Due Process Oversight Committee of the International Accounting Standards Board (**DPOC**)

IFRS Foundation

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London, E14 4HD

29th February 2023

For the attention of Teresa Ko, Chair of DPOC—submitted to DPOC through its online portal

And to Bruce Mackenzie, Chairman of the Interpretations Committee of the IASB (the **Committee or IFRIC**)

Dear Teresa & Bruce

Two submissions to the Committee on Climate-Related Commitments (IAS37)

Six governance issues under the Due Process Handbook and the imperative for a second public consultation

This letter is being sent under paragraph 9.1 of the IASB's Due Process Handbook (**Handbook**).

Its aim is explain the imperative to continue the discussions of IAS37 on Climate-Related Commitments with IFRIC through a public consultation on the Second Submission. And avoid the unnecessary time delay of this being referred to the IASB as part of its program for targeted improvements of IAS37 that will not report until 2025 at the earliest.

It concerns six governance and issues under the Handbook. Together we believe that these issues may undermine the governing principles of transparency, full and fair consultation and accountability in paragraph 3.1 of the Handbook (the **Due Process Principles**). Specific areas of the Handbook are listed in the Appendix to this letter.

This letter concludes that:

- The 5th March 2024 discussion of the Second Submission can and should continue as scheduled.
- A public consultation on the Second Submission is the logical way to meet the Due Process Principles and address the issues with the First Submission. Not to do so may also undermine the IASB's reputation.
- In this consultation, the IASB and ISSB must seek comments from investors and the net zero community.
- During and after this consultation period, the market will have the ability to take control of this issue.
- There is no reason to refer this matter back to the IASB for standard-setting but this will inform its program.
- The global accounting firms should be key enablers of these new accounting practices.
- Perceptions of the independence of the five Committee members from those firms needs thought.
- At least, DPOC must establish whether there is demand for a second consultation from primary users.

Praise for IFRIC and IFRIC staff in elevating the conversation on net zero commitments

IFRIC has become the centre of a global conversation on commitments to reduce carbon emissions over time. We were delighted with these three principles confirmed in the discussion of the First Submission (**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.

As the effects of non-recognition include that the incentives to meet a net zero commitment are upside down (explained further in the Appendix), our community believes that the Committee has begun the pathway to unlock the ability to slash the 43% of carbon emissions needed by 2030. Rethinking Capital's rethink of double-entry bookkeeping is designed to complete the pathway to flip these upside down incentives.

That pathway is for a net zero program to become profitable (an essential according to [Ray Dalio]) and to improve all material financial metrics and unlock better returns for investors including pension funds. In other words, this is materially positive and will provide better information for investors as primary users of financial statements.

Though we disagree with the staff note's technical assessment in the Second Submission, this letter does not challenge those views. It only raises the fact that this is a controversial and difficult technical interpretation. Even IASB staff seem to disagree on this interpretation shown by IASB board member Nick Anderson's public comments.

As such, the imperative is that this interpretation be discussed by the Committee on 5th March 2024 and then opened to a public consultation period. There seems no credible reason why IFRIC cannot continue this pathway. And not to do so would undermine the comments of the Committee chair on 25th January that '*connectivity is a verb not a noun*.'

The six governance issues

The six issues are below and further details on each issue are in the Appendix to this letter:

1. A vital issue to address in tackling net zero's upside down incentives. In which IFRIC can continue the conversation that has caught hold with long-term investors and the net zero community led by the UN's Race to Zero movement.

2. A controversial technical interpretation not helped by the first fact pattern. The fact pattern in the First Submission was not a 'real-world' example. The Second Submission should be considered to be the first substantive discussion.

3. **Stopping the conversation within IFRIC that has really only just begun**. Recognising that the First Submission was important to set the Three Principles but that further fact patterns and guidance was demanded by comment letters.

4. Surprising absence of comments from net zero focused investors and investor coalitions. Only one comment letter from pension funds was received. None were received from coalitions including Climate Action 100+ or GFANZ.

5. Surprising absence of comments from the net zero community. One comment letter only (Carbon Tracker) was received. None were received even from two programs in which the ISSB is actively involved or from an ISSB funder.

6. The challenge and opportunity for the global audit firms as enablers of this transition in accounting and audit practice. As expressed in our comment letter, the global audit firms can be the enabling force if they embrace it.

Conclusion and backstop

It is remarkable that these pathways have been opened in 2024 by a 23 year old standard not designed for net zero commitments. This gives seven years to increase the only 14% probability of averting a climate catastrophe according to the IPCC of the UN. Every month is critical in doing so and there should be no unneeded delay.

The submissions have catalysed a global conversation. Praise in our outreach has focused on the courage and vision of Committee Chairman, Bruce Mackenzie and Committee staff—and enhanced by Bruce's comments on connectivity and integration to view '*connectivity as a verb not a noun*.' Both connectivity and integration come into reach in 2024 if the Committee continues the conversation through a second consultation.

As a backstop, DPOC may consider outreach to establish whether there is demand for a public consultation of the Second Submission from asset owners, investment managers and the net zero community as primary users.

Paul Munter

We ask that that this letter is shared with Paul Munter who both attended the first meeting and led IOSCO's comment letter calling for further fact patterns. But for Paul's intervention in the first meeting on the problem of the '*expectations gap*', we believe that the meeting would not have had such a positive outcome.

Please acknowledge receipt of this letter. We will fully support and look forward to DPOC's response.

Andrew Watson

Co-Founder,

Rethinking Capital, andrew@rethinking-capital.org

Appendix

The first governance issue

1. A vital issue to address in tackling net zero's upside down incentives*. In which IFRIC can continue the conversation that has caught hold with long-term investors and the net zero community led by the UN's Race to Zero.*

While collaborating with Harvard's Impact-Weighted Accounts Initiative in mid-2020, Rethinking Capital made a startling discovery that it went on to write about in an SSRN paper, a bp case study called Constrained by Accounting.

That insight was that the incentives to meet a net zero commitment are, quite literally, upside down—the exact opposite of what would be needed to enable a just net zero transition and enable capital to freely flow into adaptation and mitigation. Those incentives result in part from the gap between IASB's standards and practice.

Here's the summary of this insight with which we lead our presentations today:

- Today's financial incentives to meet a net zero transition commitment are upside down,
- Accounting practice doesn't recognise a commitment as an obligation—rewarding doing nothing,
- And expenses investments purposed to meet it—creating an immediate penalty to invest,
- The transition beliefs are upside down, decision-making is constrained by fear,
- Net zero is surely guaranteed to fail by these rules.

This gap in climate accounting has between accounting standards and accounting practice has also been highlighted publicly by IASB board member Nick Anderson. Highlighting also that the Committee's decision on these two decisions differs even between different IASB staff when the staff note on the second submission is considered—an issue we pick up in the demand for a public consultation on the Second Submission.

This quote by Bill Gates, reviewing Capitalism Without Capital, the Rise of the Intangible Economy (Haskel and Westlake) supported our insight—and this remains the sharp insight on the real problem to solve:

'The portion of the world's economy that doesn't fit with the old model just keeps getting larger. That has major implications for everything from tax law to economic policy, to which cities thrive and which fall behind. But in general, the rules that govern the economy haven't kept up. This is one of the biggest trends in the global economy that isn't getting enough attention'

Our program with Harvard Business School then turned to how to use back to basics double entry bookkeeping and normative accounting theory with which to flip the incentives by accounting for the intangibles impacted by a net zero commitment—a body of work created by a global expert group and called normative accounting for intangibles.

Our informed and objective view is that the system has generally missed this shift—actually the third such shift in how value is created in the history of Western capitalism over the past 700 years according to Futuromics by our co-founder and economic historian Robert McGarvey.

Though others including Professor Baruch Lev and Feng Gu in The End of Accounting express frustration or worse with the role of the auditors, our view is that the global audit firms should not be judged or held to account for this. Most all stakeholders are making decisions derived from neoclassical economic theory which assumes natural resources to be abundant. To its credit, only the IASB's accounting standards appear to have largely stood the test of time.

The second governance issue

2. A controversial technical interpretation not helped by the first fact pattern*. The fact pattern in the First Submission was not a 'real-world' example. The Second Submission should be considered to be the first substantive discussion.*

In practice, the Second Submission should be considered to be the first substantive discussion of the application of IAS37 to climate-related commitments—because though it set the Three Principles, the fact pattern put forward and discussed was not a real-world example of any commitment we can identify. As such, the First Submission discussion and process cannot be considered to be much more than a general conversation that set the Three Principles.

The discussion and decisions in the First Submission were based on a fact pattern of a company that states a commitment to reduce carbon emissions by 2030, publishes a plan on the same day which never changes and commits to buy carbon offsets if it hasn't met the target by 2030.

This was not at all how Net Zero or 2030 Commitments were made in reality—being one reason for the Second Submission. As the Second Submission describes when applied to 2030 Commitments (eg 50% reduction in Scopes 1 and 2 emissions by 2030 in line with science-based targets) an original statement was then followed by established patterns of practice including a transition plan, negotiation of the plan with investor groups to set acceptable returns, annual emission reduction targets and capital expenditure required.

The Second Submission therefore used 'real-world' anonymised fact patterns from the oil and gas and hard to abate sectors creating a very different analysis of IAS37 and raising seventeen new interpretation issues.

This is clearly a controversial and hard technical interpretation. When Rethinking Capital first engaged with IFRIC in September 2023, the IASB had just asked IFRIC to ask the same question of itself because of a stream of challenges from the market and others—whether a provision (a quantified accounting entry) should be recognised for a Net Zero or 2030 Commitment as a constructive obligation. We had commented in the press on this twice in The Banker at the FT and in the FT's Sustainable Views.

Responding to a LinkedIn request from Committee chair Bruce Mackenzie on 'any questions for IFRIC' we agreed with Bruce and Committee staff to make the first submission. We made it because 1266 of the world's largest 2000 companies have made a Net Zero or 2030 Commitment but, to our knowledge, none has recognised this as an accounting liability or obligation or explained why not. And that just doesn't feel right to us—or ISSB board member Richard Barker at the 25th January joint board IASB-ISSB meeting.

As DPOC will know, IAS37 was adopted in April 2001 and not designed for Climate-Related Commitments. It should be very surprising that a 23 year old accounting standard designed for a different purpose has stood the test of time. This seems to also have been the view of the IASB in its contribution to the TCFD Guidelines on page 37.

The aims of the First Submission were to begin a conversation with the Committee to show how far IAS37 could be stretched—and begin to set a pathway to hand control of this issue to the market.

The third governance issue

*3. **Stopping the conversation within IFRIC that has only just begun**. Recognising that the First Submission was important to set the Three Principles but that further fact patterns and guidance was demanded by comment letters.*

There is no credible reason why the Committee cannot continue this pathway through a public consultation on the Second Submission. This will also inform the IASB's program on targeted improvements to IAS37.

Not to do so would undermine the comments of the Committee chair on 25th January that '*connectivity is a verb not a noun*' but then to decide to stop the learning. And ignore the most informed comment letters from the International Foundation for Valuing Impacts (our partner in making the Second Submission), IOSCO, A4S, Carbon Tracker, XRB New Zealand—all of whom we spoke to as part of the First Submission.

And those of ISSB board member Richard Barker in the same meeting that not recognising a provision '*just doesn't feel right*', the ability to '*learn connectivity by doing it*' and to '*close the gap between IAS37 and S2*' offered by the First Submission. And his comments at the end of the first discussion on 28th November 2023 that this was '*rich in potential*'.

The fourth governance issue

*4. **Surprising absence of comments from net zero focused investors and investor coalitions**. Only one comment letter from pension funds was received. None were received from coalitions including Climate Action 100+ or GFANZ.*

The only comment letter from this stakeholder group was from Christian Brothers Investment Services, Sarasin & Partners and others. Even this was concerned more with IAS36 than IAS37.

We do not know the extent of IASB or ISSB outreach to net zero focused investors or investor coalitions but we do know that none submitted a comment letter. The Three Principles create the potential to unlock higher returns and give accountability for net zero commitments for these primary users.

We conclude that a full and fair consultation with long-term investors and pension funds (known as asset owners) who would be the biggest beneficiaries of the Three Principles and as primary users has not been met.

We also conclude that a full and fair consultation with advisers to long-term investors and pension funds (known as asset managers or investment managers) who advise asset owners would be the biggest beneficiaries of the Three Principles in advising on strategic asset management and portfolio theory.

The list of groups to approach is easy to compile and indeed Rethinking Capital has carried out this outreach program. The Climate Action 100+ represents $68 trn of assets under management and GFANZ $130 trn of assets under management. The GFANZ group also represents insurers, banks and venture capital providers and has 675 member firms in 50 countries.

The other most vocal voice on the gap between accounting standards and accounting practice is Natasha Landell-Mills of Sarasin & Partners who is leading the campaign against audit firms—being '*a vocal advocate for reform of the accounting and audit system to promote long-term stewardship as well as action by company boards to confront climate change*'.

Our outreach program can be shared with DPOC. Our conclusion is that none of these stakeholders were aware of the First Submission. We believe that this calls into question the extent of stakeholder engagement on the first submission under paragraph 2.10 (a) of the Handbook. And why no invitations to comment were sent to these stakeholders contravening the principle of full and fair consultation in paragraph 3.42.

The fifth governance issue

5. Surprising absence of comments from the net zero community. *One comment letter (Carbon Tracker) was received. None were received even from two programs in which the ISSB is actively involved or from an ISSB funder.*

We do not know the extent of ISSB outreach to net zero community but we do know that none submitted a comment letter other than Carbon Tracker who engaged as part of our outreach campaign. Others who contributed letters as part of our campaign were A4S and the International Foundation for Valuing Impacts.

We conclude that a full and fair consultation with the net zero movement who would be the biggest beneficiaries of accountability from Three Principles and as primary users has not been met.

The list of groups to approach is easy to compile and indeed Rethinking Capital has carried out this outreach program. The Race to Zero campaign represents some 13,000 members and is "*The world's largest coalition of non-state actors taking immediate action to halve global emissions by 2030*".

The ISSB is also actively collaborating in at least two programs with the net zero community. These include the UNFCCC's Recognition & Accountability Framework, the Transition Plan Taskforce and the European Climate Foundation (also an ISSB funder). None of these three submitted a comment letter.

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The sixth governance issue

6. The challenge and opportunity for the global audit firms as enablers of this transition in accounting and audit practice. *As expressed in our comment letter, the global audit firms can be the enabling force if they embrace it.*

The global audit firms can be among the key enablers of this transition in accounting practice. With the recognition rules becoming concrete, the past can be put behind and attention can focus on how to unlock the potential for better returns on net zero programs.

We would expect however that this shift will present many strategic and operational challenges for those firms. EY's then Global Managing Partner Mark Weinberger and UK Chair and Managing Partner Hywel Ball publicly admitted this in 2015 in stating that '*the audit product was at risk of being not fit for purpose*'.

The challenges include that in effect, the Committee's decisions in the First Submission are retrospective—because if a provision has to be recognised now, it should have already been recognised when net zero commitments were first made and 2030 transition plans set in FY's 2020 to 2022.

Those involved in decisions not to recognise a provision in prior years, or explain why not, should be assumed to favour the status quo of non-recognition when making a new decision on recognition now for fear of the consequences. This places a sharp focus on the role of auditors.

Oxford University Net Zero states that 1266 of the world's largest 2000 companies have made a Net Zero and/or 2030 Commitment. To our knowledge, none has recognised this as an accounting provision or a contingent liability under IAS37 or explained why not. However we are aware that EY made the case to Shell's audit committee and Shell then recognised an asset writedown in FY'21—'*conscious that maintaining its assets at full value was inconsistent with Paris goals and of IAS37*'.

Oxford University Net Zero has been approached for an analysis of how many of these 1266 are audited by the five global accounting firms represented on the Committee. The assumption is that each of the Big 4 firms will be auditors of at least 250. This gives an aggregation of risk to the firms.

Assurances should be sought from the global audit firms that they are prepared to embrace this major shift.

As DPOC will know, five of the fourteen Committee members (~36% of its votes) are held by the Big 4 firms and BDO. In addition those firms provide around 13% of the annual funding of the IASB's programs (~$2.252m) and 13.5% of the IFRS Foundation's annual funding after the formation of the ISSB (~$4,383m).

DPOC may need to think about the perceived independence of those firm's five Committee members.

Transparency of disclosing contributions from the oil and gas sector

For transparency and balance in the context of these submissions on IAS37 to net zero commitments, DPOC and the Committee chair should also consider whether it's appropriate to disclose that the IFRS Foundation's contributors include at least six petrochemical and gas companies.

According to pages 90-94 of the IFRS Foundation's 2022 Annual Report these are Petrobras, PetroChina Company Limited, China National Offshore Corporation, China Petroleum & Chemical Corporation and Korea Gas Corporation each of whom contributed funding of $25,000 each. And Suncor Energy who's financial contribution is not disclosed.

