Demand accounting that makes net zero profitable…

A new interpretation of an old International Accounting Standard substantially changes the math of net zero commitments—giving asset owners and investment managers new rights and duties to demand better accounting

By Andrew Watson, Co-Founder of Rethinking Capital

T. Robert Zochowski, President and CEO of International Foundation for Valuing Impacts (IFVI)

In December 2023 at COP28, Bridgewater's Ray Dalio said that private capital can only finance climate solutions if the returns make sense, saying '***You have to make it profitable!***' But by today's accounting practice, investments to reduce carbon emissions are treated ('made') the opposite, as costs, with the only benefit of choosing that treatment being to reduce tax. This is illogical and just feels like bad accounting. **Better accounting can and must be demanded.**

We first wrote about the insight of '*upside down incentives*' in 2021 in the paper Constrained by Accounting. And have since described this as the true root cause of the systemic inability to tackle the climate and biodiversity crises.

For example, current accounting practice provides disincentives for Anglo American to meet its commitment to a '*30% reduction in Scopes 1 and 2 emissions by 2030'*; such commitments are treated as externalities, and investments purposed to meet it, such as innovation and carbon credits, are costed rather than capitalized as balance sheet assets, the treatment for many other long term investments.

At last the rules of the game can be changed—flipped in fact. Because, in effect, a new International Accounting Standard for net zero commitments has been adopted by the IASB on 25th April 2024. This should begin the pathway for **accounting that can and should be done** for net zero to be 'made' profitable—the only challenge being then to work out how profitable by pricing the impact of emissions saved by meeting or accelerating a commitment.

This has far-reaching effects for the rights and duties of asset owners and investment managers. Boards of investee companies must make new decisions on whether to recognise a provision in preparations for FY' 24 year ends—asset owners and managers must actively use their rights to be part of those decisions and informed decisions mean to explore different accounting treatment.

In one accounting scenario, recognising a provision enables the company to recognise each $1 invested with the purpose of meeting the commitment as into assets that grow in value—starting the pathway to unlock material hidden medium and long term returns from a net zero strategy and investment program.

Those hidden returns are very large. Applied to our prior example, Anglo American's commitment to reduce carbon emissions by 2030, meeting its commitment would increase its balance sheet assets by around $495m, materially improve its key financial metrics (profit, EPS, ROE, debt to equity ratios), and be taken into account in its credit rating as explained in this S&P paper. Additionally it would increase balance sheet assets by at least $1.5bn and flow into other medium and long term metrics if accelerated.

Unlocking these benefits begins with recognising that a commitment to reduce emissions by 2030 has created expectations that it will be met—meaning to recognise it as a '*constructive obligation'* under IAS37.

The three key implications for the rights and duties of asset owners and investment managers are…

- **Demand accounting scenarios to show true profits and better real returns**. By simply accounting for assets and obligations that exist in reality but aren't recognised by accounting practice investors get a much better recognition for the real health of a business and potentially hidden returns. Asset owners' fiduciary duties include to unlock these returns. Directors' duties are to position the company to unlock them. Investment managers should factor 'new' returns into strategic asset allocation and portfolio management.
- **Use judgement and ask the right questions**. This needs judgement. The right questions to ask include—

  (1) Could an investee company's 2030 emission reduction commitments be constructive obligations? And have affirmative actions been taken by which it has evidenced recognising those commitments?

  (2) Did these set expectations with asset owners who then made commitments to their investors?

© Copyright Rethinking Capital & IFVI 2024 All Rights Reserved

(3) What accounting decisions were made in the years when the commitments were made and affirmed?

- **Require this to be an independent board governance issue and demand that an impact analysis is created**. The potential for retrospective accounting treatment also elevates accounting for transition commitments from simply an accounting issue into a board governance and accountability one. Asset owners, insurers, banks and others are impacted and need reassuring that the board is actively and independently governing it. Legal teams should be engaged early. An impact analysis for the company and its investors is the first step.

Digging deeper—how the IASB decision enables asset owners and investors managers to exercise new judgement…

Rethinking Capital made two submissions to the Interpretations Committee of the IASB, known as IFRIC. The second was co-signed by the International Foundation for Valuing Impacts.

The submissions explained that a provision (a quantified accounting liability) should be recognised for a commitment to reduce carbon emissions by 2030—because the commitment and affirmative actions that recognise it meet IAS37's definition of a 'constructive obligation'—'*an obligation that derives from an entity's actions where:*

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities.

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities'.

In our view, the simple logic to use was explained by KPMG's Brian O' Donovan from minutes 6.55 to 8.43 of second IFRIC meeting available here—that '*affirmative actions by a company* are *powerful evidence that the company itself accepts that it has created a constructive obligation'.*

Applied to say bp's 2030 commitments, typical of those made and affirmed from 2020, this simple logic flows—

- bp's own affirmative actions, such as creating, negotiating and/or updating a detailed 2030 transition plan, are powerful evidence that bp itself accepts that it has created a constructive obligation.
- Implicitly those same affirmative actions also evidence that bp accepts that something has already happened that led to those affirmative actions—that a past event has occurred.
- A provision should be recognised unless at the time the constructive obligation is or was created, it's probable that capital will not have to be allocated to meet the commitment.
- When a provision is recognised, investments purposed to meet it should be recognised as assets.

In other words, accounting can and should be done that will create accountability, make net zero profitable and materially increase returns over time. Asset owners and boards rights are to demand this accounting be done.

IFRIC confirmed that the use of estimates is an IAS37 requirement…

Historically, an accounting challenge to implementing such principles has been the requirement of measurability, monetary quantification with sufficient reliability as to be reasonably estimable. IFRIC made it clear—in line with IAS37—that there will only be 'extremely' rare circumstances where a financial estimate cannot be made.

The emerging field of impact accounting, led by research at the International Foundation for Valuing Impacts, provides a rigorous methodology for specific valuation of emitted or averted GHG emissions in terms of changes in well-being, and allows measurement of both the liability as well as the asset created by fulfilment of net-zero commitments.

Retrospective application?…

This clarifies the rules of an existing IFRS Standard, IAS37. As an interpretation of an existing Standard, a searching question to boards is why IAS37 (which must be followed) wasn't followed when emission reduction commitments were made and affirmed from FY's '20—2023.

Logically, accounting could have 'made' net profitable from 2020.

© Copyright Rethinking Capital & IFVI 2024   All Rights Reserved

Conclusion…

The outcome should be a major shift in accounting practice which could happen very fast—if boards and investors demand it. The IASB's April approval intends to enable new decisions in preparation for FY '24 year ends. The global audit firms represented on IFRIC described their clients as being '*on a journey*' to recognise its effects in preparations for FY '24 year ends.

The effects could even be to set the conditions for commitments and transition plans to be restated in 2024 assuming the accounting that 'makes' net zero profitable and unlocks better returns is—a mindset shift and the catalyst to slash carbon emissions by 2030.

All of this should narrow the choice to either embrace it early or be forced to do so later. Our advice is to embrace it early—there is much to gain and nothing to lose.

To support this, the IFVI and Rethinking Capital are extending their collaboration. We aim to enable the shift to begin first in financial accounting for net zero commitments, using 'normative' accounting treatment in management accounts for net zero decision governance and decision reporting.

Rethinking Capital's new Net Zero Community on its website will provide to get real-time news and insights on what's happening, what it means and guidance on what asset owners, investment managers and boards should do.

© Copyright Rethinking Capital & IFVI 2024 All Rights Reserved