ESG Practice Questions

Question 01

The directors of Ecoma Co consider environmental, social and governance issues to be extremely important in a wide range of areas, including new product development, reputation building and overall corporate strategy.

The company is taking a proactive approach to managing sustainability and is actively seeking opportunities to invest in sustainable projects and embed them in their business practices. The company's financial year end is 30 September 20X5.

The following exhibits, available on the left-hand side of the screen, provide information relevant to the question:

1. Head office - this provides information about a $16 million provision that Ecoma Co wishes to make associated with its move to a new head office and the sub-let of its old head office.

2. Defined benefit pension scheme - provides details of Ecoma Co's pension scheme for the year ended 30 September 20X5 and its net obligation at that date.

This information should be used to answer the question requirements within your chosen response option(s).

Requirements

The current developments in sustainability reporting show that there is a global trend towards more extensive and more meaningful narrative reporting.

The improvements in the quality and scope of reporting are driven by both regulatory demands and market demands for transparency. 'Sustainable investing' describes an approach to investment where environmental, social or governance (ESG) factors, in combination with financial considerations, guide the selection and management of investments.

Required:

Discuss why the disclosure of sustainable information has become an important and influential consideration for investors. (8 marks)

Note: there is no need to refer to any exhibits to answer part (a). (8 marks) Professional marks will be awarded in part (a) for clarity and quality of discussion. (2 marks)

Exhibit
Ecoma Co is committed to a plan to move its head office to a building which has an energy efficient green roof that acts as a natural temperature controller. The move from the current head office, which is leased, will take place at the company's year end of 30 September 20X5.

The new green roof building requires less maintenance than a conventional building and produces oxygen which offsets Ecoma Co's CO2 emissions. The directors of Ecoma Co believe that the green roof building will save the company $2 million per annum over the useful life of the building.

However, over the next two years, it anticipates that the disruption of the move will cause the company to make a loss of $10 million per annum. The company wishes to make a provision of $16 million which comprises the loss to be incurred over the next two years net of the saving created by the green roof.

Meanwhile, the company will have to vacate its currently leased head office building. At 30 September 20X5, the lease has two years to run at a rental of $600,000 per annum payable in advance on 1 October each year. If the lease is cancelled, the full rental is payable on cancellation. The head-lease permits sub-letting and Ecoma Co has sub-let the building for one year from 1 October 20X5 at a rental of $400,000 per annum payable in advance.

Ecoma Co estimates that there is a 40% probability that it will be able to extend the sub-lease at the same rental for a second year.

The costs of moving to the green building are estimated at $1 million and the costs of terminating the lease in two years' time are negligible. The pre-tax discount rate is 5%.

Exhibit
Ecoma Co is worried that the poor remuneration package offered to employees is putting the company at risk of reputational damage.

Consequently, Ecoma Co changed its pension scheme on 30 September 20X5 to include all of its staff. The benefits accrue from the date of their employment but only vest after two years additional service from 30 September 20X5.

The net pension obligation at 30 September 20X5 of $78 million has been updated to include this change. During the year, benefits of $6 million were paid under the scheme and Ecoma Co contributed $10 million to the scheme. These payments had been recorded in the financial statements.
Answers

(a) There is increasing interest by investors in understanding how businesses are developing environmental, social or governance (ESG) goals. The positioning of the ESGs in relation to the overall corporate strategies is information which investors feel is very relevant to the investment decision which in turn will lead to capital being channelled to responsible businesses.

Sustainability practices will not all be equally relevant to all companies and investors' expectations are likely to focus on companies realising their core business activities with financial sustainability as a prerequisite for attracting investment.

Because institutional investors have a fiduciary duty to act in the best interests of their beneficiaries, such institutions have to take into account sustainability practices. Companies utilising more sustainable business practices provide new investment opportunities.

Investors realise that environmental events can create costs for their portfolio in the form of insurance premiums, taxes and the physical cost related with disasters. Social issues can lead to unrest and instability, which carries business risks which may reduce future cash flows and financial returns.

Investors screen the sustainable policies of companies and factor the information into their valuation models. Investors may select a company for investment based on specific policy criteria such as education and health. Investors may evaluate how successful a company has been in a particular area, for example, the reduction of educational inequality.

This approach can help optimise financial returns and demonstrate their contribution to sustainability. Investors increasingly promote sustainable economies and markets to improve their long-term financial performance. However, the disclosure of information should be in line with widely-accepted recommendations such as the Global Reporting Initiative (GRI) and the UN Global Compact.

Integrated reporting incorporates appropriate material sustainability information equally alongside financial information, thus providing reporting organisations with a broad perspective on risk.

Investors often require an understanding of how the directors feel about the relevance of sustainability to the overall corporate strategy, and this will include a discussion of any risks and opportunities identified and changes which have occurred in the business model as a result.

Investors employ screening strategies, which may involve eliminating companies which have a specific feature, for example, low pay rates or eliminating them on a ranking basis. The latter may be on the basis of companies which are contributing or not to sustainability. Investors will use related disclosures to identify risks and opportunities on which they wish to engage with companies.

Investors will see potential business opportunities in those companies which address the risks to people and the environment and those companies which develop new beneficial products, services and investments which mitigate the business risks related to sustainability. Investors are increasingly seeking investment opportunities which can make a credible contribution to the realisation of the ESGs.

Question 02

Juan Co has several coal-fired power plants and is currently facing challenges dealing with the impact of climate change. Juan Co has not considered the effect of climate change when preparing the current financial statements.

There has been a decline in the demand for the energy from Juan Co's coal-fired plants because of the volume of greenhouse gases emitted by the plants. The company is committed to meeting the expanding climate change regulations of its jurisdiction relating to emissions. If a company does not meet the jurisdiction's climate-related targets, then fines are imposed by the government for this failure. Juan Co is also considering a restructure to achieve eco-design of its products and services and to improve the energy efficiency of its existing buildings.

As a result, Juan Co has had to change and adapt its business activities and operations, including increased expenditure on research and development. The company has revised its assumptions about future profitability and cash flows based upon it cutting its emissions. If it does not cut emissions, it will risk losing many customers.

Juan Co's supply chains are becoming more complex and globally spread with many points of possible failure. Juan Co has subsidiaries in regions of the world which are subject to weather extremes and anticipates some physical harm to its property, plant and equipment because of this. There is the likelihood that some of the power plants will require decommissioning sooner than expected which will mean restoring the land damage. Some restoration work may not be possible at the level required by regulatory changes.

Corporate risk is increasing due to environmental damage caused by climate change.

Investors are worried about their share value in Juan Co because of an anticipated increase in carbon taxes and the significant costs which the company will have to incur if it is to meet its commitments.

In the financial statements for the year ended 31 December 20X7, Juan Co has carried out impairment tests and has not recognised an impairment loss.

(a) Many preparers of financial statements feel that there is sufficient disclosure of climate-related matters in the management commentary and therefore there is no need to disclose any further information in the actual financial statements, especially if there is no impact on those financial statements. Even though there is an acceptance that investors feel such information is important, some preparers think that the materiality decision does not extend to climate change as there is no IFRS standard dealing with the subject.

Answer

Climate-related risks are predominantly discussed within the management commentary which is outside the financial statements. However, given the importance of climate-related risks to investor decision making, the implication of the materiality definition is that companies may need to consider such risks in the context of their financial statements rather than solely as a matter of corporate social responsibility reporting. Investors need companies to make materiality judgements when they prepare their financial statements and investors have specifically identified climate-related risks as being used in their decision making. Thus, if the information is material, companies should disclose how climate-related risks have affected judgements made in relation to the recognition and measurement of items in the financial statements.

According to IFRS standards, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions which the primary users of general purpose financial statements make on the basis of the financial statements. This may lead to the disclosure of information which is not specifically required by IFRS standards but is required by investors to understand the effect of transactions and events on the company's financial position, performance and cash flows. Companies will therefore need to consider whether to provide additional disclosures when compliance with the specific requirements in IFRS standards is insufficient to enable investors to understand the impact of climate-related matters on the company's financial position and financial performance.

Companies may need to disclose to investors the significant estimates or judgements they have made about climate-related risks even if they currently face no financial impact or significant risk of materially adjusting the carrying amounts of assets and liabilities in the next financial year and, hence, are not required by IAS 1 *Presentation of Financial Statements* to make such disclosures.

(b) Discuss the potential effects of climate-related matters on the financial statements of Juan Co for the year ended 31 December 20X7 in applying the following IFRS standards.

(i) IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*

(6 marks)

(ii) IAS 36 *Impairment of Assets*

(6 marks)

(iii) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

(6 marks)

Answer

(i) IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*

Juan Co is committed to changing and adapting its business activities and operations, including research and development. It will incur increased costs in improving the energy efficiency of its existing buildings. IAS 16 specifies requirements for the recognition of these costs as assets. There may, in addition, be an increase in expenditure of research and development. IAS 38 also requires disclosure of the amounts of research and development expenditure recognised as an expense and capitalised during the reporting period.

Climate change may affect the estimated residual values and expected useful lives of assets because of obsolescence or compliance with changes in the law. Many of its subsidiaries sit in the regions of the world which are subject to weather extremes which may cause additional wear and tear on the assets. IAS 16 and IAS 38 require companies to review residual values and useful lives at least annually, and to reflect the changes in the depreciation and amortisation charges.

(ii) IAS 36 *Impairment of Assets*

A company is required to assess whether there is any indication of impairment at the end of each reporting period. IAS 36 sets out the way in which companies should estimate recoverable amounts in order to assess any impairment of goodwill and non-current assets. Climate-related matters may give rise to indications that an asset (or a group of assets) is impaired. There has been a decline in demand for the energy produced by the coal-fired power plants which emit greenhouse gases. This would seem to indicate that the plant may be impaired. In addition, there has been significant changes in the company's operating environment. For example, changes in climate change regulations. Also, Juan Co's supply chains are becoming more complex and globally spread with many points of possible failure. Many of its subsidiaries sit in the regions of the world which are subject to weather extremes. Also, Juan Co anticipates some physical harm to its corporate assets with risks rising as the world warms. All of these factors will have an adverse effect on the company and are indications of impairment.

When determining the recoverable amount using value in use, Juan Co will need to estimate the future cash flows. The company has already revised its future cash flow projections because of expectations about cutting its emissions. However, Juan Co should consider whether climate-related matters have further affected the assumptions used in the projections as they have not provided for any impairment. The assumptions used should be reasonable and supportable and based upon the current situation, it does not seem feasible that there is no impairment of non-current assets.

IAS 36 requires disclosure of circumstances and assumptions which led to the recognition of an impairment loss which would include the expansion of emission reduction legislation.

(iii) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Climate-related matters may affect the recognition, measurement and disclosure of liabilities in the financial statements when applying IAS 37. Climate-related risks and uncertainties may also affect the best estimate of a provision. Juan Co may have to make a provision for potential fines imposed by governments for failure to meet climate-related targets. There will also be regulatory requirements to remediate environmental damage. Juan Co anticipates some physical harm to its property, plant and equipment with risks rising as the world warms which could lead to environmental damage.

There will also be costs involved in the restructurings required to redesign products or services to achieve climate-related targets. These will be provided for only when a detailed formal plan is in place and Juan Co has started to implement the plan or has announced its main features to those affected.

As there is a likelihood that some of the power plants will require decommissioning sooner than expected, this will result in an increase in the provisions recognised for decommissioning. Also, the restoration of the land damaged by these plants may not be possible at the level required by regulation. Therefore, again, consideration should be given to creating a provision and a contingent liability for the costs of restoration and the potential litigation and fines which may be imposed by government. Juan Co will be required to disclose a brief description of the nature of any contingent liability and, where practicable, an estimate of its financial effect including an indication of any uncertainties.

IAS 37 requires these disclosures unless, in extremely rare cases, disclosure of the information can be expected to prejudice seriously the company's position in a dispute with other parties.