KPMG

How might climate-related risks impact the financial statements?

10 questions for audit committees

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Climate-related risks

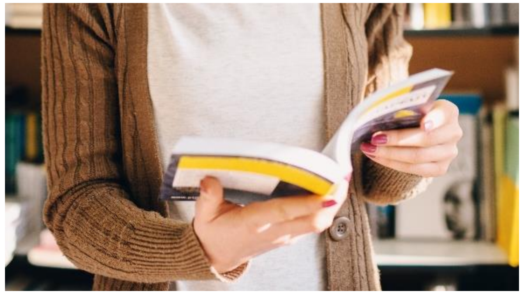
What's the issue?

All companies are facing climate-related risks and opportunities and are making strategic decisions in response.

Many are starting their transition to a low-carbon economy and are making these strategic decisions now.

What's the impact?

The impacts of climate-related risks on the financial statements are broad, potentially complex and will depend on the industry-specific risks.



What's next?

Use these ten questions as a starting point to assess the impact on your financial statements. You can also visit our climate change resource centre for further insights.

Please note, these questions do not cover every impact; companies need to assess their specific facts and circumstances.

10 questions to start your impact assessment

01 Has your company made a net-zero commitment?

02 Does your company have polluting assets?

03 Is your company exposed to carbon-related regulation?

04 What about your inventory and production costs?

05 Does your company take part in an emissions scheme?

06 Does your company borrow funds?

07 Is your company a provider of finance?

08 What about your staff benefits?

09 What about your cash flow forecasts?

10 What about your disclosures?

Has your company made a net-zero commitment?

Do you need to buy new, greener assets?

- If so, this may mean replacing existing assets with greener assets earlier than originally expected.
- This could lead to higher depreciation and amortisation expenses.

Do you need to write down your existing assets?

- If so, a significant impairment loss may arise because the assumptions for assessing the recoverable amounts may change.

Does the commitment trigger any liability?

- If your company has made a public announcement on its climate-change commitments, then this could trigger a liability.

Does your company have polluting assets?

Do you need or plan to replace them?

- If so, polluting assets may need to be depreciated more quickly or written down – e.g. because of changes to the company’s strategy or asset management policies.

Have you recorded all environmental liabilities?

- Changes in or new legislation may result in your company needing to record additional liabilities.
- Even if there is no legal requirement to clean up environmental damage but your company has made a public announcement that it is committed to do so, then it may need to recognise an environmental liability.

Do you plan to renegotiate any leases?

- Changes in economic incentives to use or cease using a leased asset in the future – e.g. a polluting asset – could cause a lease contract’s terms to be renegotiated.
- Ending or changing these terms before the lease contract expires could trigger a change in the measurement of the lease asset and lease liability.

Is your company exposed to carbon-related regulation?

How do you measure your liability for pollutants?

– A provision for emitted pollutants is measured at the company's best estimate of the future clean-up costs.

– Making this estimate may require specialised knowledge of environmental issues – e.g. the quantity and type of contaminants involved, the local geography and remediation costs.

Will compliance costs or taxes impact your prices?

– New climate-related policies or legislation may affect your company's revenues or operating costs – e.g. a carbon tax.

Can you still use your assets as planned or do you need to write them down?

– Your company may need to review the existing pool of assets if new restrictions are introduced – e.g. on using diesel trucks.

– Such restrictions may mean that assets need to be depreciated more quickly or written down.

What about your inventory and production costs?

Will the cost of your products rise?

– Inventory and production costs may increase due to carbon taxes, emissions schemes, changes in production processes or substitution of raw materials for more environmentally friendly materials.

Could your products or raw materials be banned?

– Products that are considered to contribute to climate change may see governmental limits or bans.

Could shifting customer trends impact your inventory?

– Shifts in customer trends to more climate-friendly and sustainable products could decrease demand for your less green products and cause inventory write-downs.

Would reusable or returnable items qualify as inventory?

– Reusable or returnable packaging or parts – e.g. reusable bottles – that are returned to the seller for re-use are not inventory.

– Because they will be used over more than one period, they are generally treated as property, plant and equipment.

Does your company take part in an emissions scheme?

How do you account for allowances and grants?

- If you receive emission certificates from the government or purchase them, you may account for them either as intangible assets or inventories.
- Emission certificates received are measured initially at their fair value or a nominal amount – i.e. zero. Those purchased are measured at cost.

How do you account for the liability if you exceed the emissions target?

- If your company would incur a monetary penalty if it failed to meet an emissions target, then it would recognise a liability for that monetary amount.
- Some schemes require a company to purchase emission certificates to settle the liability. If there is no active market, then measuring the liability is more complex.

Do you receive green credits that you can monetise?

- If your company receives green credits – e.g. for generating green energy – then it could sell or trade them.
- These credits could be recognised as assets if they meet relevant criteria. Measuring these assets could be complex if the credits are not actively traded.

Does your company borrow funds?

Do you have loans with climate-linked covenants?

- Failing to meet any carbon emission targets in a loan agreement could cause your company to be in breach of its covenants. Breaches would need to be disclosed.
- In some cases, a breach of a loan covenant could cause the lender to withdraw that loan or request immediate repayment.
- You would need to consider the breach as part of a broader assessment to determine your company’s ability to continue as a going concern.

Is your borrowing rate impacted by climate-related risks?

- Lenders might include environmental aspects when pricing a loan.
- For example, if they grant a discount on the interest rate when certain climate-related targets are met, then your company’s interest costs could fall. This loan may also be a hybrid contract with embedded derivatives.

Are you financing green technology through a lease?

- Leases can be an attractive way of financing investments in green technology due to the flexibility they provide.
- However, identifying and measuring on-balance sheet lease liabilities can be challenging.

Is your company a provider of finance?

Do you reflect climate-related risks appropriately in measuring credit losses?

- The impact of climate-related risks on expected credit losses (ECL) will vary depending on: their expected severity and timing, the impact on the borrower and on the lender's loan portfolio, and the duration of the loan portfolio.
- The impact on ECL today could be limited because the most significant effects of climate change may be expected to emerge over the medium to longer term.
- However, it is important to monitor the speed and scale of these matters and consider their possible impacts on the measurement of ECL.

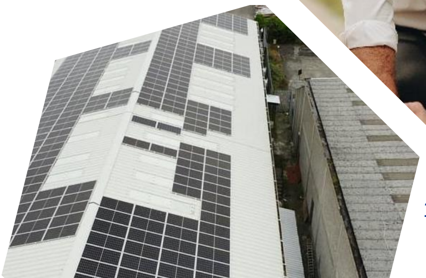
Do your credit risk disclosures address exposure to clients with higher climate-related risks?

- Your company may need to expand its credit risk disclosures to highlight sectors with higher exposure to climate-related risks.

How do you classify loans linked to climate targets?

- Classifying a loan with climate-related features will depend on how those features affect the cash flows.
- A loan with contractual cash flows that are impacted by these features may need to be classified as at fair value through profit or loss.

What about your staff benefits?



Do they reflect preferences for greener alternatives – e.g. providing low-interest loans to finance the purchase of an electric car?

- If so, then these may give rise to short-term benefits recorded in profit or loss.

Do they include climate-related performance criteria?

- For share-based payment arrangements, these criteria would generally meet the definition of a non-market condition and would not affect the fair value of the share-based payment.
- For other long-term employee benefits, a climate-related condition would be included in the measurement of the liability.

Are they affected by site closures or restructurings?

- If so, then it could have a significant impact on long-term employee obligations (e.g. defined benefit arrangements) and may involve paying termination benefits to large numbers of employees.

What about your cash flow forecasts?

Do they reflect climate-related matters adequately?

- The impact of climate-related matters on the assumptions underlying cash flow forecasts needs to be considered.
- For example, cash flow projections for impairment testing need to be based on reasonable and supportable assumptions that represent management's best estimate of the range of future economic conditions.

Are your cash flow projections used in calculating the recoverable amount impacted by climate-related matters?

- If the impacts of climate-related matters are ignored when performing impairment calculations, then the carrying amounts of assets – e.g. goodwill, property, plant and equipment, right-of-use assets and intangible assets – could be overstated.

Do the forecasts for assessing going concern consider different scenarios?

- Consider different possible scenarios, including a severe but plausible downside scenario.
- Additional disclosures may be required – e.g. significant judgements made on the assessment of material uncertainties.

What about your disclosures?

Are they clear and robust about assumptions you've made?

- Your company will need to provide disclosures in its financial statements that are specific to its circumstances and provide clear and meaningful insights into the significant judgements and estimates made by management.
- For example, this might mean enhancing sensitivity disclosures and disclosures about the key assumptions made and major sources of estimation uncertainty.

Will they help investors understand the judgements you've made about the future?

- Your disclosures of significant assumptions and judgements on climate-related matters in the financial statements need to be clear and transparent.

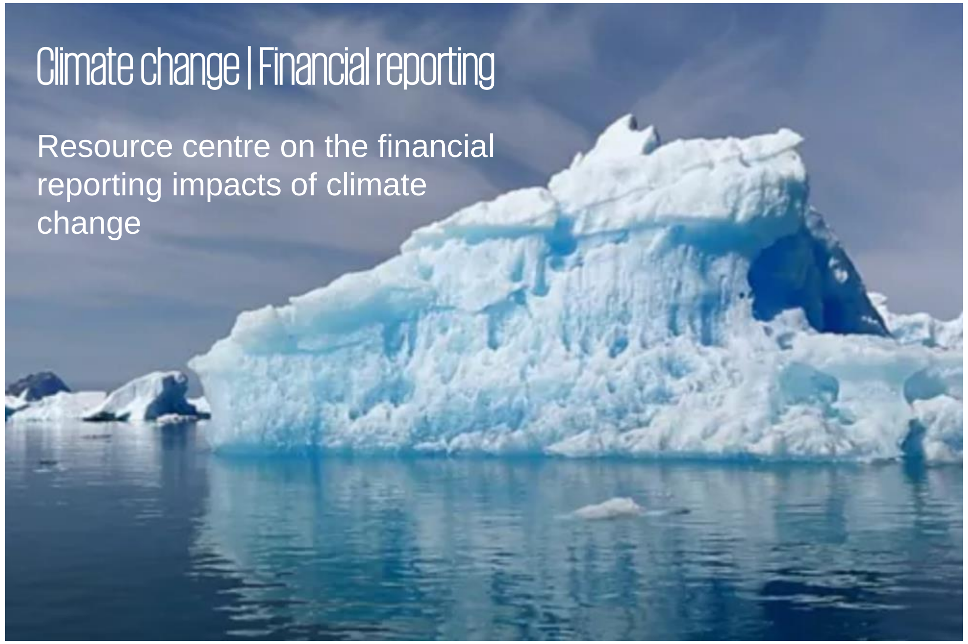
Are they in sync with other sections of your annual report?

- It is important that the information in the back and front end of your annual report is in sync to the extent appropriate and complements each other.

Find out more

To find out more about these and other potential impacts go to our Climate change financial reporting resource centre.

The site is evergreen, so please take a look and bookmark it today.



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