Air France KLM

France, Transport

Accounting		Climate Assumptions		Audit		Date of analysis: May 10 2021
Judgements	Consistency with other reporting	Visibility	Paris alignment	Visibility in KAMs	Consistency check	Year end: December 2020 Report date: April 7 2021 AGM: May 26 2021
Significant concerns	Significant concerns	Significant concerns	Significant concerns	Significant concerns	Significant concerns	CA 100+ company, so seen by investors as key to driving global net zero emissions
Summary view: • A leading airline with acknowledged clear exposures to climate change issues, both physical and transition. • Despite medium-term targets for significant CO2 emission reductions, these do not appear to be reflected in the financials, even though they have implications for a number of key liabilities and assets.						

Background

<u>The Business</u>

- Air France KLM is a leading European airline, operating regionally and globally under the eponymous brands and also low cost brand Transavia. It is a member of the SkyTeam alliance, one of the three global airline groupings.
- A bare majority of Air France KLM's shares are in free float; 14% is owned by each of the the French and Dutch states, with a further 8.8% held by each of Delta Air Lines and China Eastern Airlines. Employees own 3.7%.
- Due to the COVID-19 pandemic, 2020 capacity was reduced by 59% from 2019 levels with passenger numbers down 67%. Despite significant government support (loans from both France and the Netherlands) and aggressive cost-cutting, this led to a net loss of €7bn.

<u>Approach to climate change</u>

- Air France KLM has a stated goal of reducing CO2 emissions per passenger km by 50% by 2030 compared to a 2005 baseline (it had achieved around a 27% reduction pre-pandemic). This will be delivered through an unspecified split between a modern fleet and increased fuel efficiency, use of sustainable aviation fuel, and offsetting. It is increasingly using renewables to power its buildings, and has a target of being carbon neutral by 2030 in its ground operations (though these represent under 0.4% of Scopes 1&2 emissions).
- The company has used the crisis as a moment to retire some older aircraft and so increase average fuel efficiency. It specifies that 92 of the aircraft in its order book (which totals 102) are particularly carbon-efficient, enabling further average GHG emission reductions.
- The company notes that a term of its French government loan is that Air France must review domestic routes where there is a rail alternative of under 2.5 hours – likely to be reinforced in the country's forthcoming Climate Act. The Dutch government loan agreement requires KLM to meet various targets including on the use of sustainable aviation fuel. It is part of a coalition seeking to foster sufficient production of sustainable aviation fuel by 2050.
- Air France KLM highlights the airline industry's CORSIA initiative. CORSIA's central targets are that all growth in flights beyond 2020 (from a pre-pandemic 2019 baseline) should be carbon neutral, and that 2050 GHG emissions from the industry should be half of those in 2005, but these targets rely largely on offsetting emissions (and there are significant doubts about the programme[1]).
- The company acknowledges risks of significant additional costs arising from the physical impacts of climate change, specifically disruption from increasingly frequent severe weather events.

[1] See for example *The EU's assessment of the Corsia airline CO2 deal*, Transport & Environment, March 17 2021

Accounting: judgements and consistency with other reporting

Accounting judgements		Significant concerns

- Air France KLM applies IFRS as adopted by the EU.
- Other than a brief disclosure of the hedging of future purchases of CO_2 quotas for the EU emission trading scheme, there appears to be no reference to climate change in the notes to the financial statements. It is not apparent that any substantive consideration of climate has been built into the bulk of the numbers.
- Flights within the EU are subject to the emissions trading scheme. The bulk of Air France KLM's relevant emissions are covered by its free allowance. The limited number of quota allowances bought on the open market are accounted for at cost price in the relevant period, with a limited hedging of future purchases and a provision made at market price if there is a timing mismatch.
- Aircraft, spare engines and parts generally have estimated useful lives of 20-25 years and are amortised on a straight-line basis; the operational fleet has an average life of 13 years, indicating a remaining expected life of a decade. This means that the bulk of the aircraft flying in 2030 when the emissions target is to be met are already in the fleet. Owned aircraft are valued on the balance sheet at over €8bn, and other flight equipment at just under €3bn, of the total €12.6bn in tangible assets. A further €2bn represents the right of use assets of aircraft held under leases. Under €0.9bn of the company's €4bn total lease liabilities extend beyond five years.
- The early retirements of A380, A340, Boeing 747 and CRJ aircraft led to a charge of €670m (€514m of which was accelerated depreciation). Air France KLM has firm commitments to buy 102 aircraft (with options on a further 58). €4.2bn of the near-€6bn in liabilities for these commitments is due to be paid out over the next three years, paying for 66 of the 102 aircraft.
- Buildings have lives up to 50 years, fixtures and fittings and simulators up to 20 years and equipment and tools have lives up to 15 years.

Consistency with other reporting		Significant concerns

- The French Universal Registration Document incorporates the financials alongside detailed and specific corporate governance, risk and corporate social responsibility or extra-financial performance reporting.
- The narrative reporting incorporates Air France KLM's key climate-related undertakings. The industry-wide CORSIA standards will increase operating costs over the next few years, and the company has set a 2030 target for emission reductions (with some dependence on offsetting and on the scaling up of sustainable aviation fuel production). The risk reporting also acknowledges existing exposures to physical climate change risks, arising from weather-related disruption.
- The significance and range of the issues discussed in the narrative reporting does not seem consistent with the absence of any apparent substantive consideration of climate change within the financial statements and notes.

Climate assumptions in accounts: visibility and Paris alignment

Visibility of climate assumptions in accounts		Significant concerns

- There are no apparent climate-related assumptions. There is thus no sensitivity analysis.

Paris alignment		Significant concerns

- With no disclosure, there can be no alignment with the goals of the Paris Agreement.

Audit: visibility in KAMs and consistency check

Audit firm: KPMG Audit Deloitte & Associes	Responsible partners: Valerie Besson, Eric Dupre Guillaume Crunelle, Pascal Colin
Audit standards: French professional standards	

Visibility in Key Audit Matters		Significant concerns

- There is no explicit reference to climate change in the auditor's report.
- There are 4 KAMs identified: (i) impairment of non-current assets and flight equipment; (ii) restructuring provisions; (iii) deferred tax; and (iv) provisions for litigation and contingent liabilities.
- The first three KAMs all depend on an assessment of future levels of operational activity and profitability, and so are likely to be impacted by climate change and any carbon constraints or pricing that might be imposed. It is thus concerning that there is no appropriate reference to climate change issues in the discussion of these KAMs, and nor is there a mention of any use of experts in climate change or CO2 markets.
- The auditor formally draws attention to the material uncertainty about whether Air France KLM is a going concern in the context of the challenges arising from the COVID-19 pandemic.

Consistency check		Significant concerns

- The contrast between the climate issues covered in the narrative reporting and their apparent absence from the financials gives rise to concerns.
- Under the French regime, one of the statutory auditors (in this case KPMG) also provides assurance as an independent third party on the non-financial statements in the annual report. Among other things, this involves an assessment of the completeness and fairness of the information and its consistency based on the firm's full knowledge of the entity. This report is signed by Eric Dupre and sustainability services partner Fanny Houlliot.

The Climate Accounting Project is an independent investor-led project to reinforce the statements of the IASB and IAASB that material climate change issues are incorporated within their standards. This analysis seeks to understand the extent to which companies and auditors are delivering against this aspect of these standards and similar local standards.		**Key**
		Good practice
		Few concerns
		Some concerns
		Significant concerns

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