PARIS-ALIGNED ACCOUNTING AND AUDIT TO DELIVER NET ZERO EMISSIONS

BACKGROUND NOTE FOR THE COMMITTEE ON CLIMATE CHANGE'S POLICY ADVISORY GROUP[1]

SARASIN & PARTNERS

4 SEPTEMBER 2020

THE PROBLEM: ACCOUNTS THAT IGNORE THE PARIS AGREEMENT WILL UNDERMINE ITS ACHIEVEMENT

The Paris Agreement calls for *"finance flows consistent with the pathways towards (…) climate-resilient development[2]"*. Investors need to ensure that their capital is directed towards businesses that are profitable as the global economy transitions to net zero[3].

Financial statements are a key driver of financial flows. They provide information on levels of capital and profitability which underpin company and investor decisions on where to deploy fresh capital. Accounts that leave out material climate impacts misinform executives, shareholders and creditors and, thus, result in misdirected capital. In the case of climate change, the consequences of misdirected capital are not only harmful for shareholders, but also potentially disastrous for the planet.

Take a power company with gas generation. Does the company presume asset lives that take us beyond 2050 and thus understate its depreciation cost? Has the company failed to account for carbon capture and storage costs, escalating carbon taxes, or the falling costs of competing renewable energy – again resulting in overstated profit? Might there be impairments in certain fossil fuel-dependent assets? What about end-of-life clean-up liabilities; will these need to be brought forward, thereby wiping out capital previously reported?

Ignoring these expected costs of fossil-fuel-related activities may make the entity look more profitable than it really is. Consequently, it would likely see more capital reinvested than would be compatible with a net zero pathway. The outcome will either be excessive emissions and/or – where the government shuts the enterprise down to meet its Paris obligations – stranded assets. Neither is desirable.

TCFD RECOMMENDATIONS DO NOT COVER ACCOUNTS

At present there is little evidence that companies are taking decarbonisation (or indeed the physical impacts from climate change) into account as they draw up their financial statements. Apart from two notable exceptions (BP and Shell), auditors are likewise currently silent on whether financial statements are 'net-zero-proof'.

"At present there is little evidence that companies are taking decarbonisation (or indeed the physical impacts from climate change) into account as they draw up their financial statements"

While the Task Force for Climate-related Financial Disclosures (TCFD) guidance is being adopted increasingly widely, it does not cover financial statements. It focuses on companies' strategic report and management discussions, including the disclosure of climate risks.

This is important, but not sufficient to drive Paris-aligned investment. Company accounts shape incentives. Taking the example above of a gas-fired power plant: if it's profitable, more money will tend to be invested. To change incentives, the numbers need to change to reflect the real economic and societal costs of the activity. Companies today are declaring profits based on a presumption that their carbon emissions will continue indefinitely at no cost. There could be no clearer example of the 'tragedy of the horizon'.

THE IASB AND THE UK'S FRC HIGHLIGHT THE RELEVANCE OF CLIMATE IMPACTS TO FINANCIAL STATEMENTS, BUT THEY HAVE NOT REQUIRED PARIS-ALIGNMENT

To their credit the International Accounting Standard Board (IASB) has recently made clear that material climate factors should be considered when drawing up accounts[4]. The UK's Financial Reporting Council has also reminded directors that – under current rules – they must ensure material climate factors are properly reflected in financial statements[5].

While this guidance has reaffirmed that existing rules require that material climate risks are reported to be incorporated into accounts, this will not ensure that accounts are drawn up in line with the Paris goals.

Put simply, if directors believe the Paris Agreement is unlikely to be implemented, they are likely to disregard it in their

SARASIN
& PARTNERS

accounting. This approach is not only short-sighted, potentially putting significant capital at risk where it is allocated to carbon-intensive activities, but it will help to ensure the Paris Agreement is not met. Capital flows will not be adjusted to a net zero pathway.

Rising concern over this approach has prompted a growing number of investors to call for Paris-aligned accounts: the Institutional Investor Group on Climate Change – representing £30 trillion in assets – sets out this expectation in a forthcoming paper[6].

THE UK SHOULD MANDATE PARIS-ALIGNED ACCOUNTS AND AUDITS

While investor calls for Paris-aligned accounts have started to have an impact, and – critically – demonstrated the ability of companies to deliver Paris-aligned accounts[7]; we do not have the time to wait for this practice to ripple across markets voluntarily.

To ensure an immediate system-wide change in company accounting that supports the delivery of the UK's 2050 net-zero target, the UK Government should insist that companies and auditors deliver Paris-aligned accounts. The sooner they are introduced, the lower will be the cost — both financial and societal.

Specifically, the Department for Business, Energy and Industrial Strategy should require that directors:

- Confirm whether they have adopted Paris-aligned assumptions / estimates in their accounts, and in all cases follow IASB guidance in showing the assumptions they have used; and
- If not, explanations should be made, and supplementary disclosures provided in the Notes as to how the accounts would be impacted if they had used Paris-aligned assumptions/estimates.

Auditors should likewise be required to undertake audits that test accounts against Paris-aligned assumptions/estimates, and that flag where the assumptions fall short. The Financial Reporting Council should be tasked with enforcing these rules.

MANDATORY PARIS-ALIGNED ACCOUNTING OFFERS A QUICK AND EFFECTIVE POLICY TOOL TO HELP SHIFT THE ECONOMY ONTO A NET ZERO PATHWAY – IT ALSO PROVIDES A MODEL FOR OTHERS TO FOLLOW

Paris-aligned accounting and audit – a relatively small intervention – can be delivered quickly, and would have a systemic impact[8]. It is unlikely to require primary legislation, and it reinforces existing policies to promote Paris-aligned strategies and risk management in line with the TCFD. It is applicable to all companies that will be affected by global efforts to deliver net zero emissions, whether in energy, transportation, industry, utilities, infrastructure, real estate or finance. It offers the UK Government a powerful policy tool to deliver on its statutory climate targets, and it provides a model for other governments to follow in the run-up to hosting COP26.

[1] This briefing is made in support of Sarasin & Partners Climate Pledge and as part of Sarasin & Partners' Climate Active strategy, which seeks to ensure investee companies are run in alignment with the Paris Climate Agreement. Paris-aligned accounting is a key aspect of delivering this goal.
[2] Article 2 (1) c - https://unfccc.int/sites/default/files/english_paris_agreement.pdf#page=5
[3] https://www.nature.com/articles/s41558-017-0042-4
[4] https://www.ifrs.org/news-and-events/2019/11/nick-anderson-ifrs-standards-and-climate-related-disclosures/
[5] https://www.frc.org.uk/getattachment/71345784-8f60-438b-a474-fc7c79ace9e3/Year-end-letter-(003).pdf
[6] Paris-aligned accounts: investor expectations" forthcoming IIGCC paper, Sept 2020.
[7] The ability for companies to act swiftly has been demonstrated by oil and gas companies BP, Royal Dutch Shell and Total, which – following investor engagement – all reviewed their 2019 accounts in light of the Paris Agreement and the accelerating energy transition. All three adjusted critical accounting judgements, resulting in impairments.
[8] https://science.sciencemag.org/content/364/6436/132.full

IMPORTANT INFORMATION

SARASIN & PARTNERS LLP

Juxon House
100 St. Paul's Churchyard
London EC4M 8BU

T +44 (0)20 7038 7000
www.sarasinandpartners.com