risks?

And always provide clear and robust disclosures – these should include disclosures about any uncertainties identified in the going concern assessment and any significant judgements that were involved.

Ryan Jong
Associate Partner

KPMG in the UK

What's the impact on expected credit losses (ECL)?

Hi – I'm Ryan Jong, and I'd like to talk about the implications of climate risk for expected credit losses.

When we measure the impact of climate-related risk, we usually look at physical risks (for instance, risks arising from more frequent or severe weather events); and transitional risks (those are risks that come about as a result of the movement to a less polluting, greener economy).

The systemic impact of both physical and transitional risks depends on the severity and timing of such events. Most people are expecting the impacts to feed in gradually over a long time horizon, say fifteen years plus. So, further in the future than current loans and limiting the impact on ECL today.

But there's no room for complacency. Uncertainty is the only real constant here and there's no doubt that if the speed and scale of climate risk were to accelerate, then the impacts on ECL could suddenly start looking a lot more significant. It's important to monitor closely and not to get caught unawares.

Colin Martin
Partner

KPMG International Standards Group

Do green bonds contain embedded derivatives?

I'm Colin Martin, and I'll be taking a closer look at the challenges facing companies that issue green bonds. This is a relatively new phenomenon and many companies will be wondering how they should account for and present this type of bond in their financial statements.

Green or sustainability-linked bonds are increasingly popular. They work as standard debt instruments but with certain extra features. For example, they may have restrictions on the use of the funds raised or coupons that are linked to environmental, governance or social responsibility by meeting ESG targets.

When issuing green bonds, there a few questions that you'll need to consider.

– Could any of the contractual terms in issued green or sustainability-linked bonds be considered an embedded derivative?

– Is any embedded derivative in the hybrid contract required to be separated from the host contract under IFRS 9?

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- Are any embedded derivatives appropriately presented and disclosed in the issuer's financial statements?

We can expect to see green bonds more and more in the coming years and ensuring their appropriate treatment in the accounts – by determining if they are hybrid contracts with embedded derivatives – is key.

Brian O'Donovan
Partner

KPMG International Standards Group

Do you have a lease of green technology?

Hello – I'm Brian O'Donovan… I spoke earlier about the risks of being tied into leases of polluting assets. But what about the opportunities of the shift to newer technologies? Companies can often access government incentives by investing in greener technologies. Using leasing as a financing tool to access these technologies can provide flexibility.

But care is needed when identifying and measuring 'on balance sheet' lease obligations. This can be a tricky area. If you're taking all of the output from say a solar farm or a wind farm, if you're taking the renewable energy credits, then you need to work through the lease definition. And the financial structures I see in this space can be highly complex. This can raise additional financial statement questions, around consolidation and financial instrument accounting. There can be a lot to think about, a lot to disclose.

So, what should you be doing now?

- Firstly – Test any proposed investment against the lease definition at an early stage to avoid any surprises later.
- Secondly – Focus on the balance of fixed and variable payments to understand the size of any potential lease liability.
- And thirdly – Think more broadly about the financial statement impacts, particularly around consolidation and financial instruments and of course disclosure.

Reinhard Dotzlaw

Closing comments

Thank you everyone for your insights on financial reporting in these challenging times. I hope the overall takeaway is clear. There's a lot to do and a lot at stake for all involved in facing the financial reporting challenges of climate change. To meet these challenges, close attention to clear and meaningful disclosures will be critical.

In this podcast, we've highlighted some of the big issues to consider – but we don't stop there. A more detailed web article sits behind each of the topics covered. Together they make up the **Climate change financial reporting resource centre** we've just launched. We've set this up as a FAQ-style resource, designed to help preparers to identify the potential financial statement impacts for their business.

A quick way to find this information is to type KPMG IFRS into your browser, or to follow KPMG IFRS on LinkedIn.

Thank you very much for joining us. Take care and stay safe!

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