CHAPTER 2

ESG reporting - Intersection with Financial Accounting Standards

This article aims to:
Discuss considerations for companies on ESG matters that may affect their financial statements under US GAAP and the developments under IFRS.

Introduction

The demand for Environmental, Social and Governance (ESG) disclosures is rapidly increasing from various stakeholders in particular from investors who seek to understand the effects of relevant ESG matters on an entity's business strategy, cash flows, financial position, and financial performance. ESG is also at the forefront of regulators' agenda around the world.

Recently, the Financial Accounting Standards Board (FASB) has issued an educational material to provide an overview of the intersection of ESG matters with financial accounting standards[1]. Additionally, it provides examples of how an entity may consider the effects of material ESG matters when applying current accounting standards similar to how an entity considers other changes in its business and operating environment with material direct or indirect effect on the financial statements and accompanying notes.

1. The educational paper does not change or modify current generally accepted accounting principles (GAAP).

Considerations around ESG matters and financial reporting

This section summarises the guidance provided by FASB vis-à-vis consideration of relevant ESG matters in financial reporting.

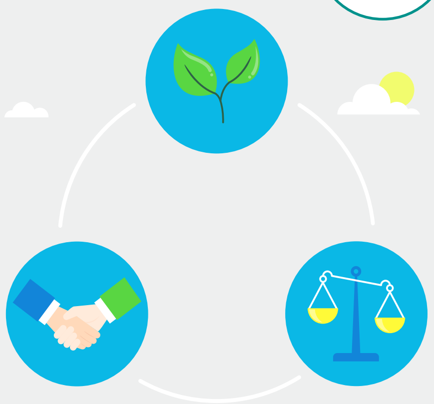
Going concern

- Management may consider the effects of environmental matters (e.g., increased compliance costs related to enacted emission regulations) and other relevant factors that may be material to an entity's ability to meet its obligations as they become due within one year after the date the financial statements are issued.
- In case of a substantial doubt about an entity's ability to continue, management should consider whether its plans alleviate the doubt.
- Disclose information about matters significant to the going concern evaluation.

Risks and uncertainties

- Management should determine the effects of environmental matters that are material and could significantly affect the amounts reported in the financial statements in the near term (i.e. period not exceeding one year from the date of the financial statements) and provide adequate disclosures.
- In case of estimates that are sensitive to change, resulting in material change to the carrying amount of assets and liabilities in the near term, an entity may also be required to disclose the nature of uncertainty along with an indication that it is reasonably possible that the estimates will change in the near term.

  Entities are also encouraged to disclose the factors that cause the estimate to be sensitive to change as well as any risk reduction techniques (e.g. insurance) used by the entity.



Inventory

Estimates of Net Realisable Value (NRV) could be materially affected by various factors. For instance:

a. A regulatory change that renders inventories obsolete

b. A significant weather event that causes physical damage to inventories

c. A decrease in demand for an entity's goods resulting from changes in consumer behaviour

d. An increase in completion costs owing to raw material sourcing constraints.

Management should consider all relevant facts and circumstances while estimating NRV for the purpose of valuation of inventory.

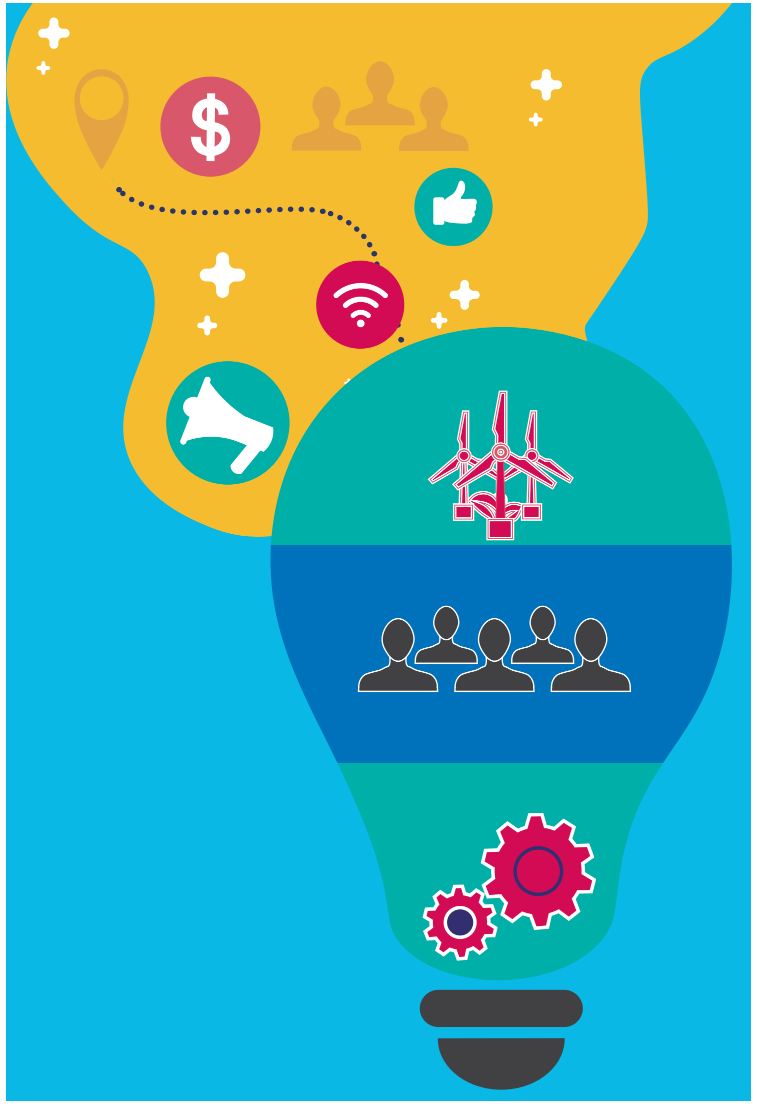
Impairment of goodwill and intangible assets

- Direct or indirect effects of an environmental matter could give rise to an impairment indicator. For instance, changes in hazardous waste management regulations that could adversely affect an entity's operations.
- Environmental matters may also affect the measurement of an impairment loss. For instance, the matter could materially affect the market participant's assumptions used to calculate the fair value of the reporting unit (goodwill) or the fair value of the indefinite lived-intangible assets.
- Amongst other matters, an entity should disclose the facts and circumstances that led to the recognition of impairment loss and the method for determining fair value while doing impairment assessment of goodwill and indefinite-lived intangible assets.
- The effect of an environmental matter may also be one of the factors that can affect the estimated useful life of finite-lived intangible assets (e.g. client relationships or developed technologies). For instance, an entity may develop more energy efficient product to substitute a legacy product which could result in a change in the estimated useful life of the client relationship intangible asset associated with the legacy product.

  Alternatively, an entity may acquire the rights to certain green technology that did not perform commercially as expected and thus, would be subject to an impairment charge.

Property, Plant and Equipment (PPE)

Similar to goodwill and intangible assets, environmental matters could give rise to impairment indicators for PPE. If there are impairment indicators, then an entity should evaluate whether the long-lived asset is recoverable. Additionally, there could be an effect on the salvage value or estimated useful life of a PPE. For instance, availability of more energy-efficient equipment may result in decrease in estimated salvage value and/or decrease in the estimated useful life of less energy efficient equipment.



Loss contingencies and related topics

Loss contingencies

- Management judgement is required to evaluate whether a condition, situation or set of circumstances meets the definition of a contingency to be provided for. Examples of loss contingencies could include liabilities for injury or damage caused by products sold and obligations related to product warranties.

Gain contingencies

- Gain contingencies are not recognised in the financial statements until all contingencies are resolved and the amount is realised or realisable.
- A gain contingency may result from an insurance recovery (exceeding a recognised loss) related to damage sustained to a manufacturing facility during a significant weather event.

Environmental obligations

- An entity is required to consider relevant regulatory, legal and contractual requirements when accounting for environmental obligations. For example, regulatory requirements to remediate land contamination or fines imposed by the government for failure to meet emission targets.
- Disclose nature of the contingency and an indication that it is reasonably possible that the amount accrued could change in the near term.
- In case of unrecognised loss contingencies, disclose an estimate of the possible loss/range of losses or a statement that such an estimate cannot be made.

Asset Retirement Obligation (ARO)

- Environmental matters may affect the recognition, measurement and disclosure of an ARO in the financial statements. For instance, those related to:

  a. A legal obligation to remove a toxic waste storage facility at the end of its useful life

  b. A regulatory requirement to decommission a nuclear power plant or an offshore drilling platform.

Income taxes

Environmental regulations could affect estimates of future taxable income. For example, projected increase in costs to comply with enacted environmental regulations can affect estimates of future taxable income.

Fair value measurement

Market participants' assumptions may affect fair value measurements. For example, those related to potential legislation or an asset's highest and best use.

Conclusion

As companies present ESG disclosures, there is a growing acknowledgement that the information presented in certain cases lacks comparability and consistency. Therefore, it is imperative for entities to continuously monitor developments in the area of ESG reporting and assess ESG related risks on their financial statements.

ESG and related reporting is gaining significant momentum across various forums. The trustees of the IFRS Foundation have proposed to form a new International Sustainability Standards Board (ISSB) under the Foundation's governance structure with an objective to develop globally accepted IFRS sustainability standards. These standards would provide a global sustainability reporting baseline that would allow for greater comparability and consistency of application of the standards, while also providing flexibility for coordination on additional jurisdictional and multi-stakeholder reporting requirements. The new board would build on the well-established work of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), as well as work by the alliance of leading standard-setters in sustainability and integrated reporting focussed on enterprise value creation such as International Integrated Reporting Council (IIRC), Sustainability Accounting Standards Board (SASB), Climate Disclosure Standards Board (CDSB) and the World Economic Forum (WEF). The board will also coordinate with the International Organisation of Securities Commission (IOSCO) to drive international consistency on sustainability-related disclosures[2].

Entities should refer to their current GAAP and consider the regulatory guidance provided in light of their specific facts and circumstances while preparing the financial statements.

2. IFRS Foundation Trustees announce working group to accelerate convergence in global sustainability reporting standards focused on enterprise value, announcement dated 22 March 2021.