KPMG

IFRS Today

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

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PODCAST TRANSCRIPT

Climate-related risks – More tips on identifying potential financial statement impacts for your business

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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.

Since our **last podcast** on the impacts of climate-related matters on companies' financial statements, things have been moving at quite a pace!

We've had the world's governments meeting in Glasgow – at COP26 – to agree future climate targets for the planet. And, announced at that meeting was the creation of an International Sustainability Standards Board – the ISSB. In the next few months, we're expecting the ISSB to release proposals for a new type of IFRS Standard – an IFRS Sustainability Disclosure Standard – on climate-related disclosures, together with proposals for a new general sustainability disclosure standard.

An important aim of these new IFRS standards issued by the International Sustainability Standards Board will be to provide enterprise value-focused sustainability disclosures. Under the governance of the IFRS Foundation, the ISSB will work closely with the IASB Board, reflecting the importance of connectivity with financial reporting.

And that's important, because interconnectivity between the financial statements and the rest of the annual report on climate-related matters is a key concern for investors and regulators. Investors are challenging the lack of sufficient disclosure of climate-related information in financial statements and are seeking transparency and clarity in disclosures. The 2021 reporting season is an opportunity for companies to close this information gap by enhancing their disclosures of the impact of climate-related matters.

In response, our colleagues from across KPMG's global network have continued to contribute their latest insights to our online **Climate change resource centre**. Here are just some of them. Each speaker will introduce themselves and will then give you some brief insight into how you and your company might best tell your story.

Kim Heng
Partner

KPMG in Australia

What are the potential impacts on inventories?

Hello – I'm Kim Heng. Many companies handling products that contribute to climate change are seeing increased inventory costs due to ESG (environmental, social and governance targets) measures taken by governments. Carbon taxes, emissions schemes or the need to swap out materials used in production for greener alternatives – all of these can bring significant added costs…

A company might need to overhaul its product range, potentially while facing decreased demand as customers shift to more climate-friendly and sustainable products. In some cases, the combined effect of all of this is to make certain inventories much harder to sell (or even obsolete).

So what can companies do to cover this risk? Here are some pointers…

- Firstly, get fully up to speed with any current and upcoming legislation that might affect any of the goods or services you provide.
- Next, check whether your NRV – that's net realisable value – calculation appropriately takes into account the effect of climate-related matters on your selling price and the cost of your inventories.
- And work out which costs related to new products or updated production processes you might be able to include as cost of inventory.

Anthony Voigt
Director

KPMG International Standards Group

How might employee benefit arrangements be affected by climate-related risks?

Hi – I'm Anthony Voigt. I'm here to talk about how employee benefit arrangements can be affected by climate-related risks.

Some companies might be looking at adding climate-related performance criteria into employee incentive arrangements (e.g. emission-reduction targets) or offering new climate-related employee benefits (think electric car or bicycle schemes), while others could be looking at changes in employee benefit arrangements due to site closures or restructurings.

Either way, accounting for arrangements in the scope of both IFRS 2 *Share-based Payment* and IAS 19 *Employee Benefits* could be affected.

If you're wondering what can be done now to put your company in a strong position, these are a few areas management could look at.

- Understand the accounting for climate-related employee benefit arrangements.
- Check out the impact on employee benefit arrangements of any potential site closures or restructurings – e.g. the impacts of a redundancy programme.
- Assess whether the measurement and disclosure of plan assets properly considers significant exposures to climate-related risks.

Agnieszka Sekita
Director

KPMG International Standards Group

Have you disclosed the impacts of climate-related matters clearly?

Hi – I'm Agnieszka Sekita. I'd like to start by picking up Reinhard's point on the growing demand for transparency and clarity in disclosures of climate-related information. Based on my experience working on the KPMG topic team covering financial statement presentation, I would say he's absolutely right. Investors not only want to understand how climate-related matters might impact a company both now and in the longer term, but also what the company is doing about this *now* – specifically, how is the company managing or responding to these matters currently, particularly the downside exposures? Why? Because it might affect their decision making. How a company responds to climate-related risks is likely to impact a number of accounting areas but I will focus on the disclosures.

Now, you might assume that because IFRS Standards don't refer explicitly to climate-related risks or climate-related matters, such disclosures are not required. But that would be a false assumption – IFRS Standards would indeed require disclosure of climate-related information in the financial statements – but only if that information is material. And information may be material even if there is no current-period financial impact, no impact on the numbers.

So there is a real challenge here for companies because they will need to make materiality judgements when deciding what to disclose about climate-related matters in their financial statements. And they need to remember that even if that information is not material in amount, it may be material in nature. So just because an IFRS standard doesn't include specific disclosure requirements on this, in some cases companies may need to go further in view of the overarching requirements in IAS 1 *Presentation of Financial Statements*. What I mean here is the concept of fair presentation, and companies needing to think about what other information might be relevant to investors in understanding the company's financial statements. Also, not to forget, IFRS Standards specifically require disclosures on key judgements and estimates made by management in preparing the financial statements.

As well as enhanced disclosures, investors and regulators are also expecting consistency – between the front part of the annual report and the financial statements. So if any key assumptions made in the financial statements differ from those disclosed in the front part of the annual report – say, on a net-zero commitment – companies will be expected to explain exactly why in the annual report.

All this of course depends on a company's specific facts and circumstances. We've captured in more detail some considerations for management, including actions to take now, in our web article **Have you disclosed the impacts of climate-related matters clearly?** Have a look and see how your company measures up.

Mahesh Narayanasami
Partner

KPMG US, DPP New York

Do green loans meet the SPPI criterion?

My name is Mahesh Narayanasami and I'm a partner in KPMG based in New York. I'll be taking a closer look at the challenges companies face in figuring out whether loans with ESG features meet the so-called SPPI criterion under IFRS 9 – the financial instruments standard. The SPPI criterion asks us to think through whether the contractual terms of the financial asset give rise on specified dates to cash flows that are *solely payments of principal and interest* (SPPI) on that principal amount outstanding.

So what am I talking about when I say loans with ESG features? Well, many banks are issuing loans where the interest rate is adjusted based on the customer meeting or not meeting certain predefined environmental, social and governance targets, or ESG. By the way, we all need to get used to a lot of acronyms in the ESG space.

Anyway, the loan terms could say that if the borrower doesn't meet certain targets – for cutting carbon emissions, for example – the borrower would face an increase in the contractual interest rate. Conversely, if that same borrower meets those targets, the contractual interest rate would be reduced. We're seeing more of these types of loans in the marketplace as banks and their customers make plans to meet their ESG mandates.

This market development is all good, and arrangements like this can give borrowers a clear incentive to support green projects that minimise their negative impact on the environment. But when a lender comes to assess the classification of loans with ESG features, it's not always clear whether any related adjustments to interest rates are consistent with the SPPI criterion. The analysis is important because the impact can be big on the lender's financial statements. If the SPPI criterion is not met, then the entire loan has to be recorded at fair value through profit or loss. In contrast, if the SPPI criterion is met along with certain other criteria, the loan could be measured at amortised cost.

So it is really important for management to consider:

- the nature and types of loans with ESG features held by the lender;
- whether these features adjusting the contractual cash flows in the form of interest adjustments meet the SPPI criterion or not; and
- potential disclosures in the financial statements if judgements around the SPPI assessment have a significant effect on amounts recognised in the financial statements.

Irina Ipatova
Director

KPMG International Standards Group

How do you account for different forms of government assistance?

Hello – I'm Irina Ipatova. Many governments around the world are introducing various measures to meet the targets set at COP26 and help companies to reduce emissions and move to new greener technologies. Companies may receive government assistance in various forms – e.g. emissions certificates, land for green projects, forgivable loans, waiver of expenses, investment tax credits and other subsidies.

Although types of government assistance vary, the accounting considerations are the same. A company recognises a government grant when it has reasonable assurance that it will comply with the relevant conditions and the grant will be received.

So, to determine how to account for that assistance, you need to answer three key questions.

- First, does the assistance meet the definition of a government grant?
- If yes, then the second question: Is there reasonable assurance that you will comply with the conditions and what are the expenses the grant is intended to compensate?
- Last but not least, how should that grant be measured and presented in the financial statements?

So, there's a lot to consider and companies may need to apply significant judgement – e.g. when there is little established practice for assessing compliance with a grant's conditions. This might be the case for any new government assistance programmes.

Following COP26, there could be more companies receiving government assistance and information about it will be critical for the users of the financial statements for them to assess how companies progress towards their climate-related goals. So if you receive government assistance, don't forget to provide clear and robust disclosures, especially of the key judgements and estimates affected by climate-related matters.

Brian O'Donovan
Partner

KPMG International Standards Group

Lessors – How will climate-related risks impact operating and finance leases?

Hello – I'm Brian O'Donovan. If a company leases assets to its customers, then it will be exposed to the same underlying climate-related risks its customers face. However, the specific accounting impacts could be different.

For the companies that lease out assets – the lessors – the key accounting issues will often be around valuation and impairment. Are the underlying assets – are the lease receivables – carried at the right amounts? Are those carrying amounts recoverable? Lessors will also need to think about income recognition and how to deal with requests to modify leases or terminate them early.

These climate-related impacts could be particularly profound for lessors who supply certain industries – I'm thinking energy, aviation, automotive – industries that use polluting assets and are under pressure to invest in greener technologies.

Dealing with this could be complex, but I'd like to flag up three clear actions management can take now.

- Firstly, identify those lease arrangements that are likely to be impacted by climate-related risks.
- Secondly, evaluate the impact on accounting systems and processes. I would focus particularly on controls around valuations, estimates and changes to lease contracts.
- And, thirdly, provide clear and robust disclosures, especially of the key judgements and estimates affected by climate-related risk.

Reinhard Dotzlaw

Closing comments

Thank you everyone for your insights. Of course, there is much more to discuss on these vital topics. Each of our speakers has written a more detailed web article on the topic they have covered, which sit alongside our other articles in the **Climate change resource centre**. We've set this up as an FAQ-style resource, designed to help preparers to identify the potential reporting 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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