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

IFRS Foundation

7 Westferry Circus

London, E14 4HD

1st February 2024

Dear Sirs

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

Comment Letter by the Rethinking Capital community

Second Submission relating to 2030 Commitments

This comment letter is being sent on behalf of the members of the Rethinking Capital community. It replaces our first comment letter of 22nd December 2023 and is being re-submitted today after acceptance the Committee staff of our second submission described below.

It comments on the Interpretations Committee's discussion of Rethinking Capital's submission (**First 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.

Summary of comments

It is hard for us and should be hard for the Interpretations Committee members and all concerned to separate out a technical accounting conversation from the real-world impact of upside down incentives—what we describe as the hidden root cause of the system's inability to tackle today's climate and biodiversity crises. Our root cause presentation is attached again titled '*Tackling the root cause of climate inequity*.' This is serious stuff.

We are though delighted with the outcome of the First Submission and thank the Committee staff and members for an excellent and rich discussion.

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 (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.

In particular we were delighted that the discussion and Tentative Agenda Decision established three key principles for investors and other stakeholders when interpreting IAS37—a 23 year old standard which was not designed with net zero commitments in mind (**Three Principles**):

- That a commitment to reduce carbon emissions can be a constructive obligation;
- That if a constructive obligation then a provision must be recognised if the criteria for recognition are met;
- That if a provision is recognised then investments to meet the commitment could be recognised as assets.

These are very positive steps forward and, in our view, can play a vital role in tackling the climate crisis.

The view of our community is that further fact patterns can be used to create greater clarity of interpretation—specifically anonymised fact patterns of 2030 Commitments drawn from the real world. Without these further fact patterns it is considered that the Tentative Agenda Decision will encourage the status quo of non-recognition of a provision for 2030 Commitments rather than enabling a thoughtful transition.

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As such a second submission has been made and accepted by Interpretations Committee staff on 1st February 2024 (**Second Submission**). This Second Submission concerns the questions of whether:

- a first public statement of the 2030 Commitment, for example a 50% reduction in Scopes 1 and 2 emissions by 2030 (**Original Statement**) together with,
- a subsequent established pattern of practice relating to the 2030 Commitment by which the entity itself acknowledges and affirms the first public statement, typically including a transition plan explaining how the 2030 Commitment will be achieved (**Established Pattern of Practice)**,

meet the criteria to be recognised as a provision under IAS37 (Provisions, Contingent Liabilities & Contingent Assets) as a constructive obligation and/or a legal obligation.

Supporting the third decision of the Interpretations Committee and the joint IASB/ISSB board meeting

We also to support the third decision by the Interpretations Committee on 28th November 2023 not to refer the matter back to the International Accounting Standards Board (**IASB**). Referral back to the IASB would seem to mean that this issue would be included in the IASB's program to review IAS37 which is not due to publish amendments until 'Potentially 2025' (see slide 5).

By contrast further fact pattern submissions and using the mandate of the Interpretations Committee means that a transition in of the interpretations Committee's decisions could occur in one financial year (FY24). This thoughtful transition plan is explained in paragraph 2 below. This Second Submission can therefore minimise delay and support the aim expressed at COP28 to slash carbon emissions by 43% by 2030.

We were informed by the Committee's staff in December 2023 that the Interpretations Committee can receive and discuss subsequent submissions on the same subject area provided that the further fact patterns submitted raise new areas of interpretation and/or clarification. We believe that the two new fact patterns relating specifically to 2030 Commitments raise seventeen new points for interpretation and/or clarification of interpretation as detailed in the Second Submission. And are grateful to Committee staff for agreeing to support this Second Submission.

The Second Submission also supports the integration and connectivity aims expressed and discussed at the first joint board meeting of the IASB and International Sustainability Standards Board (**ISSB**) on 25th January 2024. We noted in particular the comments on the benefits of discussing the First Submission—by Bruce Mackenzie that 'connectivity is a verb not a noun' and the 'positive response to the First Submission'. And by ISSB board member Richard Barker on 'the importance of learning connectivity by doing it' and using the Committee process to 'close the gap between ISSB standard S2 and IAS37. We have tried twice now to engage with the ISSB chair and vice-chair and hope that the Second Submission will get greater engagement.

Connectivity issues in this submission also relate to intangibles in the application of IAS38 to carbon credits and to innovation (research and development) needed to meet the 2030 Commitment. We note that similar questions about accounting for carbon credits have been made by Accounting Standards Board Canada and EY in commenting on the Tentative Agenda Decision.

Comment sections

Our comments on the Tentative Agenda Decision are in six parts:

1. A suggested revised write up of the decision and publishing the 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 the fact pattern discussed.

5. Closing the uncertainty gap 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.

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Comments in detail

1. A suggested write up of the decision and publishing the 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 the First Submission and by adding context including the root cause presentation sent to Committee members but not made public so far.

Our suggested amendments are included 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') 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~~ offseting 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].

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

The most surprising conclusion of a 23 year old Standard

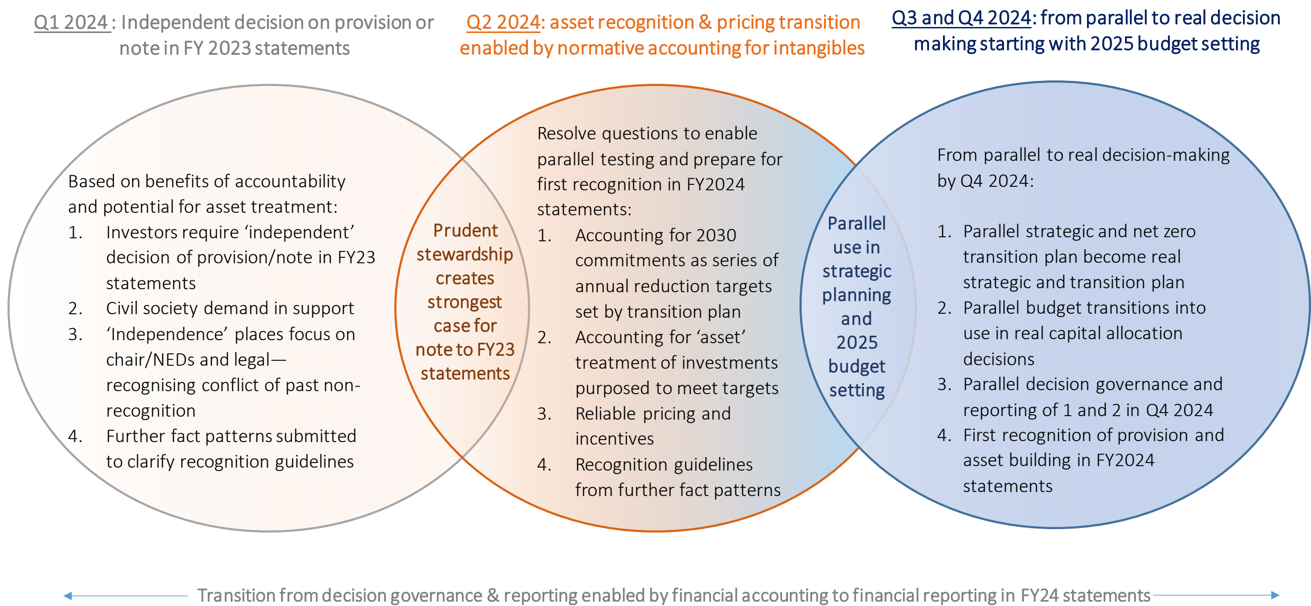
The most surprising conclusion should be that net zero commitments can actually be constructive obligations. IAS37 was adopted in April 2001 to solve a different problem—that's like the user guide for the iPhone 15 being published when the iPhone was only a twinkle in Steve Job's eye. Informed decisions 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.

It is submitted that with our Second Submission made on 1st February 2024 (and possibly other submissions) creating greater certainty, a thoughtful transition in can be achieved in FY24—without the matter needing to be referred back to the IASB. The proposed 2024 program is in three phases with two crossover points.



Market based adoption

The path to adoption of the proposed solution can be determined by the market supported by the Interpretations Committee in this year. It could be voluntarily adopted by an entity (probably after testing on previous capital allocation decisions), required by Net Zero Focused Investors and/or required by regulators and stock exchanges.

As is already standard practice in capital markets, Net Zero Focused Investors could require entities to apply it to govern and report capital allocation decisions in strategic planning and/or budgeting, either to meet a Net Zero Transition Commitment (as defined in the First Submission) or a 2030 Commitment (as defined in the Second Submission) or not to. And to parallel (or shadow) report these to organisations that are already active in carbon reporting such as CDP or Carbon Tracker.

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Disclosures would first appear in the notes to the financial statements to provide the information to Net Zero Focused Investors, Insurers & Bankers and Net Zero Focused Consumers and other stakeholders—while avoiding any unforeseen or unintended consequences from immediate recognition on the statement of financial position. 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.

As is also standard practice in capital markets, Net Zero Focused Investors (and other affected stakeholders) could create their own financial statements applying the proposed solution from the outside for the purposes of their own decision-making.

Restatement of the Net Zero Transition Commitment and/or 2030 Commitment in 2024

Net Zero Transition Commitments and 2030 Commitments were typically previously made in either 2020 or 2021. However standard accounting practice has been not to recognise a provision or explain why not. Here, the entity may have made decisions since:

(a) to invest into meeting the Net Zero Transition Commitment and/or 2030 Commitment assuming that investments will be expensed through the income statement, effectively penalising investments into programs that have the intent and purpose of meeting the commitment. This would also have resulted in operating cash outflow classification that reinforced the impression that the board, investors and other stakeholders should not view them as investments into the future.

(b) to reduce the extent of its commitment, particularly 2030 Commitments to reduce the percentage of emissions by 2030, as has been seen in 2023 in the oil and gas sector and known as 'walking back'. If a provision has not previously been recognised, these reductions in the commitment may create materially negative economic effects.

The recommended logical alternative to restating financial statements backwards to the date of the original Net Zero Transition Commitment and/or 2030 Commitment would be for the entity to update and restate its Net Zero Transition Commitment now, particularly its 2030 Commitments. And to restate its associated net zero transition plan now, explaining the reason for recognition now. This new 'past event' would create the present event criteria.

Indeed any entity, whether it has made a Net Zero Transition Commitment to date or not, would be recommended to state or restate its Net Zero Transition Commitment and 2030 Commitment now to achieve the listed benefits above. The resulting accounting treatment would result in better and more complete information for all stakeholders.

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'.

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 the Second Submission 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

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(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 the fact pattern discussed

This fact pattern discussed by the Interpretations Committee on 28th November 2023 established the Three Principles. Again we thank the Interpretations Committee and its staff for an excellent and rich discussion.

Fact pattern

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.

Limitations

The limitations of this fact pattern when applied to 2030 Commitments include that it:

a) Assumes that an Original Statement (as defined in the Second Submission) is made and at the same time a detailed plan is published. In reality, the detailed plan followed the Original Statement by a period of time and often involved negotiation of how the transition would be financed with investors and others. This simultaneous timing assumption then confuses what is the past event that creates the present obligation—whereas in reality with 2030 Commitments, the Original Statement becomes the past event from which the Established Pattern of Practice (as also defined in the Second Submission) then derives.

b) Assumes that a transition plan is created and never changes. Whereas in reality plans to achieve 2030 Commitments were dynamic and involved 'negotiation' with investors and others. When applied to 2030 Commitments, technical confusion can include that an entity could name its transition plan with words like 'ambitions, aims or aspirations' to come outside of the definition of a constructive obligation—whereas the substance of the constructive obligation and whether a valid expectation has been created should be the only determining factors. Further clarity is then also needed as to when the entity would take the decision to make

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a provision. With other fact patterns it becomes clear that the recognition decision must be made when the threshold to be a constructive obligation is reached.

c) Assumes that the commitment is to be met 'in 2030' rather than the reality that 2030 commitments were to transition over a period of years in a series of carbon emission reduction targets. When applied to 2030 Commitments, this creates technical confusion (a) as to what is the past event that gives rise to the present obligation (b) and would result in an illogical accounting conclusion that a provision would only be recognised in 2030 if the entity did not meet the obligation and buy offsets. Accounting between 20X9 and 2030 would have to anticipate that the commitment might not be met.

d) Assumes that offsets are one of the primary means by which emissions will be reduced—whereas in reality, the focus of transition plans for 2030 Commitments is to reduce carbon emissions in a series of annual emission reduction targets with carbon credits/offsets being part of the mix if this target cannot be achieved.

e) Assumes that the entity is not committing to invest capital to meet the emissions reduction target—whereas in reality transition plans for 2030 Commitments are explicit about the estimates and ranges of capital expenditure required, This assumption then brings into question the probable outflows criteria of recognition of a provision—whereas in reality Net Zero Focused 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 uncertainty gap 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: Second Submission of real-world anonymised fact patterns

Two further fact patterns are included in the Second Submission. These are anonymised but real-world fact patterns:

1. In Fact Pattern 1 (Oil and Gas sector) the reality of 2030 Commitments being an originating statement followed by a series of at least two affirmative actions by the entity illustrates that an Established Pattern of Practice followed an Original Statement.

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.

Although this Second 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

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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 fact patterns.

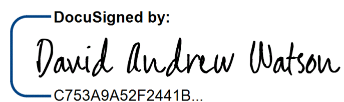
The global audit firms though may be compromised by self-interests in objecting because of four effects that naturally result from the decisions, combined with entities that now recognise having not done so before:

- 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

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