Koninklijke Philips NV

Netherlands, Other Industrials

<table>
<tr><td colspan="2">Accounting</td><td colspan="2">Climate Assumptions</td><td colspan="2">Audit</td><td>Date of analysis: April 28 2021</td></tr>
<tr><td>Judgements</td><td>Consistency with other reporting</td><td>Visibility</td><td>Paris alignment</td><td>Visibility in KAMs</td><td>Consistency check</td><td>Year end: December 2020
Report date: February 23 2021
AGM: May 6 2021</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td rowspan="2">Climate Action 100+ company, so seen by investors as key to driving global net zero emissions.</td></tr>
<tr><td>Significant concerns</td><td>Significant concerns</td><td>Significant concerns</td><td>Significant concerns</td><td>Significant concerns</td><td>Significant concerns</td></tr>
<tr><td colspan="7">Summary view:
The carbon neutrality of own operations achieved in 2020 was reliant on offsets. Philips is now setting its ambition on ensuring emissions across its value chain are in line to limit global warming to the 1.5 °C scenario.
Given the significance of such commitments and interim goals for 2025, and the relatively central nature of combatting climate change to the company's strategy, a lack of visibility in the accounts and audit report is disappointing.
As the commitments are translated into more concrete plans for specific activities and their associated costs, separate disclosure of climate assumptions, associated R&D, capex, and other costs (including offsets) would help investors to monitor progress.</td></tr>
</table>

Background

The Business

- Philips is a Dutch health technology company, operating globally through three segments: Diagnosis & Treatment (Diagnostic Imaging, Image Guided Therapy, Ultrasound, Enterprise Diagnostic Informatics); Connected Care (Sleep & Respiratory Care, Monitoring & Analytics, Therapeutic Care, and Connected Care Informatics and Population Health Management); and Personal Health (Domestic Appliances, Personal Care, Oral Healthcare, Mother & Child Care).
- It has two planned divestments: the Aging and Caregiving portion of the Population Health Management business, and the Domestic Appliances business (approx. 11% of sales). Assets of the first are classified as assets held for sale (€141m); the latter is in the process of being segregated internally to facilitate divestment.
- The Covid-19 pandemic reduced 2020 sales of the Diagnosis & Treatment businesses due to postponed installations and elective procedures, and of the Personal Health businesses due to lockdowns. The Connected Care businesses, however, recorded growth in both Monitoring & Analytics and Sleep & Respiratory Care needed to help its customers combat the pandemic.
- In-scope emissions for 2020 (under the GHG Protocol) were: 32 kilotonnes CO_2e for scope 1, 3kt for scope 2, and 500kt for scope 3 (relating only to business travel and distribution). The company notes that this was fully offset through the financing of carbon reduction projects. (2019: emissions of 706kt CO_2e partially offset by 440kt CO_2e). 2020 emissions benefitted from the increased usage of renewably sourced electricity, and were also helped by reduced emissions from air travel and air freight due to Covid-19.

Approach to climate change.

- Philips links its environmental commitments and strategy to UN SDGs 12 (Ensure sustainable consumption and production patterns) and 13 (Take urgent action to combat climate change and its impacts). The company's 5-year Sustainable Planet programme concluded in 2020.
- In September 2020, it set new climate-related goals, including an ambition to ensure emissions across the value chain are in line to limit global warming to 1.5°C. It will work with suppliers to reduce their carbon footprints. However, the specific steps involved in this do not seem clear, nor are existing Scope 3 emissions including the supply chain.
- Offsetting will continue to play a significant role; Philips plans that emissions in its own operations will be offset via investment in health-benefitting environmental projects.
- It also targets by 2025: 75% of energy usage to be renewably sourced (appears to be 72% in 2020); 25% of revenues from circular products, including trade-ins on all professional

medical equipment and responsible repurposing; circular practices to be embedded at all sites and zero waste sent to landfill; and all new products to fulfil its EcoDesign requirements (aimed at improving energy efficiency, especially during customer use), and its ‘Eco-Heroes’ products (innovative products with sustainability benefits) to account for 25% of revenue.

- The company also uses a Life-Cycle Assessment approach to provide insight to the lifetime environmental impact of products, and to steer its EcoDesign efforts and Green and Circular Solutions portfolio. The approach assigns financial costs to environmental impact. Its 2020 analysis suggests a total cost of €4.9bn: 83% for customer use of its products, 14% for supplies of materials and components, and <3% for the company’s own operations.
- Natural disasters or extreme weather events caused by climate change are listed together with various other risks of disruption to the international supply chain. Other risk topics do not appear to consider climate change.
- In March 2020, Philips issued a €500m sustainability innovation bond due in 2025.
- For Long-Term Incentive performance shares granted in 2020, an additional criterion was added to give a 10% weighting to sustainability, with reference to the three SDGs that are included in the company’s strategy, including SDGs 12 and 13.

Accounting: judgements and consistency with other reporting

Accounting judgements		Significant concerns

- The financial statements are prepared in accordance with IFRS (as endorsed by the EU and as issued by the IASB) and statutory provisions of Part 9 of Book 2 of the Dutch Civil Code.
- There is no explicit reference to climate in the notes to the financials. It is not apparent that any consideration of climate has been built into the numbers.
- Assets subject to impairment consideration include goodwill of €8bn, other intangibles of €3bn (technology and product development being the largest), and PP&E of €2.7bn.
- In 2020, the company recorded goodwill impairment charges of €144m related to the Population Health Management and Aging and Caregiving cash generating units (CGUs). The amount was based on values estimated using the ‘fair value less costs of disposal’ approach, as these were higher than ‘value in use’ (VIU) estimates. It appears that VIU was used for other CGUs, based on internal forecasts for 2021-2024, extrapolated for 3 further years based on stable growth/decline rates, followed by terminal values using growth rates capped at the historical long-term average growth rate. Growth and discount rates are disclosed, but further details of assumptions (including any related to climate change) are not. In 2020 the company increased the forecast years from 3-4 and reduced extrapolated years from 4-3, reflecting changes in the internal forecasting process. The company discloses that any reasonable change in assumptions would not cause VIU to fall to carrying amounts.
- Impairment of other intangibles was €235m in 2020, due to delays in commercialisation, revision of strategies, and market dynamics relating to COVID-19.
- Environmental provisions include €183m for environmental remediation, and €30m in decommissioning obligations.

Consistency with other reporting		Significant concerns

- Given the significance of commitments to address climate change and the prominence of climate risk in the company’s strategy, it is concerning that separate disclosure is not more apparent, for example of associated R&D, capex, other costs (including offsets), and the impact on margins etc. of steps being taken in relation to climate risk commitments. To illustrate, outside of the financials the company discloses that investment in green innovation was €7.4bn over the 5-year programme period ending in 2020 (€280m in 2020), versus a goal of €7.5bn. This is not apparent from the financials.
- As its new commitments turn into more concrete plans for activities and their associated costs, such information would help investors to monitor this aspect of progress.

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.
- However outside of the financial statements, and indeed outside of the Annual Report and the 20-F, the company's TCFD report indicates that two global warming scenarios were developed: 2-degrees and 4-degrees by 2030. The purpose was to assess the impact on the supply chain, the company's own operations, and its customers. A total of 15 vulnerabilities were identified and the company has said findings will be incorporated in, for example, its sourcing strategy. It concluded that the impact of future carbon pricing (between €50 and €200 per ton CO_2e) did not comprise a material risk, due to the neutrality of operations reached by the end of 2020. However, the Scope 3 emissions considered in assessing carbon neutrality appear to exclude materials and supplies purchased, and customer use.

Paris alignment		Significant concerns

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

Audit: visibility in KAMs/CAMs and consistency check

Audit firm: Ernst & Young Accountants LLP	Responsible partner: S.D.J. Overbeek - Goeseije
Audit standards: Dutch Law, incl. Dutch Standards on Auditing, and PCAOB (US – re. the 20-F)	

Visibility in Key/Critical Audit Matters		Significant concerns

- There is no apparent reference to climate change in the auditor's report.
- The separate audit reports included in the Annual Report and in the 20-F both include the following KAMs/CAMs (respectively): Revenue recognition – Sales-related accruals, Valuation of Goodwill for Cash Generating Units Population Health Management and Aging and Caregiving, and Valuation and disclosure of provisions for legal claims, litigations and contingencies.
- The auditor's KAM/CAM on goodwill focuses on estimates of fair value for the specific CGUs whose goodwill was impaired on this basis, not other CGUs for which a value in use approach was used to support the carrying value based on future cash flows to be generated.
- It does not appear that any of the disclosed legal contingencies relate to climate.

Consistency check		Significant concerns

- Other information checked for consistency in the Annual Report includes specified sections: the management report, remuneration report, and other information required by the Dutch Civil Code. The auditor confirms the other information is consistent with the financial statements and does not contain material misstatements.
- PCAOB audit standards require the auditor to read other information that is presented together with financial statements and the auditor's report thereon (in this case within the Form 20-F). The auditor's report is silent on the outcome of the review, which implies that no material inconsistency was identified in the other information within the 2020 10-K.
- However, consistency would entail greater coverage in the financials given the focus of climate in the company's strategy and commitments.

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

Terms, conditions and disclaimer

The information contained in this document is for general information and educational purposes only.

Nothing in this document constitutes investment, legal, accounting, tax or other professional advice, or any recommendation to buy, sell or hold any security or other financial instrument, nor to exercise voting rights in any particular way. The information contained in this document is not intended to form the basis of any investment or voting decision, it does not constitute any form of investment recommendation or investment research and has not been prepared in accordance with any legal requirements designed to promote independence or objectivity. The authors of this report are not regulated by the Financial Conduct Authority or any other financial regulatory authority. You should make your own independent assessment and seek your own professional advice.

No representation or warranty is made that any of the information contained in this document is accurate or complete and no responsibility or duty of care of any kind is assumed by any person for errors or omissions in the contents or for the fairness of the opinions given. The authors do not accept any liability whatsoever for any direct or consequential loss howsoever arising, directly or indirectly, in connection with the use for any purpose of the information contained in this document.

You expressly agree that you use the information in this document at your own risk.

All information in this document is believed to be current as of the date of publication. Information may have been updated subsequently. The authors may make additions, deletions, or modifications to the contents at any time without prior notice.

This document reflects the authors' own interpretation and opinion of accounting and auditing standards and how companies and their auditors have applied those standards. No representation or warranty is made that any interpretation or opinion of International Financial Reporting Standards, International Standards for Auditing, other financial reporting and regulatory requirements or the application of these standards or requirements by individual companies or their auditors is correct, complete or fair, nor that they are incorrect, incomplete or unfair, or that the same views would or would not be arrived at by others. You should seek your own professional advice if making decisions that depend on the interpretation of any standards related to financial reporting or auditing, or other regulatory requirements.

The views expressed in this document reflect the personal opinions of the authors and not those of any other companies, organisations, committees or persons with which they may be associated.

Stripes image credit: Prof. Ed Hawkins www.showyourstripes.info