IFRS® Interpretations Committee meeting

Date	**November 2023**
Project	**Climate-related Commitments (IAS 37)**
Topic	**Initial consideration**
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Session overview

1. The IFRS Interpretations Committee (Committee) has received a submission asking it to clarify how IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies to climate-related commitments.

2. This paper presents a staff analysis of this topic and asks the committee whether it agrees with our analysis and our recommendation not to add a standard-setting project to the workplan.

3. This paper includes:

   (a) information on:

      (i) the reasons for discussing the topic (paragraphs 5–7);

      (ii) the questions asked in the submission (paragraphs 8–9);

   (b) the staff's analysis of the questions asked in the submission (paragraphs 10–39); and

   (c) the staff's analysis, conclusion and recommendation on whether to add a standard-setting project to the work plan (paragraphs 40–43).

4. There are two appendices to this paper:

   (a) Appendix A—suggested wording for a tentative agenda decision

   (b) Appendix B—a copy of the submission.

Reasons for discussing the topic

5. At its September 2023 meeting, the IASB discussed stakeholder concerns relating to the information entities report in their financial statements about the effects of climate-related risks. Among other things, the IASB noted confusion about when a liability should be recognised for the costs of fulfilling climate-related commitments.[1]

6. The staff papers for that meeting suggested that it may not be clear how to apply IAS 37 to climate-related commitments in some circumstances. The IASB decided to refer to the Committee a question about the circumstances in which an entity recognises a liability when applying IAS 37 to such commitments. However, soon after that IASB decision, the Committee received a submission seeking clarification on similar matters. The receipt of that submission obviates the need for a referral from the IASB.

7. When we receive a submission, we often ask members of the International Forum of Accounting Standard Setters, securities regulators and large accounting firms for information about the prevalence of the matters described in the submission, and about the extent of any diversity in practice. We have not asked them for information in this case because the IASB's discussions and decision to refer the topic to the Committee provide us with evidence that the matters described in this submission have widespread effect and a material effect on those affected.

[1] See IASB September 2023 meeting Agenda Paper 14B *Results of work on the nature and cause of concern* and Agenda Paper 14C *Potential Actions*.

The questions asked in the submission

8. The submission, reproduced in Appendix B, discusses 'net zero transition commitments'—statements in which an entity indicates that it has accepted a responsibility to reduce its carbon emissions. The submission describes examples of net zero transition commitments, including:

   (a) end state commitments—for example, to be 'net zero', 'carbon neutral' or 'carbon negative' (perhaps even to repair past emissions) by a specified future date, say 2050. End state commitments might be aligned with the general imperative to limit global temperature rises to 1.5 degrees Celsius.

   (b) interim commitments—for example, to reduce carbon emissions by specified amount, say 50%, by a specified interim date, say 2030.

   (c) commitments to actions that have the secondary effect of reducing carbon emissions—for example, to reduce plastic usage.

   (d) transition plans of entities in the oil and gas sector—for example, to replace fossil fuel production with renewable energy production, or to repurpose petrochemical plants to produce chemicals using raw materials from renewable sources.

9. The submitters ask the Committee to consider their views that:

   (a) a net zero transition commitment meets the definition of a constructive obligation;

   (b) IAS 37 requires that obligation to be recognised as a provision; and

   (c) IFRS accounting requirements for the costs of fulfilling asset decommissioning provisions can be applied by analogy in determining how to account for the investment required to fulfil a provision for a net zero transition commitment. In other words, the expenditure required to settle the provision may be recognised as an asset, rather than as an expense, when the provision is recognised.

Staff analysis—how an entity applies IAS 37 to climate-related commitments

10. In this section, we consider the three questions raised by the submission:

    (a) *Question 1:* does the public statement of a net zero transition commitment create a constructive obligation as defined in IAS 37 (paragraphs 14–23)?

    (b) *Question 2:* does a constructive obligation created by a net zero transition commitment meet the criteria in IAS 37 for recognising a provision (paragraphs 24–34)?

    (c) *Question 3:* if a provision is recognised, is the expenditure required to settle it recognised as an asset or as an expense when the provision is recognised (paragraphs 35–36)?

11. We also discuss other accounting consequences of a net zero transition commitment (paragraphs 37–39).

12. To focus our analysis we have created a fact pattern that reflects two common features of the net zero transition commitments described in the submission—a commitment to reduce greenhouse gas emissions and a commitment to offset greenhouse gas emissions.

Fact pattern

13. The fact pattern we analyse is set out below:

Net zero transition commitment

In December 20X0 an entity, a manufacturer of household products, publicly states a 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.

Question 1—does the statement of a net zero transition commitment create a constructive obligation?

14. In determining whether an entity recognises a provision for its net zero transition commitment, the first question to consider is whether the entity's public statement of the commitment creates a constructive obligation to discharge it.

Applicable requirements in IAS 37

15. Paragraph 10 of IAS 37 defines a constructive obligation as:

> 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; and

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

16. Paragraph 20 of IAS 37 states that:

> An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

17. Paragraph 72 of IAS 37 specifies the circumstances in which a management decision to restructure a business has been communicated to those affected in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring:

> A constructive obligation to restructure arises only when an entity:
>
> (a) has a detailed formal plan for the restructuring identifying at least:
>
> (i) the business or part of a business concerned;
>
> (ii) the principal locations affected;
>
> (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
>
> (iv) the expenditures that will be undertaken; and
>
> (v) when the plan will be implemented; and
>
> (b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

18. Paragraph 74 further clarifies that:

> For a [restructuring] plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

Application to the fact pattern

19. The submitters express a view that:

    (a) there are other parties to whom the entity making a net zero transition commitment would owe an obligation (as required by paragraph 20 of IAS 37); and

    (b) the commitment raises a valid expectation among those other parties that the entity will discharge the commitment (as required to satisfy the definition of a constructive obligation).[2]

20. We agree with the submitters that there are other parties to whom the entity would owe a constructive obligation to reduce its greenhouse gas emissions and offset the emissions it cannot eliminate. We think this obligation would be owed to all people adversely affected by the entity's emissions, so would extend to the public at large.

21. However, we do not agree with the submitters that a net zero transition commitment necessarily creates a constructive obligation. Applying the definition of a constructive

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2 See page 37.

obligation, as elaborated on in paragraph 20 of IAS 37, the management of the entity described in our fact pattern would need to judge whether the entity's statement:

(a) indicates to the public at large that the entity has accepted a responsibility to fulfil its stated commitments; and

(b) communicates that responsibility in a sufficiently specific manner to raise a valid expectation in the public at large that the entity will discharge it.

22. In reaching its conclusion, management would consider all the facts of the commitment and the circumstances surrounding it. Management could refer by analogy to the criteria set out in paragraphs 72 and 74 of IAS 37 for concluding that an entity has a constructive obligation for the costs of restructuring a business.

23. Factors affecting management's conclusion might include, for example:

(a) *the language used in the statement*—a statement describing the actions the entity 'will take', 'is committed to taking' or 'pledges to take' may be more likely to indicate that that entity will fulfil the commitment than a statement describing the entity's 'ambitions', 'targets' or 'aspirations'.

(b) *the specificity and status of plans supporting the statement*—a statement may be more likely to raise a valid expectation that the entity will achieve its stated greenhouse gas emission reductions if it is supported by formally-approved plans detailing, for example:

(i) the nature and timing of the actions the entity will take to achieve the reductions;

(ii) milestones the entity has committed to achieve on the path to its longer term goals; and

(iii) how management will measure progress towards the milestones and longer term goals (for example, the metrics it will use).

(c) *the timing of the actions required to fulfil the commitment*—plans for short and medium-term actions are less likely to be changed than those for longer term actions.

(d) *publicly available evidence of progress to date*—evidence that an entity has achieved milestones it committed to in previous statements may enhance expectations that it will achieve milestones and longer term goals it commits to in its current statement. Conversely, evidence that the entity has failed to achieve milestones may reduce those expectations.

Question 2—does a constructive obligation created by a net zero transition commitment meet the criteria in IAS 37 for recognising a provision?

24. If an entity's public statement of its commitment creates a constructive obligation to discharge it, the next step is to consider whether and when that obligation meets the criteria in IAS 37 for recognising a provision.

Applicable requirements in IAS 37

25. Paragraph 14 of IAS 37 sets out three criteria for recognising a provision. It requires that:

(a) the entity has a present obligation (legal or constructive) as a result of a past event (the present obligation recognition criterion);

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation (the probable outflows recognition criterion); and

(c) a reliable estimate can be made of the amount of the obligation (the reliable measurement recognition criterion).

26. Paragraphs 18 and 19 of IAS 37 explain the present obligation recognition criterion:

> 18 Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's statement of financial position are those that exist at the end of the reporting period.
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> 19 It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

Application to the fact pattern—present obligation recognition criterion

27. The submitters express a view that the constructive obligation created by a net zero transition commitment satisfies the present obligation recognition criterion because the commitment has already been made. In other words, the publication of the statement of commitment was the past event that has given rise to a present obligation.[3]

[3] See page 38.

28. We disagree with this reading of IAS 37. Although the publication of a statement that creates a constructive obligation is *an* event (just as the enactment of a law that creates legal obligations is *an* event), it is not the event that creates a present obligation unless the statement or law applies retrospectively. The event that creates a present obligation is the action to which the statement or law applies, resulting in a requirement for an outflow of resources. At the time the statement is made, or the law is enacted, that event will be a future event unless the statement or law applies retrospectively. For example, suppose a new law is enacted requiring entities to pay a minimum wage to their employees from a specified future date. The enactment of that law does not in itself give those entities a present obligation to pay employee wages. A present obligation will arise only when the entity receives the employee services for which it will need to pay the wages—the receipt of employee services is the past event necessary for a present obligation. As paragraph 18 of IAS 37 states, no provision is recognised for costs that need to be incurred to operate in the future.

29. In the fact pattern described in paragraph 13:

    (a) when the entity publishes its net zero transition commitment in 20X0, both the costs of modifying its manufacturing methods and the costs of purchasing and retiring carbon credits—like the costs of fitting a smoke filter referred to in paragraph 19 of IAS 37—are costs that need to be incurred to operate in the future. The obligations do not exist independently of the entity's future actions. Accordingly, applying paragraphs 18 and 19 of IAS 37, there is no present obligation for those costs.

    (b) the entity will never have a present obligation for the future modifications to its manufacturing methods because the costs of those future modifications will always be costs that need to be incurred to operate in the future. The entity will at some point incur a present obligation to pay for resources it purchases to modify its methods—for example, to pay for new plant or equipment or for renewable energy—but only when it receives those resources.

(c) only when the entity emits the gases it has committed to offset will it have a present obligation to purchase and retire the carbon credits required to offset those gases. The entity will have a present obligation to purchase and retire carbon credits only if and when it emits greenhouse gases in 20X9 and later years.

Application to the fact pattern—probable outflows recognition criterion

30. The submitters express a view that the constructive obligation created by an entity's net zero transition commitment also satisfies the probable outflows recognition criterion, noting that an entity can fulfil the obligation only through a transition strategy and plan of investment into innovation that may include buying carbon credits.[4]

31. We think that whether a constructive obligation satisfies the probable outflows criterion depends on the nature of the actions required to settle it. Even if an entity will incur expenditure to settle an obligation, it will not suffer a net outflow of resources if it receives resources of equal value in exchange for that expenditure. In the fact pattern described in paragraph 13:

(a) the entity's commitment to reduce its greenhouse gas emissions does not satisfy the probable outflows recognition criterion. Although the entity will incur expenditure to modify its manufacturing methods, it will receive resources of equal value—for example, property, plant, equipment, energy, product ingredients or packaging materials—in exchange for that expenditure, and will be able to use these resources to manufacture products it can sell at a profit.

(b) the entity's commitment to offset its remaining emissions does satisfy the probable outflows recognition criterion. The entity will be required to purchase and retire carbon credits without receiving any resources in exchange.

4 See page 38.

Application to the fact pattern—reliable measurement recognition criterion

32. We think it is likely that, if a constructive obligation arising from a net zero transition commitment satisfies both the present obligation recognition criterion (as discussed in paragraphs 27–29) and the probable outflows recognition criterion (as discussed in paragraphs 30–31), it will also satisfy the reliable measurement criterion. Paragraph 25 of IAS 37 states that except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

33. For the fact pattern analysed in this paper, the present obligation and probable outflows criteria are satisfied only in 20X9 and thereafter, and only for a constructive obligation to retire the number of carbon credits needed to offset greenhouse gases emitted to date. At that time, we think it is likely that the entity will be able to make a reliable estimate of the amount of the obligation.

Conclusion for the fact pattern analysed

34. Our conclusion for the fact pattern described in paragraph 13 is that:

    (a) whether the entity's statement of its net zero transition commitment creates a constructive obligation will depend on the facts of the statement and the circumstances surrounding it.

    (b) if the statement creates a constructive obligation:

        (i) the entity does not recognise a provision when it makes the statement. At that time, the constructive obligation is not a present obligation as a result of a past event.

        (ii) as the entity emits greenhouse gases in 20X9 and thereafter, it will incur a present obligation for the expenditure required to offset its past emissions. If it has not already bought the carbon credits needed to offset its past emissions, and assuming that a reliable estimate can be made of the amount of the obligation, the entity recognises a provision for the cost of buying and retiring those carbon credits.

Question 3— if a provision is recognised, is the expenditure required to settle it recognised as an asset or as an expense when the provision is recognised?

35. The third question raised in the submission is how an entity accounts for the expenditure required to settle a net zero transition provision—does the entity recognise an asset when it recognises the provision, or does it recognise an expense? The submitters suggest that an entity recognises an asset—the entity could capitalise the expenditure into innovation, carbon credits and other assets, applying by analogy IFRS accounting requirements for the costs of settling asset decommissioning provisions.[5]

36. The staff's view is that when an entity recognises a provision, it recognises the expenditure required to settle that provision as an asset, rather than as an expense, only if that expenditure gives rise to—or forms part of the cost of—an item that qualifies for recognition as an asset in accordance with an IFRS Accounting Standard. The expenditure required to fulfil an asset decommissioning provision is recognised within assets because it is an element of the total cost of the item to which it relates, and included in the measure of that item applying paragraph 16 of IAS 16 *Property, Plant and Equipment* or paragraph 24 of IFRS 16 *Leases*.

[5] See page 40.

Other accounting consequences of a net zero transition commitment

37. Irrespective of whether an entity's commitment to reduce or offset its greenhouse gas emissions results in the recognition of a provision, the actions the entity plans to take to fulfil that commitment could affect the amounts at which the entity measures its other assets and liabilities. For example:

    (a) if the entity's plans involve replacing existing property, plant or equipment sooner than was previously expected, the entity might need to:

        (i) test the carrying amount of that property, plant or equipment for impairment—applying IAS 36 *Impairment of Assets*;

        (ii) reassess the period over which the property, plant or equipment is being depreciated and the estimate of its residual value—applying IAS 16; and

        (iii) as illustrated in the example following paragraph 38(c) below, re-estimate the amount and timing of the expenditure required to settle decommissioning or environmental rehabilitation obligations relating to that property, plant or equipment, and recognise a change in the measure of that obligation—applying IAS 37 and IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

    (b) if the changes needed to reduce an entity's emissions will increase the costs the entity incurs to produce its goods or supply its services:

        (i) obligations under existing contracts with customers might become onerous, or more onerous. Applying IAS 37, the entity might need to recognise, or increase the measure of, a provision for onerous contracts.

        (ii) the entity might need to reflect changes in assumptions about those costs when testing any of its assets or cash generating units for impairment.

38. Furthermore, irrespective of whether an entity's net zero transition commitment results in the recognition of a provision, the commitment could affect the information the entity discloses in its financial statements about existing assets and liabilities whose carrying amounts could be affected by the actions needed to fulfil the net zero transition commitment as described in paragraph 37. For example:

    (a) paragraph 125 of IAS 1 *Presentation of Financial Statements* requires an entity to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Such assumptions could include the assumptions the entity makes about how the actions it will take to implement its net zero transition commitment could affect the carrying amounts of existing assets and liabilities.

    (b) paragraph 134 of IAS 36 requires an entity to disclose information about the key assumptions on which management has based its estimate of the recoverable amount of some cash-generating units containing goodwill or intangible assets with indefinite useful lives. Such assumptions could include assumptions about the effects of the entity's net zero transition commitment on the future cash flows of those units.

    (c) paragraph 85 of IAS 37 requires an entity to disclose for each class of provision a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits, and an indication of the uncertainties about the amount or timing of those outflows—including, where necessary to provide adequate information, the major assumptions made concerning future events. If the amount or timing of the outflows required to settle any of the entity's provisions is affected by uncertainties created by the entity's net zero transition commitment, the entity might need to disclose information about those uncertainties and the assumptions it has made in measuring the provision:

Example—A transition strategy that affects an entity's asset decommissioning provisions

Fact pattern

An entity, a petrochemicals manufacturer, announces that it has adopted targets to reduce its greenhouse gas emissions and a strategy for meeting those targets. The targets include closing some petrochemical plants or repurposing them to produce fuels and chemicals from biological sources.

The entity has plant decommissioning and site restoration obligations in respect of its petrochemical facilities. Previously, the entity has omitted the expenditure required to settle some of those obligations from the measure of its asset decommissioning and restoration provision. It has done so on assumption that the facilities have indefinitely long useful lives, meaning that those costs will be settled so far into the future that when they are discounted to their present value, their effect on the measure of the provision is immaterial.

Accounting consequences of adopting the transition strategy

When it adopts the transition strategy, the entity reconsiders the amounts at which it recognises its existing assets and liabilities—including its petrochemical facilities and associated decommissioning and restoration provisions—and the information it discloses about those assets and liabilities:

(c) applying IAS 16 and IAS 36, the entity tests the carrying value of the property, plant and equipment at its petrochemical facilities for impairment, and reassesses both the periods over which it is depreciating this property, plant and equipment and the estimate of its residual value.

(d) applying IAS 37, the entity reassesses the amount and timing of the costs required to settle its plant decommissioning and site restoration obligations. The entity's transition strategy might bring forward some of those costs, meaning that their present value increases.

(e) also applying IAS 37, the entity discloses:

    (i) a brief description of the nature of the plant decommissioning and site restoration obligations and the expected timing of the outflows required to settle them.

(ii) an indication of the uncertainties about the amount or timing of those outflows, including, where necessary to provide adequate information, the major assumptions made concerning future events. These assumptions could include assumptions about the future use of the petrochemical facilities—for example, their useful lives, and whether and when facilities may be closed or repurposed.

The information disclosed includes material information about the obligations for which no costs have been included in the measure of the provision—even if the present value of these costs is not quantitatively material, other information about the obligations might be qualitatively material.

39. IFRS Foundation Educational Material *Effects of Climate-Related Matters on Financial Statements*, first published in November 2020 and updated in July 2023, identifies other ways in which climate-related matters need to be considered in applying IFRS Accounting Standards.

Whether to add a standard setting project to the work plan

Staff analysis and conclusion

40. Paragraph 5.16 of the IFRS Foundation *Due Process Handbook* states that the Committee decides to add a standard-setting project to the work plan only if, among other things, the principles and requirements in IFRS Standards do not provide an adequate basis for an entity to determine the required accounting.

41. Based on our analysis in paragraphs 10–39 of this paper, we conclude that this criterion is not satisfied—the principles and requirements in IAS 37 provide an adequate basis for an entity to determine how to apply that Standard to climate-related commitments.

Staff recommendation

42. For the reasons described in paragraph 41, we recommend that the Committee not add a standard-setting project to the work plan. We recommend that the Committee instead publish a tentative agenda decision that outlines how an entity applies IAS 37 to climate-related commitments.

43. Appendix A to this paper sets out suggested wording for the tentative agenda decision. In our view, the proposed tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Accounting Standards.

Questions for the Committee

Questions for the IASB	
1	Do you agree with the staff analysis in paragraphs 10–38?
2	Do you agree with our recommendation not to add a standard-setting project to the workplan?
3	Do you agree that the proposed tentative agenda decision does not add or change requirements in IFRS Accounting Standards?
4	Do you have any comments on the proposed wording of the tentative Agenda Decision in Appendix A to this paper?

Appendix A—Suggested wording for a tentative agenda decision

Climate-related Commitments (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)

The Committee received a request asking it to clarify:

(a) the circumstances in which an entity recognises a provision for the costs of fulfilling a commitment to reduce or offset its greenhouse gas emissions; and

(b) if a provision is recognised, whether the expenditure required to settle it is recognised as an asset or as an expense when the provision is recognised.

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

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.

Does the entity have a constructive obligation?

The first question to consider is whether the entity's public statement of its commitment creates a constructive obligation to discharge the commitment.

Paragraph 10 of IAS 37 defines a constructive obligation as 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; and

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

The Committee observed that a constructive obligation to reduce or offset greenhouse gas emissions would be owed to all people adversely affected by the emissions so would extend to the public at large. The Committee further observed that, whether an entity's statement of its commitment to reduce or offset its emissions creates a valid expectation that it will fulfil its commitment depend on the facts of the commitment and the circumstances surrounding it. Management would apply judgement to reach a conclusion considering those facts and circumstances.

Does the constructive obligation satisfy the criteria for recognising a provision?

If the entity's statement has created a constructive obligation for the entity, the next question to consider is whether that obligation satisfies the criteria for recognising a provision.

Paragraph 14 of IAS 37 requires an entity to recognise a provision when:

(a) the entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

Present obligation as a result of a past event

The first criterion for recognising a provision is that the entity has a present obligation as a result of a past event.

The Committee observed that, just as the enactment of a law is not the event that creates a present legal obligation for an entity unless the law applies retrospectively, the publication of a statement is not the event that creates a present constructive obligation for an entity unless the statement applies retrospectively. The event that creates a present obligation is the action to which a law or statement applies.

In explaining the requirement for a present obligation, paragraph 18 of IAS 37 states that 'no provision is recognised for costs that need to be incurred to operate in the future' and paragraph 19 of IAS 37 states that 'it is only those obligations arising from past events existing independently of the entity's future actions (ie the future conduct of its business) that are recognised as provisions'. Applying those paragraphs, the Committee concluded that, if the commitment described in the fact pattern creates a constructive obligation for the entity:

(a) that obligation is not a present obligation as a result of a past event when the entity publishes its commitment in 20X0. The costs that the entity will need to incur to modify its manufacturing methods and to offset the greenhouse gases that it emits in 20X9 onwards are costs that it will need to incur to operate in the future—the obligations for those costs do not exist independently of the entity's future actions.

(b) only when the entity has emitted the greenhouse gases that it has committed to offset will it have a present obligation to purchase and retire the carbon credits required to offset those greenhouse gases. The entity will have a present obligation to purchase and retire carbon credits only if and when it emits greenhouse gases in 20X9 and later years.

Probable outflow of resources

The second criterion for recognising a provision is that it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

The Committee concluded that, if the commitment described in the fact pattern creates a constructive obligation for the entity:

(a) settling the obligation to reduce the entity's greenhouse gas emissions will not require an outflow of resources embodying economic benefits. Although the entity will incur expenditure to modify its manufacturing methods, it will receive resources of equal value—for example, property, plant, equipment, energy, product ingredients or packaging materials—in exchange for that expenditure, and will be able to use these resources to manufacture products it can sell at a profit.

(b) settling the obligation to offset the entity's remaining greenhouse gas emissions will require an outflow of resources. The entity will be required to purchase and retire carbon credits without receiving any resources in exchange.

Reliable estimate

The final criterion for recognising a provision is that a reliable estimate can be made of the amount of the obligation.

Paragraph 25 of IAS 37 states that 'except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision'.

The Committee concluded that in the fact pattern described, it is likely that the entity would be able to make a reliable estimate of the amount of an obligation that satisfies the other recognition criteria.

Conclusion on whether a provision is recognised

The Committee concluded that, in the fact pattern described:

(a) whether the entity's statement of its commitment to reduce and offset its greenhouse gas emissions creates a constructive obligation will depend on the facts of the statement and the circumstances surrounding it.

(b) if the statement creates a constructive obligation:

  (i) the entity does not recognise a provision when it makes the statement. At that time, the constructive obligation is not a present obligation as a result of a past event.

  (ii) as the entity emits greenhouse gases in 20X9 and thereafter, it will incur a present obligation for the expenditure required to offset its past emissions. If it has not already bought the carbon credits needed to offset its past emissions, and assuming that a reliable estimate can be made of the amount of the obligation, the entity recognises a provision for the cost of buying and retiring those carbon credits.

The Committee observed that, irrespective of whether an entity's commitment to reduce or offset its greenhouse gas emissions results in the recognition of a provision, the actions the entity plans to take to fulfil that commitment could affect the amounts at which it measures its other assets and liabilities and the information it discloses about them, as required by various IFRS Accounting Standards.

Continues/

If a provision is recognised, is the expenditure required to settle it recognised as an asset or as an expense when the provision is recognised?

The Committee observed that expenditure is recognised as an asset, rather than as an expense, only if it gives rise to—or forms part of the cost of—an item that qualifies for recognition as an asset in accordance with an IFRS Accounting Standard.

The Committee's conclusion

The Committee [tentatively] concluded that the principles and requirements in IFRS Accounting Standards provide an adequate basis for an entity to determine:

(a) the circumstances in which an entity recognises a provision for the costs of fulfilling a commitment to reduce or offset its greenhouse gas emissions; and

(b) if a provision is recognised, whether the costs are recognised as an asset or as an expense when the provision is recognised.

Consequently, the Committee [tentatively] decided not to add a standard-setting project to the work plan.

Appendix B—Submission

Submission: Recognising a provision for a Net Zero Transition Commitment as a constructive obligation

'A **Net Zero Transition Commitment** is a sufficiently specific statement and/or established patterns of past practice through which an entity has indicated to other parties—including the public at large—that it has accepted responsibility to reduce carbon emissions and as a result of which has created a valid expectation that it will reduce those emissions. An example is '*50% reduction in Scopes 1 and 2 emissions by 20X9'*. Other examples are below.

This submission is being made to the Interpretations Committee by the Rethinking Capital community and The Catatysts.io Limited. It concerns the key question of whether a Net Zero Transition Commitment meets the criteria to be recognised as a provision under IAS37 (Provisions, Contingent Liabilities & Contingent Assets) as a 'constructive obligation'.

This submission also explains:

- The perceived market distortion and other negative economic and other effects of the current accounting practice of not providing for a Net Zero Transition Commitment as a constructive obligation, and

- the positive future economic and other benefits that would flow from providing for a Net Zero Transition Commitment as a constructive obligation and an entity investing to meet the commitment over time.

Net Zero Transition Commitments began to be made at scale in early 2020 following the commitments of oil and gas leaders to transition out of fossil fuels and into a mix of fossil fuels and new energy technologies by 2050—with interim steps to reduce emissions in Scopes 1 and 2, typically by 20X9. In the run up to the United Nations' COP26 in Glasgow in December 2021, driven by valid expectations of the public at large, many hundreds of companies, cities and countries followed and set both end state and interim net zero targets to reduce carbon emissions over time.

To our knowledge, no company has so far recognised and provided for its Net Zero Transition Commitment as a constructive obligation, nor explained why not. Among the negative effects of this are that the incentives to transition to net zero are upside-down, explained in the supporting presentation '*Tackling the Root Cause of Climate Inequity'*.

It is acknowledged that the IASB is currently developing proposals to amend IAS37 which could be issued in 2025. The purpose of this submission is to establish that a valid interpretation of IAS37 could provide a bridge in time and the financial incentives to enable business, investors and others to make better informed decisions to tackle the climate crisis now. The timing imperative was emphasised on 20th September 20X0 by UN Secretary General Antonio Gutteres describing that, in failing to tackle the climate crisis, 'humanity has opened the gates of hell'.

This submission therefore requests that the Interpretations Committee consider the interpretations that:

1. A Net Zero Transition Commitment meets the definition of a constructive obligation under IAS37 paragraphs 10 and 20, and

2. A Net Zero Transition Commitment should be recognised as a provision according to the principles of paragraphs 11-26 of IAS37, and

3. Starting with recognising a provision, the principles and accounting for asset decommissioning should be applied to a strategy and investment program designed to meet a Net Zero Transition Commitment—using the analogy that an entity is committing to decommission its carbon-emitting infrastructure.

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5. Economic and other benefits of the proposed solution and path to adoption
6. Counter-argument against recognising a provision as a constructive obligation.

1. Definitions

In this submission these words mean:

Words	Meaning
Net Zero Transition Commitment	A sufficiently specific statement through which an entity has indicated to other parties—including the public at large—that it has accepted responsibility to reduce carbon emissions and as a result of which has created a valid expectation that it will reduce those emissions. The sufficiently specific statement may have been supported by published polices and/or Established Patterns of Practice (as defined below). Examples are below, illustrating also that a common language and concepts exist including definitions of Scopes 1, 2 and 3 emissions and how they are reliably measured and reported. The entity may have created and reflected its Net Zero Transition Commitment in a transition plan describing how emissions can be

	reduced and possibly describing the technical, economic and other constraints to this being achieved. A Net Zero Commitment can be any or all of: 1. An entity committing to be 'net zero or 'carbon neutral' or similar words by a future date, say 2050' (End State Commitments). End State Commitments can sometimes be described as 'Paris-Aligned' or 'in line with IPCC Pathways' or 'science-based targets' or similar—indicating an intention to recognise the general imperative to remain within a 1.5 degrees centigrade increase (System Level Imperative). 2. An entity committing to interim targets to reduce carbon emissions by percentages such as 25, 30 or 50% by an interim date such as 20X9 or 2035 and/or to reduce specific amounts or ranges of emissions reductions by target dates (Interim Commitments). 3. An entity in the oil and gas sector describing how emissions will be reduced through actions including (a) changing the products it produces and sell, for example by replacing fossil fuel production with renewable energy production and/or (b) repurposing petrochemical plants to produce chemicals using raw materials from renewable sources (c) purchasing carbon credits or offsets (d) investing into innovations such as carbon capture or direct air capture (e) investing into exploration of renewable energy sources (Oil and Gas Sector Commitments). 4. Entities in other sectors with high carbon emissions including steel, chemicals, mining and concrete (known as 'hard to abate' sectors, described further in the mission of the Mission Possible Partnership) setting out sector-level strategic plans to meet an End State Commitment across the sector, typically also making an Interim Commitment and participating in initiatives to create sector-specific pathways to Net Zero (Sector-Specific Commitments). 5. Entities typically in the consumer product sector responding to consumer expectations by making commitments for the entity and its supply chain and the

	consumers of its products. For example an Interim Commitment to 'carbon neutrality of direct operations (scopes 1+2) by 2025' and/or 'net-zero emissions of value chain (scopes 1+2+3) by 2040' (Consumer Commitments). 6. An entity committing to actions that have the secondary effect of reducing carbon emissions. Examples are (a) to reduce tonnes of plastic waste which has a secondary effect of reducing carbon emissions in the plastic production process or (b) investing in regenerative farming or land use preservation to increase nature's capacity to sequester carbon or (c) other forms of what are known as nature-based solutions (Secondary Effect Commitments). 7. An entity, for example in the cloud computing sector, committing to accelerate its net zero targets and End State Commitment by identifying how to achieve that target with certainty through a combination of moving to cloud data centres and purchasing carbon credits and/or offsets to accelerate to '20 years ahead of target' (Acceleration Commitments). 8. An entity stating that its operations are already carbon neutral and will remain so in future—for example by emissions being offset through the purchase of carbon credits (Current State Commitments). 9. An entity stating that it will be 'carbon negative' by a future date and/or that it will repair its past emissions (Beyond Net Zero Commitments). Although sometimes described as either 'ambitions' 'aspirations' or 'pledges' by those making them, for these purposes these and other similar statements are defined as a Net Zero Transition Commitment.
Established Patterns of Practice	Established patterns of practice by the entity over time can indicate that it recognises the obligation and/or updates and reports on its progress in meeting the Net Zero Transition Commitment, including all or any of actions such as: 1. Stating the commitment on its website or otherwise in public.

	2. In the narrative to or otherwise stated in its financial statements. 3. In investor presentations. 4. By creating and/or publishing a net zero transition plan. 5. By allocating capital into meeting the obligation, which would be wasting resources if it were not an obligation. 6. By the entity joining programs to work on the net zero transition and sustainability generally. 7. In its statements made when 'walking back' from the commitment (including the original commitment still being on its website) that recognise the original commitment. 8. By Consumer Commitments and other valid expectations set with Net Zero Focused Consumers.
Net Zero Focused Consumers	Consumers of an entity who are conscious of whether and to what extent the entity is making decisions purposed to reduce its carbon emissions and who are or may be taking into account the entity's Net Zero Transition Commitment and its Established Patterns of Practice in their buying decisions. These decisions may include paying higher prices to share in the cost of the transition to net zero—thereby effectively contributing financially to the entity and improving the entity's cashflows.
Net Zero Focused Investors	Investors of an entity who are conscious of whether and to what extent the entity is making decisions purposed to reduce its carbon emissions, and who are or may be taking into account the entity's Net Zero Transition Commitment and its Established Patterns of Practice in their investment decisions. These investors may be accepting lower economic returns in the short term in return for long-term growth and the lowering of economic risks to the entity from the climate crisis over time—thereby effectively contributing economically to share in the cost of the net zero transition. These investors can be referred to by descriptions such as ESG, impact, sustainable, responsible or similar.

2. About Net Zero Transition Commitments

The imperative that seemed to both force and enable Net Zero Transition Commitments to be made at scale was COP26 in Glasgow in 2021 and, in particular, the climate crisis being described in its annual report by the Intergovernmental Panel on Climate Change (IPCC, the United Nation's body for assessing the science related to climate change) as 'code red for humanity' in 2021. After the 20X0 IPCC report UN Secretary General Antonio Gutteres has referred to this being '*The Age of Global*

Boiling'. And in his 20th September 20X0 address to the United Nations conference in New York, Gutteres described how, in failing to tackle the climate crisis, '*humanity has opened the gates of hell*'.

Net Zero Transition Commitments began to be made at scale in early 2020 following commitments in the oil and gas sector to transition out of fossil fuels and into a mix of fossil fuels and new energy technologies, typically by 2050 with interim steps towards that target, typically by 20X9. In response, thousands of companies made Net Zero Transition Commitments. The significance in the corporate sector cannot be understated because, according to research, 20% of embodied carbon emissions can be traced back to the global supply chains of multinational corporations. As a further response, Net Zero Focused Investors in listed companies made their own Net Zero Transition Commitments, individually and in groups such as the Glasgow Financial Alliance on Net Zero (GFANZ), Climate Action 100+, and the Net Zero Asset Owners Alliance. Together these alliances, representing hundreds of trillions of dollars of assets under management themselves 'committed' to the net zero imperative—and on the basis of which those Net Zero Focused Investors then made their own Net Zero Transition Commitments to their own investors and other stakeholders.

According to research from NetZeroClimate.org at Oxford University, some 1266 of the 2000 largest listed companies have made a Net Zero Transition Commitment, according to its 20X0 Net Zero Stocktake Report. The report summary states:

- *65% of the annual revenue of the world's largest 2000 companies is now covered by a net zero target, demonstrating that net zero is becoming a corporate norm.*
- *There has been a huge rise in targets enshrined in national legislation or policy in the last 2.5 years, from 10% to 75%. The authors say this shows that net zero has moved from ambition to implementation.*
- *Integrity is lacking; there are few signs of improvement in national, subnational and company net zero strategies over the past year.*

With which parties has a valid expectation been set?

It is our view that a valid expectation has been set:

(a) In the capital markets, with Net Zero Focused Investors many of whom have adopted a strategy of staying with the company and '*greening it*' over time. And committing to take lower financial returns in the short term in order to meet the net zero imperative with the expectation of increased shareholder value over time.

(b) In the capital markets with Net Zero Focused Investors joining alliances to support the net zero targets such as GFANZ, the Climate Action 100+, Net Zero Asset Owners Alliance and Net Zero Asset Managers Alliance. Investors within these groups have then made their own commitments within and to these groups and, by fiduciary duty, to their own investors and the public at large.

(c) In the capital and insurance markets with a similar Net Zero Insurers Alliance.

(d) With the capital markets themselves where the International Organization of Securities Exchanges (IOSCO) has committed to support and adopt new standards in climate and sustainability reporting.
(e) In the capital markets and otherwise, for boards and in particular non-executive directors, who have a duty of care to investors and to their company to hold management to account. And for whom, the entity not recognising a Net Zero Transition Commitment could even open the risk of personal liability.
(f) In the capital markets and generally to comply with and simplify the creation of transition plans—a project in which the Transition Transparency Taskforce has been active since COP26 in Glasgow in 2021.
(g) With suppliers and other stakeholders of the entity and which has just published its first Disclosure Framework.
(h) With Net Zero Focused Consumers from whom an entity would expect to receive future economic benefits in reliance on the Net Zero Transition Commitment.
(i) With the public at large who may be users, staff or have other stakeholder relationships with an entity and from whom an entity would expect to receive future economic benefits in reliance on the Net Zero Transition Commitment.

3. Negative economic and other effects of non-recognition of a provision

3.1 The accounting practice of not recognising a Net Zero Transition Commitment as a provision

Despite all these Net Zero Transition Commitments having been made:

- To our knowledge, no entity has recognised a provision for a Net Zero Transition Commitment a constructive obligation applying the principles of paragraphs 10 and 20 and 11-26 of IAS37.

- To our knowledge, nor has any entity explained why its Net Zero Transition Commitment is not being recognised as a provision as a constructive obligation.

It is mostly beyond the scope of this paper to discuss why. Our opinion is described in the presentation '*Tackling the Root Cause of Climate Inequity*' attached with this submission—suggesting why the problem may simply have become too big to recognise. Given the time imperative to act in the face of the climate crisis, it is recommended that non-recognition is accepted as fact and that the emphasis be placed on providing a solution to the problem that benefits the entity and all those with whom a valid expectation may have been created.

3.2 Market distortion and other economic effects of non-recognition

In our view, the consequences of non-recognition of a Net Zero Transition Commitment include:

(a) Upside down incentives. That an entity is then disincentivised from making investments to meet the commitment because it cannot then recognise investments with the purpose of meeting the commitment as assets on the balance sheet. The effects here include that it '*appears*' that returning excess profits of the energy crisis (some $298 billion in 2022-23) to investors through share buybacks and dividends, is a better investment than investing into the balance sheet through meeting or accelerating the Net Zero Transition Commitment. This benefit also not therefore being taken into account in credit rating analysis.

(b) Mindset effect. That a mindset has been created that deciding to allocate capital into meeting the Net Zero Transition Commitment may risk missing projected and assumed growth rates and/or negatively impact profitability in the short term.

(c) Pressure to walk back. As shown by recent events in the oil and gas sector, pressure can be applied by investors that are not Net Zero Focused Investors to reduce an End State Commitment and the Interim Commitment even though Net Zero Focused Investors expect or may want the entity not to reduce it. This practice of 'walking back' on a Net Zero Transition Commitment then sets the tone for others in the market to do the same. This distortion is unfavourable to the economic interests of Net Zero Focused Investors, for whom Net Zero Transition Commitments should be assumed to 'become' and be priced as obligations in the future—whether by regulation or a carbon tax for example.

(d) Low accountability for stewarding economic resources. In that those parties with whom a valid expectation has been set are not able to hold the entity and its board accountable and/or that progress against meeting the target is not transparent in the annual published financial statements. And further that non-executive directors and boards are not able to hold their entities accountable or assess management's stewardship of the entities economic resources—a principle enshrined in the IASB Conceptual Framework for example in paragraphs 1.3, 1.13, 1.15, 1.16, 1.18, 1.20, 1.22 and 3.2.

(e) Consumers affecting. In that Net Zero Focused Consumers are not able to make informed decisions.

4. Proposed solution: recognising a provision for a Net Zero Transition Commitment as a constructive obligation

The proposed solution is described in the three submission questions, which are answered here and supported by the relevant paragraphs of IAS37.

Interpretations for submission

<u>Interpretation 1: A Net Zero Transition Commitment meets the definition of a constructive obligation under IAS37 paragraphs 10 and 20</u>

Paragraph 10: definition of a constructive obligation

'A constructive obligation is 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'.*

Paragraph 20: the obligation may be to the public at large

An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

It is submitted that a Net Zero Transition Commitment does meet the definition of paragraphs 10 and 20 for these reasons:

Reason 1: Decision logic

In making a Net Zero Transition Commitment, what logically were the directors of an entity doing? Deductive logic says that they were:

(a) recognising that a social norm was being established and recognising an obligation to investors, the public at large and other stakeholders to reduce carbon emissions.

(b) committing to a program to reduce emissions over time through a series of emission reduction targets from current emissions state to an end state or an interim state.

(c) to the extent possible when making Interim Commitments, making a decision on what emissions could be most easily achieved in a shorter timeframe to 20X9—reflecting the System Level Imperative.

Reason 2: Separating the definition of a constructive obligation

Does the obligation derive from the entity's actions?

This is a matter of fact. It seems clear from each of the categories and examples reviewed that a first Net Zero Transition Commitment and then each category came from the entity, typically announced by the Chief Executive Officer or another executive level member or board member. And was then typically followed by an Interim Commitment and more granular commitments specific to the entity. Further, the entity typically then created all or any of the Established Patterns of Practice, itself recognising its own commitment.

Put another way, no third party either made the commitment and/or created the Established Patterns of Practice. Though with net zero transition plans there is evidence that Net Zero Focused Investors reacted and worked with the entity in its creation.

Concluding that the obligation has derived from the entity's own actions.

Three part logic

The following three part logic can be applied to sub-paragraph (a) of paragraph 10.

'A constructive obligation is 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.

Part 1: Strength

A Net Zero Transition Commitment can be seen as the implied terms of a contract between the entity and its stakeholders to reduce emissions over time—including investors, nature as a stakeholder from whom the entity uses resources, the public at large, staff, etc. Strength recognises the reality that achieving a Net Zero Transition Commitment is hard and needs to rethink well-established business strategies and practices and be balanced against the entity's need to be financially sustainable. Strength is a continuum ranging from:

(1) an End State Commitment which will typically be longer term (2040 or 2050) but typically expressed to be guided by the System Level Imperative acknowledging that action is needed now and over time.

(2) shorter or near term Interim Commitments with increasingly granular elements that describe what the entity can commit to now and work towards now with certainty.

Part 2: Nature

There is no realistic alternative to avoid future economic outflows as a result of a Net Zero Transition Commitment and it is only a matter of quantum. There is also no realistic alternative to avoid because, as the NetZeroClimate.org at Oxford University, 20X0 Global Stocktake Report states '*There has been a huge rise in targets enshrined in national legislation or policy in the last 2.5 years, from 10% to 75%. The authors say this shows that net zero has moved from ambition to implementation'* indicating a possible shift from not only a constructive obligation to a legal obligation (explained further below). And the reason that a commitment is to be met over time is the entity recognising that outflows must be balanced against the requirement that the entity is financially sustainable over its duration. Nature is also a continuum from:

(1) the higher certainty of the quantum of outflows needed over the shorter term to meet Interim Commitments, typically described in a net zero transition plan or other Established Patterns of Practice.

(2) the lower certainty of the quantum of outflows over the medium to long term.

Part 3: Timing

Timing is determined by dates expressed in the commitment itself. Timing seems typically to acknowledge the System Level Imperative and also the extent to which the entity can meet the Strength and Nature elements. Timing is also a continuum from:

(1) the shorter term Interim Commitments and steps in between typically described in a net zero transition plan or other Established Patterns of Practice;

(2) the medium or longer term beyond Interim Commitments and towards End State Commitments.

Logical general principles

Using these three criteria, three logical general principles can be established consistent with management's stewardship of the entities economic resources:

Principle 1: any Net Zero Transition Commitment meets the Strength, Nature and Timing criteria but

Principle 2: Longer Timing gives greater uncertainty in quantum of outflows in Nature and consequently must be lower in Strength, and

Principle 3: Shorter Timing gives greater certainty in quantum of outflows in Nature and is consequently can be greater in Strength.

The analogy here is a new business strategy, often called a pivot, to transition from a current to a new business model over time. Naturally in business (and life) longer timeframes must mean higher uncertainty.

Reason 3: Analysis of each category of Net Zero Transition Commitment

No	Category	Strength	Nature	Timing	Meets the general logical principles
1.	End State Commitments	Yes, particularly when combined with Interim Commitments and other categories.	Yes, because the starting state and the end state can be reliably and independently measured and verified.	Yes, particularly when combined with Interim Commitments and other categories.	Yes
2.	Interim Commitments	Yes, particularly when supported by Established Patterns of Practice.	Yes, because the starting state and the end state can be reliably and independently measured and verified.	Yes, particularly when supported by Established Patterns of Practice.	Yes

3 to 8.	Each or any combination of: Oil and Gas Commitments Sector-Specific Commitments Consumer Commitments Secondary Effect Commitments Acceleration Commitments Current State Commitments Beyond Net Zero Commitments	Yes, particularly when supported by Established Patterns of Practice.	Yes, because the starting state and the end state can be reliably and independently measured and verified.	Yes, particularly when supported by Established Patterns of Practice.	Yes

A legal obligation under paragraph 10 of IAS37?

We believe that as net zero transition plans become increasingly required and enforceable by legislation and litigation actions to require accountability for existing fiduciary and other duties grow, prudence in stewardship supports the argument that a Net Zero Transition Commitment has already or will become a 'legal obligation' as defined in paragraph 10 of IAS37:

A legal obligation is an obligation that derives from:

(a) a contract (through its explicit or implicit terms);

(b) legislation; or

(c) other operation of law.

Reason 4: Has the Net Zero Transition Commitment created valid expectations under paragraph (b) and do these include the public at large?

'A constructive obligation is an obligation that derives from an entity's actions where:

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

It is submitted that a valid expectation has been created with a range of stakeholders. And that this was the intended purpose of making it. In particular a valid expectation has been created with Net Zero Focused Investors and Net Zero Focused Consumers because each can have a material impact on the entity's operating success and hence its share price and the value of its debt obligations.

Net Zero Focused Investors have typically adopted an investment strategy of staying with the company and '*greening it*' over time. And committing to take lower financial returns in the short term in order to meet the net zero imperative with the expectation of increased shareholder value over time. A constructive obligation would be supported if it could be shown that Net Zero Focused Investors either made decisions to purchase or to continue to hold the entities debt or equity securities, at least in part, because of the commitment.

In the capital markets many Net Zero Focused Investors joined alliances to support the net zero targets such as GFANZ, the Climate Action 100+, Net Zero Asset Owners Alliance and Net Zero Asset Managers Alliance. Investors within these groups have then made their own commitments within and to these groups and, by fiduciary duty, to their own investors and the public at large. A constructive obligation would be supported if it could be shown that Net Zero Focused Investors either made decisions to join these groups and make their own commitments, because of the entities in which they hold equities making a commitment.

Valid expectations have been created with Net Zero Focused Consumers from whom an entity would expect to receive future economic benefits in reliance on the Net Zero Transition Commitment. Often advertising by the entity will emphasise the commitment. And with the public at large who may be users, staff or have other stakeholder relationships with an entity and from whom an entity would expect to receive future economic benefits in reliance on the Net Zero Transition Commitment. A constructive obligation would be supported if it could be shown that Net Zero Focused Consumers had made decisions to purchase the entity's products, at least in part, because of the Net Zero Transition Commitment made by the entity at some point during the past (past action of the entity and related stakeholder transactions).

Similarly a decision by staff to seek or continue employment with the entity based on its commitment supports the existence of a constructive obligation.

It is further submitted that valid expectations have been created:

(a) In the capital and insurance markets with a similar Net Zero Insurers Alliance.
(b) With the capital markets themselves where the International Organization of Securities Exchanges (IOSCO) has committed to support and adopt new standards in climate and sustainability reporting.
(c) In the capital markets and otherwise, for boards and in particular non-executive directors, who have a duty of care to investors and to their company to hold management to account.

And for whom, the entity not recognising a Net Zero Transition Commitment could even open the risk of personal liability.

(d) In the capital markets and generally to comply with and simplify the creation of transition plans—a project in which the Transition Transparency Taskforce has been active since COP26 in Glasgow in 2021.

(e) With suppliers and other stakeholders of the entity.

Interpretation 2: A Net Zero Transition Commitment should be recognised as a provision according to the principles of paragraphs 11-26 of IAS37.

It is submitted that the Net Zero Transition Commitment is a constructive obligation and should (or is required to be) be recognised as a provision according to the principles of paragraphs 11-26 of IAS37 for these reasons:

Reason 1: Paragraph 14 of IAS37

A provision shall be recognised when:	Analysis
(a) an entity has a present obligation (legal or constructive) as a result of a past event;	The entity has a present obligation because the Net Zero Transition Commitment has been made and has set a valid expectation that it will be met over time in a series of emission reduction targets. Established Patterns of Practice by the entity over time create new past events by indicating that it recognises the original Net Zero Transition Commitment. See Interpretation Submission 1 for further analysis.
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and	In commercial reality, the entity can realistically only meet the Net Zero Transition Commitment through a transition strategy and plan of investment into innovation that may include buying carbon credits. Net zero transition plans are typically created to explain the transition strategy and plan with specific focus on Interim Commitments that can probably achieved. See Interpretation Submission 1 for further analysis.
(c) a reliable estimate can be made of the amount of the obligation.	Reliable prices and price ranges for a tonne of carbon that are 'standard enough' already exist and are in the public domain with support from the G7 and others. Simultaneously with review of this submission the Rethinking Capital community intend to publish a paper explaining their thinking and rationale for how and from where a board

	should select its carbon price to reliably estimate the constructive obligation and investments made with the purpose of meeting it.

Reason 2: Further supporting paragraphs of IAS37

Paragraph	Analysis
17. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only: (a) where the settlement of the obligation can be enforced by law; or (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.	17 (b) specifically covers a constructive obligation being an obligating event.
19. It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.	The example of asset decommissioning of a nuclear power station is analogous and explained in the answer to Interpretation Submission 3 below. The entity cannot avoid future expenditure to meet the Net Zero Transition Commitment.
21. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive	Established Patterns of Practice represent acts that give rise to the constructive obligation being repeated and updated.

obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.	

<u>Interpretation 3: Starting with recognising a provision, the principles and accounting for asset decommissioning should be applied to a strategy and investment program designed to meet a Net Zero Transition Commitment—using the analogy that an entity is committing to decommission its carbon-emitting infrastructure.</u>

The business principles, strategies and accounting for 'asset decommissioning' are well-established. They provide a good parallel in both business and accounting terms for the strategy and investment program designed to meet the Net Zero Transition Commitment—or to decide not to meet it. Paragraph 19 of IAS37 specifically mentions the established principles of asset decommissioning and in particular that of a nuclear power station is analogous.

From a business and strategy perspective, in making the Net Zero Transition Commitment, the entity is effectively committing to 'decommission its carbon emitting infrastructure and business practices' over time through a series of emission reduction targets that may be reflected in a net zero transition plan. The implied 'contract' terms can be determined from the Net Zero Transition Commitment itself and by the associated Interim Commitments and any of the other commitment categories set out in paragraph 2, together with associated Established Patterns of Practice.

The Strength, Nature and Timing and other terms of the Net Zero Transition Commitment explained in Submission Interpretation 1. may alter over time during the commitment periods (an entity may increase the emissions to be reduced and/or accelerate the commitment date and/or set granular targets for example) each of which would alter the terms.

And as with contracts for asset decommissioning, the entity should consider in its strategy, program and accounting the probability that it will (a) meet the commitment targets—and that meeting those targets will create future inflows of economic resources (the equivalent of milestone or similar payments in contracts for decommissioning a nuclear power station) or (b) miss the commitment targets and incur future outflows of economic resources (the equivalent of penalties for delays or missed targets in contracts for decommissioning a nuclear power station).

The accounting treatment for asset decommissioning having recognised the provision is well established, both in IAS37 and in accounting practice. The equivalent accounting treatment for investments purposed to meet the Net Zero Transition Commitment would be to capitalise expenditure into innovation, carbon credits and other assets at cost of creation and to either revalue or impair those investments depending on whether they achieved their intended purpose of reducing emissions in the year in question.

A note to the financial statements would be made to explain that the Net Zero Transition Commitment will be met over time in a series of annual emission reduction targets and to refer users to the strategy and transition plan for meeting it. This note would also explain the associated accounting treatment and be updated at least annually.

5. Future economic and other benefits of the proposed solution and path to adoption

The six main features and benefits of the proposed solution for the entity, Net Zero Focused Investors, Net Zero Focused Consumers, boards, capital markets, the public at large and other stakeholders will be:

(a) **Better informed decisions and stewardship.** Enabled by accounting for and governing the assets, obligations and risks impacted by the Net Zero Transition Commitment and the associated strategy and plan to meet it.

(b) **Many key financial metrics will materially improve.** As the entity allocates capital into and achieves its Net Zero Transition Commitment over time, each of profitability, shareholder equity, earnings per share, return on equity and debt to equity ratios will materially improve. It may be that the entity could appear to be more highly leveraged when it recognises the provision at the start of the year in question but the accounting treatment explained in the suggested note can explain that this appearance is necessary to recognise the future economic benefits of meeting the commitment.

(c) **Creates positive, immediate and certain incentives**. Giving the financial incentives to invest into meeting the Net Zero Transition Commitment and incentives to accelerate—flipping today's upside down incentives.

(d) **Should remove the risk of personal liability for directors and officers**. By demonstrating that the Net Zero Transition Commitment is being recognised and investments made to meet it recognised as assets.

(e) **Transparency of the important management decisions**. Using financial statements to inform and report decisions to allocate capital to the transition in annual budget setting and strategic planning.

(f) **Accountability to internal and external stakeholders**. Showing stakeholders that the board and management are taking conscious decisions to govern economic resources impacted by the Net Zero Transition Commitment.

5.2 Path to adoption as a decision governance and parallel reporting framework & should or could?

Market based adoption

The path to adoption of the proposed solution can be determined by the market. 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 or deciding not to. And to parallel (or shadow) report these to organisations that are already active in carbon reporting such as CDP or Carbon Tracker. How reported decisions could be audited and assured can also be left to the market to determine. Such disclosures could appear in the notes to the financial statements to provide the information to Net Zero Focused Investors 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.

Applying normative accounting principles (in particular the subjectivity of value and the needs of the user) financial statements using the proposed solution are able to validly sit alongside existing published statements. This may require the entity to explain the reconciliation between both.

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.

Should or could?

For the purposes of enabling market based adoption, it is submitted that the word 'should' can be replaced with 'could' in Submission Interpretations 2 and 3.

6. Counter argument against recognition of a provision as a constructive obligation

The only argument identified against recognition and provision as a constructive obligation is the application to a Net Zero Transition Commitment previously made, say in 2020, but which has not so far been recognised as a constructive obligation and a provision by the entity. Here, the entity may have made decisions since:

(a) to invest into meeting the Net Zero Transition 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 Interim Commitments to reduce the percentage of emissions by 20X9, as has been seen in 20X0 in the oil and gas sector and known as 'walking back'. If not previously recognised as a constructive obligation, these reductions in the commitment may create materially negative economic effects including a possible charge to shareholder equity or the income statement.

The recommended logical alternative to restating financial statements backwards to the date of the original Net Zero Transition Commitment would be for the entity to update and restate its Net Zero Transition Commitment now, particularly its Interim Commitments, assuming that the proposed solution applies. 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 now to achieve the listed benefits above. The resulting accounting treatment would result in better and more complete information for all.