Interpretations Committee of the International Accounting Standards Board ('Interpretations Committee')

IFRS Foundation

7 Westferry Circus

London, E14 4HD

22nd December 2023

Dear Sirs

Tentative Agenda Decision and comment letters: Climate-related Commitments (IAS 37)

First comment Letter by the Rethinking Capital community

This comment letter is being sent on behalf of the members of the Rethinking Capital community. It comments on the Interpretations Committee's discussion of Rethinking Capital's submission and its decisions that—depending on the terms of the commitment—a provision (a quantified accounting entry) should be recognised for a net zero transition commitment (for example a '*50% reduction in Scopes 1 and 2 emissions by 2030*') as a constructive obligation under the existing IAS37. We expect to raise further comment letters in 2024.

The three 14-0 decisions in support of the Staff Note exceeded our expectations. We had expected greater pushback from the Big 4 audit firms for whom the decision may give a serious business challenge (explained in paragraph 6 below) but noted the important contribution of SEC Chief Accountant Paul Munter in holding the audit firms to account—in particular the objection that there is an 'expectation gap'—this phrase was used by each of Deloitte, EY and PwC in the meeting and is believed to mean the gap between what stakeholders such as investors and civil society may expect an entity to be responsible for and what it is required to be responsible for under IAS37. In reality, we believe that there should be no such expectation gap if IAS37 is properly followed.

Comment sections

Our comments on the decision are in six parts:

1. A better write up of the decision and missing root cause presentation.

2. A good start but much work still to do to ensure a thoughtful transition in 2024.

3. The two unexpected effects of the decision and the real-world governance challenge in Q1 2024.

4. Technical limitations of the decision caused by a too narrow fact pattern.

5. Closing the technical limitations by further real-world fact patterns and an ISSB Guidance Note.

6. Who is expected to object to the decision and why, and how to overcome these objections.

Comments in detail

1. A better write up of the decision and missing root cause presentation

The write up of the decision on the Interpretations Committee website would benefit from being more precise in describing the questions actually asked in our Submission and by adding context including the root cause presentation sent to Committee members but not made public so far.

Our suggested amendments have been sent to the Committee chairman but we're told are not able to be made so we include them here—marked up.

Tentative Agenda Decision

The Committee received a request asking it to clarify:

a. whether an entity's commitment to reduce its carbon emissions in a first public statement (for example in 2020 a public statement of 'net zero by 2050' and a '50% reduction in Scopes 1 and 2 emissions by 2030')

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followed by a series of affirmative actions (such as a transition plan, ongoing website publication or joining coalitions committed to the net zero transition) and which may include ~~or~~ offsetting its greenhouse gas emissions, creates a constructive obligation for the entity;

b. whether a constructive obligation created by such a commitment meets the criteria in IAS 37 for recognising a provision; and

c. if a provision is recognised, whether the expenditure required to settle it is recognised as an expense or as an asset when the provision is recognised—using the analogy of asset decommissioning over time.

~~The Committee considered this request by reference to the following fact pattern.~~

Context for our Submission

The context for the submission was in four parts:

a. Many hundreds of entities made net zero transition commitments in financial years 2020 and 2021 and continued those commitments through affirmative actions (for example a transition plan, ongoing website publication, referring to them in financial statements and/or joining coalitions committed to the transition) in those years but no entity appears to have recognised a provision, or explained why not.

b. These commitments are believed to have created a valid expectation with investors (who took their own affirmative actions in response) and the public at large.

c. This practice not to recognise a provision has market distorting effects—including that the incentives to meet the commitment are upside down.

d. Creating the incentives to meet a net zero transition commitment is essential to tackling the challenge of slashing carbon emissions by 43% by 2030.

Relevant background documents

a. The submission linked here.

b. The presentation referenced in the submission 'Tackling the Root Cause of Climate Inequity' also provided to Committee members—now attached to this comment letter.

c. The staff note considered by the Committee linked here.

d. The final staff note approved by the Committee linked here [to our knowledge this is not yet available].

2. A good start but much work still to do to enable a thoughtful transition in 2024

The most surprising conclusion of a 22 year old Standard

The most surprising conclusion should be that net zero commitments can actually be constructive obligations. IAS37 was adopted in April 2001 to solve a different problem—that's like the user guide for the iPhone 15 being published when the iPhone was only a twinkle in Steve Job's eye. Informed decisions to meet or not meet net zero commitments should not be made using a 22 year old standard with unclear application. Commitments must be obligations and the asset-building treatment will naturally follow.

Nick Anderson at the IASB has strongly made similar points that existing Standards contain 'adequate measures' relevant to net zero transition commitments and climate-related risks generally. And that the problem is not the Standards but the way in which accountants are choosing to practice them—and auditors to audit them. We agree with Nick's analysis.

A thoughtful transition in 2024

As we see it, the challenge from this point is how to enable a thoughtful transition in of the decision—ideally in 2024. That begins with recognising the real-world governance challenge set by the unexpected effects of the decisions described in paragraph 3 below.

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A thoughtful transition in the context of why the submission was made would recognise and plan for this phasing:

- That recognising a provision in Q1 2024 is hard to conclude acting prudently while (a) the decision is still to be ratified (b) further fact patterns will be in progress to clarify the guidelines on recognition (c) the asset treatment having recognised a provision using the analogy of asset decommissioning is good but not ideal (d) creating a reliable estimate of the provision will need further guidance.
- More realistically the entity's decision will be to create a note in the FY2023 year-end statements, acknowledging the decision and this uncertainty and committing to revisit the decision when these four issues are clearer.
- A parallel decision governance and reporting framework being implemented to meet investor and stakeholder demand for the rest of 2024.
- First accounting entries being made in the FY2024 statements.

This would be analogous to the evolution of the accounting treatment of employee stock options that occurred in the notes prior to formal recognition that appeared on the statement of financial position.

And though a 2024 transition in will seem ambitious, the imperative of the climate crisis should force all parties to work towards it—recognising that according to the IPCC, there is only have a 14% probability of avoiding a catastrophic failure of the climate and a need to 'slash emissions by 43% by 2030'.

Setting the path for fit for purpose standards in 2024

Though it may not have known it, the Committee gave seven signals that to enable entities to meet the challenge of the climate crisis, a new global financial accounting (not reporting) standard for net zero, nature and circular must be quickly created, tested and adopted.

Here are the seven signals of this direction of travel, leaning first on existing IFRS Standards IAS37 and IAS38:

1. **There are already adequate measures in IAS37 to support the interpretations—depending on the facts of each commitment.** The Committee's tentative agenda decision confirmed that (1) a net zero transition commitment can be a constructive obligation (2) if so a **provision** must be recognised and (3) starting with recognising a provision, the principles and accounting for asset decommissioning in IAS37 can be applied to a strategy and investment program designed to meet the commitment—using the analogy that an entity is committing to decommission its carbon-emitting infrastructure and business practices.

2. **'Provision' is the key word—meaning an accounting entry**. In net current liabilities and shareholder equity on the balance sheet. The way to convert an externality into an obligation that must be quantified.

3. **Reliable measurement must be done—there is no option not to quantify.** SEC Chief Accountant Paul Munter made the point consistently in response to what appeared to be a consistent theme raised by Deloitte, EY and PwC of the 'expectation gap'—the key question is only when the threshold for recognition has been reached.

4. **Meeting a net zero commitment must be an asset building strategy.** By endorsing an analogy of asset decommissioning the Committee gave the signal that a net zero program should not be a cost. The analogy of asset decommissioning good start but work on the asset building accounting treatment is needed.

5. **Less the Standards than the way that accountants are choosing to practice them.** Further explained here by IASB board member Nick Anderson who's strong note making this point was referred to in the meeting.

6. **Recognition is for management and boards to decide.** Consistent with its approach to IAS37 on pages 37/38 of the TCFD Guidelines, the Committee agreed 14-0 that the matter would **not** be referred to the IASB—meaning the decision whether or not to provide is for management and boards and for auditors to assure.

7. **A guidebook can be created to guide the decision for when a provision is required to be recognised.** The Committee discussed how to apply the requirements to one fact pattern. And although there was general concern among the Big 4 audit firms that every company analysis would be unique, this isn't the case in reality. From the staff note and Committee discussion, and by submitting further fact patterns (see paragraph 5) we're confident that a list of around ten can be created—with a default of recognition.

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3. The two unexpected effects of the decisions and the real-world governance challenge in Q1 2024

The decision of the Interpretations Committee combined with its timing and retrospective effect are an important lever for transition in Q1 2024 because the decision has two unexpected effects in the real world.

Unexpected effect 1—the 2023 year end reporting cycle will coincide with the consultation and ratification process

The decision is followed by a consultation process to 5th February 2024 and will be ratified in the Committee's meeting on 5th/6th March 2024. The further fact patterns described in paragraph 5 would extend this period further. But between now and the end of March any company with a December year end is going to have to decide how to respond to it in its next annual reporting cycle. Listed companies will typically have filed their annual statements by week 2 of March 2024 based on recent history.

Of the decisions options to:

(a) recognise a provision (**Option A**), or

(b) note the decision and wait for ratification and further clarity on the four issues mentioned above (**Option B**), or

(c) ignore the decision (**Option C**),

we believe that Option C creates personal risk for all concerned and should be disregarded following the prudence and stewardship requirements of the IASB Conceptual Framework.

To enable management, boards, audit committees and auditors to make an informed decision between Option A or Option B, the guidance to be used in these decisions must be enhanced (see paragraph 5 below).

Unexpected effect 2—in effect, the decision is retrospective

By implication if a provision has to be recognised now, it should have already been recognised when the net zero transition commitments were first made in 2020-2022. Little known, Shell protected itself from this risk in 2021 by recognising a first asset decommissioning provision.

This means that anyone who was involved in the decision not to recognise a provision in 2020-2022 cannot be independent in making the decision to provide now, should declare a conflict of interest if a director and should be excluded from this new decision. Still though far better guidance is needed for those who are independent to decide between Option A or Option B.

4. Technical limitations of the decision caused by a too narrow fact pattern

The fact pattern chosen does not reflect the reality of commitments that have occurred in the real world. And though the discussion begins to set out the guidelines to be used, it is not helpful because it creates too much uncertainty for those making a real-world decision in Q1 2024 and beyond—and will encourage the status quo of non-recognition rather than embracing a thoughtful transition.

The fact pattern here is too narrow:

In 20X0 an entity, a manufacturer of household products, publicly states its commitment:

a. *to reduce its current greenhouse gas emissions by at least 60% by 20X9; and*

b. *to offset its remaining emissions in 20X9 and thereafter, by buying carbon credits and retiring them from the carbon market.*

With its statement, the entity publishes a detailed plan setting out how it will gradually modify its manufacturing methods between 20X1 and 20X9 to achieve the 60% reduction in emissions by 20X9. The modifications will involve investing in more energy-efficient processes, buying energy from renewable sources and replacing existing petroleum-based product ingredients and packaging materials with lower-carbon alternatives. Management is confident that the entity can make all these modifications and continue to sell its products at a profit.

It is too narrow and gives rise to technical doubt on whether a provision is required to be recognised for five reasons:

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- It assumes a commitment is made in 20X9 and at the same time a detailed plan is published. In reality, the detailed plan followed the initial commitment by several months and involved negotiation of how the transition would be financed with investors and others. This assumption then flows through the Committee discussion on what is the past event that creates the present obligation—whereas in reality the original statement and each subsequent affirmative action becomes the past event.
- It assumes that a transition plan is created and never changes. Whereas in reality plans were dynamic and involved 'negotiation' with long-term investors. And that in reality the original statement was followed by a pattern of established practice that itself acknowledged and resulted from the commitment. The technical confusion here includes that an entity could name its plan with words like 'ambitions, aims or aspirations'—whereas in reality only the substance of the constructive obligation is the determining factor and what the plan is called must be irrelevant—consistent with the definition of a constructive obligation it is not what the plan is called but what it contains and the expectations set.
- It assumes that the commitment is to be met by 2030 rather than the reality that commitments were to transition over a period of years in a series of carbon emission reduction targets. This again creates technical confusion (a) as to what is the past event that gives rise to the present obligation (b) reaches an illogical accounting conclusion that a provision would only be recognised in 2030 if the entity did not meet the obligation and buy offsets. Surely accounting between now and 2030 would have to anticipate that the commitment might not be met.
- It assumes that offsets are two of the primary means by which emissions will be reduced—whereas in reality, the focus of transition plans is to reduce emissions in a series of annual emission reduction targets with offsets being part of the mix if this target cannot be achieved.
- It assumes that the entity is not committing to invest capital to meet the emissions reduction target—whereas in reality transition plans were explicit about the estimates and ranges of capital expenditure required, in particular over the life of shorter term commitments to 2030 (for example a 2021 commitment to a '35% reduction in Scopes 1 and 2 emissions by 2030'. This flawed assumption then brings into question the probable outflows criteria of recognition of a provision—whereas in reality long-term investors were agreeing to accept lower returns in the transition period to enable transition capital to be allocated.

Effects of the uncertainty gap

Our community believes that there is a risk that the decision could create market disruption and too great unnecessary uncertainty in this period. In the context of the importance of this topic in tackling the climate crisis, we believe that closing this gap is central to the IFRS Foundation's mission to.

"The IFRS Foundation was founded on the belief that better information supports better economic and investment decisions. As a public interest organisation, we work to achieve this vision through the development of high-quality, global standards that result in corporate information that informs investment decisions. This work contributes towards efficient and resilient capital markets".

How can the uncertainty gap be narrowed following the Due Process Handbook and/or other options available to the IFRS Foundation?

5. Closing the technical limitations by submitting further real-world fact patterns and an ISSB Guidance Note

Rethinking Capital has taken two actions since the publication of the decision to close this uncertainty gap.

Action 1: Submitting further real-world fact patterns

Three further real-world fact patterns have been submitted to the Interpretations Committee on 18th December 2023 to overcome these challenges. These are anonymised but real-world fact patterns:

1. In Fact Pattern 1 (Oil and Gas sector) the reality of net zero transition commitments being an originating statement followed by a series of at least two affirmative actions by the entity.

2. In Fact Pattern 2 (Net zero pathways in each hard to abate sector) the reality that these sectors came together to create pathways to net zero in 2021 and have continued since.

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3. In Fact Pattern 3 (Legal obligations) that in many countries, a constructive obligation has crossed over into being a legal obligation—in particular because transition pathways are now legally required.

These have been submitted and receipt acknowledged and will be discussed with Committee staff in January 2024. Subject to being approved as different from the fact pattern considered by the Committee in December 2024, they would be discussed by the Committee on 5th/6th March and then subject to a further consultation and ratification period. Although this new submission creates greater uncertainty in time, it will create materially better certainty of the guidelines to be used in making an informed independent decision on whether or not to recognise a provision in 2024—and thereby contribute to enabling a thoughtful 12 month transition.

Action 2: Requesting the ISSB to create a Guidance Note for this specific purpose

On 18th December 2023, we also submitted a second letter to the chair and vice-chair of the International Sustainability Standards Board (**ISSB**) suggesting that the ISSB consider working with us to create a guidance note for boards for this specific decision in Q1 2024. The governance sections (5 to 7) of the S2 standard seem to us to create the authority to do so.

Given ISSB technical adviser Richard Barker sat in the Committee meeting and described the decisions as 'rich in potential', we remain hopeful that the ISSB will respond. But may need to create the guidance note ourselves.

6. Who is expected to object to the decision and why, and how to overcome their objections

Based on the concerns of Deloitte, PwC and EY at the Committee meeting (in contrast to the enthusiasm of KPMG's Brian O' Donovan) we expect the global audit firms and probably companies in the so-called 'hard to abate' sectors to (a) raise technical concerns on the decision (though the uncertainty of the fact pattern used may argue against this because uncertainty will encourage the status quo) and/or (b) argue for a 2 or 3 year transition period rather than a 12 month thoughtful transition.

The concerns of the hard to abate sectors can be addressed by the further three fact patterns. The global audit firms though may be compromised by self-interests in objecting because of four effects that naturally result from the decisions, combined with entity's that now recognise having not done so before:

- To our knowledge no entity has recognised a provision or explained why not. This should be remarkable—and must question why not. It does question whether the firms have been sufficiently robust in their audit challenge of management's decision not to recognise a provision. And whether audit statements could credibly confirm that the statements complied with all relevant Standards.
- It begins to illustrate Nick Anderson's assertion that the existing Standards contain adequate measures for climate risks and liabilities, and net zero transition commitments but are not being followed in practice by management and therefore not effectively challenged in the audit process—a point strenuously made by other stakeholders in the market such as Natasha Landell-Mills from Sarasin & Partners.
- It begins to question what other assets and obligations may be missing from balance sheets.
- It should question whether existing auditors can be genuinely independent in being part of the decision whether or not to recognise in Q1 2024 and beyond—to choose Option A or Option B.

We would ask the Interpretations Committee to bear these points in mind in reviewing comment letters and to ensure that the true sources behind comment letters are made clear. And to robustly decline any request from these firms or those who might represent them for comment letters to remain confidential.

We would also encourage the firms themselves to consider the impact on their reputations when making comment letters raising objections. The reality is that like Big Tobacco, climate risks and liabilities have become simply too big to recognise. The decision creates a win-win for all including the firms.

Yours faithfully

Andrew Watson, Co-Founder

Rethinking Capital and The Catalysts.io Limited:

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