NET-ZERO ACCOUNTING TO DELIVER NET-ZERO EMISSIONS

AN INVESTOR CALL FOR GOVERNMENT ACTION AT COP26

CALL FOR ACTION AT COP26

The Paris Agreement calls for “finance flows consistent with the pathways towards (…) climate-resilient development”[1].

For this to be delivered, companies’ financial statements must be aligned with a 1.5°C-pathway. Based on current scientific understanding, this means companies’ accounts should consider the global transition towards net-zero greenhouse gas emissions by 2050[2]. Likewise, for governments that have committed to achieve net-zero emissions by 2050, net-zero aligned accounting is an essential policy lever without which efforts to redirect private capital flows will be severely hampered. Global institutional investors representing over $100 trillion in assets have been calling on companies and auditors to deliver net-zero aligned accounts since last year. As we approach COP26, governments should set a clear and urgent timeline for companies to produce accounts and audits that consider the global transition onto a 1.5°C pathway.

ACCOUNTS THAT IGNORE THE PARIS AGREEMENT WILL UNDERMINE ITS ACHIEVEMENT

The financial statements act as the nerve centre for decision-making on capital allocation. They provide information on levels of capital and profitability which underpin company and investor decisions on where to invest. 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 investors, customers, staff and suppliers, but also disastrous for the planet.

Take a power company with gas generation. If the company presumes that its assets will be in use beyond 2050 (or indeed 2035 in certain cases, as set out by the IPCC), it will understate its annual depreciation cost. If the company fails to account for costs or market disruption associated with the net-zero transition, such as cheaper renewable energy or escalating carbon taxes, again it will likely overstate its capital and profitability. Hidden impairments would be a risk, as would earlier decommissioning liabilities.

These accounting considerations are not just technical matters, and they are not limited to gas-fired power companies. Ignoring the expected disruption

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from decarbonisation that we know will come for companies in a multitude of sectors – which the vast majority of listed companies appear to be doing in their accounting today – is potentially making a wide range of entities look more profitable than they really are. This, in turn, results in fresh capital flowing into potentially impaired businesses whose continued operation is not compatible with a net-zero pathway. Neither is desirable.

GOVERNMENTS SHOULD MANDATE NET-ZERO ACCOUNTS AND AUDITS

Governments need to act now by setting out a clear and urgent timeline for companies to produce accounts and audits that consider the global transition onto a 1.5ºC pathway. This means that companies should consider how the global decarbonisation effort to achieve a 1.5ºC outcome will impact their businesses, and thus the reliability of their reported financial positions[3]. To deliver this, the IEA's recently published Net-zero Emissions 2050 scenario offers a credible third-party reference point[4].

If companies decide not to use a 2050 net-zero pathway as their base case for their financial statements – for instance, because they do not believe this is the most likely outcome – then they should be required to disclose how the entity's financial position would likely be impacted by such a pathway in the notes to the accounts. This sensitivity analysis should cover all aspects of the business that are likely to experience material impacts.

Furthermore, governments should require auditors to test whether companies' accounts adequately consider accelerating decarbonisation. When they determine that the company has not done so, they should be required to report publicly where they believe the largest material risks to lie.

MANDATORY NET-ZERO ACCOUNTING WOULD BOLSTER TCFD REPORTING

A requirement for companies to report on how a net-zero pathway will impact their financial statements complements moves to oblige companies to publish strategic and risk reports in line with the Task Force for Climate-related Financial Disclosures (TCFD) guidance. Indeed, net-zero accounts will prove critical to ensuring companies do not just report their climate risks, but act in a way to mitigate such risks.

We have seen helpful guidance published by the International Accounting Standard Board (IASB), the International Audit and Assurance Standards Board, and the UK's Financial Reporting Council in the past two years, setting out expectations that material climate factors need to be considered when drawing up accounts[5]. However, none of these oblige companies to consider a 1.5ºC pathway. Consequently, if directors choose to ignore the Paris Agreement, they can.

INVESTORS ARE CALLING FOR NET-ZERO ACCOUNTING

Rising concern over the lack of financial disclosures has prompted a growing number of investors to call for Paris-aligned accounts. In September 2020, a clear call for action by companies to publish accounts compatible with the Paris Agreement was published by the Principles for Responsible Investment, the Institutional Investors Group on Climate Change, the Asset Owner Alliance, the UNEP Finance Initiative, the Investor Group on Climate Change, the Asia Investor Group on Climate Change, and the UK's Pensions and Lifetime Savings Association[6]. Taken together, these institutions represent over $100 trillion in assets under management. In November 2020, the IIGCC published a detailed paper setting out precisely what investors expect from companies and auditors to meet these expectations[7]. A similar paper was published in June 2021 by Ceres in the US for oil and gas companies[8].

GOVERNMENTS SHOULD MANDATE PARIS-ALIGNED ACCOUNTS AND AUDITS

While investor calls for Paris-aligned accounts have started to have an impact, and demonstrated the ability of companies to produce Paris-aligned accounts[9], time is not on our side. We do not have years to wait for companies to voluntarily review and revise their financial statements. To ensure a sufficiently rapid system-wide change, governments should mandate 1.5ºC-aligned accounts. The sooner governments act, the lower the cost - both financial and societal.

Specifically, governments should require that directors:

- Confirm whether they have adopted 2050 net-zero-aligned assumptions and estimates in their accounts, and in all cases follow IASB guidance in showing the assumptions they have used; and
- If they choose not to use net-zero-aligned assumptions, explanations should be made, and supplementary disclosures provided in the notes as to how such assumptions/estimates would be expected to impact the entity's financial position.

Auditors should likewise be required to test accounts against net-zero-aligned assumptions/estimates, and alert shareholders where the assumptions fall short.

SIGNATORIES

SARASIN & PARTNERS LLP

ANDRA AP-FONDEN (AP2)

BRUNEL PENSION PARTNERSHIP LIMITED

CANDRIAM

CHURCH COMMISSIONERS FOR ENGLAND

EOS AT FEDERATED HERMES (ON BEHALF OF ITS STEWARDSHIP CLIENTS)

ENVIRONMENT AGENCY PENSION FUND

KBI GLOBAL INVESTORS

LAEGERNES PENSION

LOCAL AUTHORITY PENSION FUND FORUM

P+ (PENSIONSKASSEN FOR AKADEMIKERE)

PKA LTD (DANISH LABOUR MARKET PENSION FUND)

[1]https://unfccc.int/sites/default/files/english_paris_agreement.pdf#page=5 (see Article 2, item 1).

[2]A 2050 net-zero target is an average, with earlier or later net-zero targets dependent on the sector and geography. The IPCC provides more detailed breakdowns, which are regularly updated for the latest climate science. Ultimately, the goal must be aligned with a 1.5ºC temperature outcome, as identified in the Paris Agreement.

[3]They should also underline the need to reflect any foreseeable impacts from the physical changes we expect to happen. This should already be incorporated under existing accounting standards (see below).

[4]https://www.iea.org/reports/net-zero-by-2050

[5] https://www.ifrs.org/news-and-events/news/2019/11/nick-anderson-ifrs-standards-and-climate-related-disclosures/ https://www.frc.org.uk/getattachment/71345784-8f60-438b-a474-fc7c79ace9e3/Year-end-letter-(003).pdf

[6]https://www.unpri.org/accounting-for-climate-change/investor-groups-call-on-companies-to-reflect-climate-related-risks-in-financial-reporting/6432.article

[7]https://www.iigcc.org/resource/investor-expectations-for-paris-aligned-accounts/

[8]https://www.ceres.org/resources/reports/lifting-veil-investor-expectations-paris-aligned-financial-reporting-oil-and-gas

[9]The ability of 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.

CONTACT US

T +44 (0)20 7038 7000
E marketing@sarasin.co.uk
sarasinandpartners.com

IMPORTANT INFORMATION

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