IFRS Today

Exploring topical issues in financial and sustainability reporting

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PODCAST TRANSCRIPT

Emissions series | Net-zero commitments – Impacts on financial reporting

James

Hello and welcome to another episode of KPMG's emissions podcast series, in which we explore emerging trends in emissions and green schemes and the related financial reporting impacts under IFRS® Accounting Standards.

I'm joined today by **Adrian King** (Partner in Charge of the Climate Change and Sustainability team at KPMG Australia) and **Irina Ipatova** (an Associate Partner in the International Standards Group) to discuss net-zero commitments, in particular:

- what they are;
- how they impact the financial reporting; and
- why it's so important to tell a connected net-zero story in the front and the back of your annual report.

Adrian, let's start with the basics – what exactly is a 'net-zero commitment'?

Adrian

Thanks. It may seem a basic question, but there is confusion out there... So when a company is making a commitment to be net zero by, say, 2050, they usually mean that by 2050 or a date, they will reduce their gross greenhouse gas emissions to as close to zero as possible and offset the remaining emissions to achieve net-zero emissions.

Now, offsets are really just verified removals of carbon, such as through things such as growing new forests or intentional actions to reduce emissions. Now, this net-zero commitment should typically include all of the emissions across the value chain: what the Greenhouse Gas Protocol defines as Scope 1, Scope 2 and Scope 3 emissions. But sometimes these net-zero commitments only include direct operational emissions, which are the Scope 1 and Scope 2 emissions only.

So that's what 'net-zero commitment' is. Now, of course, there are variations on this, which you may have heard about, such as:

- carbon neutral;
- carbon negative; and
- climate positive.

But this podcast will focus on net zero. Now all of these types of commitments are actually very common at the moment across many organisations. In our 2022 KPMG survey, more than half of the largest companies surveyed across the globe actually disclose climate targets.

James

That's really interesting. So where do you usually find information about net-zero commitments?

Adrian

So these commitments are typically in what we call the front half of an annual report, whether it's a chairman's address, the CEO report or some of the other sustainability disclosures. But you might also find them in standalone sustainability reports and climate change reports.

James

Right. And what types of disclosure do you typically see from the companies reporting?

Adrian

Well, certainly at the moment, most companies are initially starting off with narrative disclosures, but we are starting to see more quantification of these. The level of disclosures, they do vary. And certainly at this stage, they often really just communicate a company's strategic intent on how they will plan and how they do plan to achieve these net-zero commitments.

Now, this is improving, and I actually do expect this to get better as we get closer to the commitments and the target dates that the companies have set out. Now, given all of these many different interpretations and time frames I've just set out, it won't surprise you that there are guidelines that are emerging to set out exactly what net zero means.

A really good example of this is the UN High-Level Expert Group guidance that was issued at COP27. Some examples of what this set of guidance sets out as minimum standards include:

- that the commitments must be company-wide and not selective;
- that there must be five-year interim targets of progress; and
- that they must be science based and aligned to 1.5 degrees.

Now, given this general narrative, there are also many regulators around the world who are focused on this, and I'm sure you've heard the term 'greenwashing'. And so, when a company is making a net-zero commitment, it's important that they actually have benchmarks against which they can measure their progress and actually have a specific plan for the business to achieve those goals and targets.

James

Okay. That's a really good overview. You mentioned greenwashing. Can you give us a flavour of how companies are actually backing up their words with planned actions?

Adrian

Yes, exactly. There are lots of companies doing a lot in this space. Let me give three very different examples of what actually is happening out there.

The first one would be from an energy company here in Australia, which is actually committed to shutting down our single great largest carbon-emitting power plant a decade earlier than they were actually planning to do it.

Another example would be a global diversified food and beverage manufacturer which – as part of their commitment to net zero by 2050 – has pledged that by 2030 they will source 50 percent of their key ingredients through regenerative agricultural methods.

And to give you a completely different one – again, a global IT manufacturer has committed to become carbon negative by 2030 for all of its emissions – Scope 1, 2 and 3 – and to actually have removed all of their historical emissions from the day they actually came into existence.

James

Thank you. It's really insightful. So over to you, Irina. Do net-zero commitments have an impact on the financial reporting?

Irina

In a nutshell, James? Yes. I would highlight two key areas. First, the impairment and useful life of existing assets and second, liabilities. And as usual, the devil is in the detail. To determine the impact on the financial reporting, you need to understand how a company plans to achieve its net-zero targets. So let's explore the impact using Adrian's examples.

First, the energy company shutting down its power plant a decade earlier. So, in 2023, this may impact the impairment analysis and the remaining useful life of the existing equipment.

The second example – the food and beverages manufacturer who is changing suppliers of key ingredients – this is also a future event that is unlikely to result in a liability in 2023. But the impact of any expected increases in purchase prices will need to be considered in the 2023 impairment analysis.

And the third? So let's assume the IT manufacturer will need to offset any remaining emissions by purchasing carbon credits from 2030. Again, this is a future event and there is no liability in relation to this in 2023.

Adrian

So, Irina, let me jump in here because I think that's really interesting and actually, to many people listening today, it could be surprising that for some of these real actions there are no liabilities in 2023.

Can you explain that a bit more?

Irina

Happy to do that, Adrian. Perhaps let's go through the framework step by step. So under the specific accounting standard, we need to understand:

- the nature of the commitment;
- how the company promises to deliver it; and
- whether the promise has created a present obligation at the reporting date.

So there are three steps to consider.

First step – has the company made a sufficiently specific public statement? And does that statement create a valid expectation amongst the members of the public? I have to say, this will require a judgement based on the specific facts and circumstances.

So if the answer is yes, then I would follow **Step two**: does the statement relate to the past damage done or to a future event? Under the provisions standard, a liability is recognised only for a present obligation for past damage done. Companies are not allowed to provide for future losses. In our examples (the second example and the third example – that is, the food and beverages company and the IT manufacturer), the commitment is related to a future event. So there is no liability.

And in the scenarios where we do have a present obligation, we would follow **Step three**, and that's to consider if the company can avoid a future outflow of resources. If a company cannot do this, then it needs to recognise the liability.

James

Okay. Irina, can I just ask how might you apply that thinking to one of the scenarios Adrian just gave?

Irina

Okay, James, let's use the IT manufacturer example to run through the steps. So first, let's assume that the company has created a valid expectation that it will discharge its responsibility to purchase carbon credits. So then we'll follow to Step two. The need to purchase the credits will arise only when the company emits pollutants at above the specified level, starting from 2030. This is a future event, and the company does not have a present obligation. That is, it does not have a liability in 2023. I would mention, though, that the International Accounting Standards Board (IASB) has an active project on provisions, and it may introduce some examples illustrating how to apply the accounting standard to net-zero commitments. So, watch this space.

James

Thank you, Irina. That brings us quite neatly on to the last point we'd like to discuss today, and that is the connectivity between the front and the back of the annual report. Why is it so important to tell that connected net-zero story?

Adrian

So we've seen, and investors have seen, a significant increase in the voluntary climate disclosures that investees are putting out there.

A good example of a typical good climate report is around 50 to 100 pages long. But what we haven't seen, and what investors haven't seen, is the same increase in the level of disclosures in the financial statements. So many would be asking, so if the companies are expecting to be significantly impacted by climate-related risks, why are they not providing information about the effects of these in their financial statements?

Now, I know there were specific requirements under IFRS Accounting Standards that determine when climate impacts can get reflected in the financial statements, and Irina has just taken us through some of those examples. But users are asking for a connected story. So whilst there are valid differences in assumptions between what we put in the financial statements and what you might put in other climate reports, the solution here – and we all want solutions – is for the companies to actually start bridging that gap by explaining the different assumptions between the climate report and the climate disclosures and the financial statements.

At the moment, the financial statements are often quite silent on these types of assumptions, which can lead to all sorts of misinterpretations.

Irina

Adrian, I absolutely agree with all of what you said, and I think from my perspective, James, this is a very, very hot topic and it even may require a separate podcast. But maybe in a few words, it is critical for the users of the financial statements to be able to understand how a company's net-zero commitment discussed in the front part of the annual report impacts its financial position and performance, which is reflected in the financial statements.

So, to make this connection and assess the impacts, companies need to consider including specific and meaningful disclosures. And I also have to say that this is an important area of focus for regulators and the IFRS Foundation. So the good news is that the International Accounting Standards Board has just kicked off a project addressing climate-related risks in the financial statements.

And at the same time, the International Sustainability Standards Board (ISSB) is consulting on whether to add a project on 'integration in reporting' to its agenda. So as you can see, both boards are focusing on connectivity.

James

I see. Okay – that's great. But to sum up for listeners, what would you say your key action points are?

Adrian

So I'd say there's two for me. The first one is to make sure that you actually do have a detailed plan behind your net-zero commitments.

And secondly make sure you're telling a connected story throughout your annual reporting. Readers really are looking for this.

Irina

Yes, I agree, Adrian. I would also add my two points: assess the financial reporting impacts of your detailed net-zero plan; and monitor standard-setting developments.

James

Perfect. Nice, clear takeaways. So if you're looking for a bit more detail on the points we've just discussed, we've prepared a web article to accompany this podcast. So take a look. Search in your browser for **KPMG IFRS** for this article and also lots of other resources. Thank you to our speakers and to you all for listening. Stay tuned!

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