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# The case for building climate reporting into financial accounting

Temanummer: Klimakrisen – de næste skridt

*For mitigation efforts against climate breakdown to be effective they need to bring in the private sector in a meaningful way. Current standards for financial reporting for commercial organizations focus on the interests of capital suppliers to the exclusion of other stakeholders and civil society. These stakeholders include the suppliers of capital, trading partners, employees, regulators, tax authorities, and civil society. So far initiatives to include environmental and social costs have been additive rather than substantive. In this think piece we offer a radical proposal in the form of sustainable cost accounting (SCA). As a standard SCA would build on existing accounting principles to require commercial organizations to report on how they will manage the costs of becoming net carbon zero compliant. SCA does not include carbon pricing or the cost of offsets. It would require the commercial organization to establish the costs of the transition to carbon neutrality. Regulatory requirements, enmeshment in transnational standards, and adequate auditing would implement SCA. If SCA was mandatory and comprehensively applied it would take a significant step in bringing business onside in addressing climate breakdown.*

## 1. Introduction

There is a crisis created by global warming.<sup>1</sup> It is now acknowledged science that this has been created by human activity, largely as a consequence of the burning of fossil fuels, much of which has been undertaken in the course of commercial activity. Despite this, many of the calls for social, economic and environmental reform, such as those described as the Green New Deal, have very little at all to say about how private sector commercial activity will be impacted by the transition to a net zero carbon economy that they propose. In this think piece we suggest that sustainable cost accounting (SCA) might provide a mechanism to address this deficiency by integrating the impact of climate change into the financial statements of major commercial organisations.<sup>2</sup>



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## 2. Background

At present very few commercial organisations recognise the cost of global heating in their financial statements. This is because the International Financial Reporting Standard Foundation (IFRSF), who are responsible for setting the reporting standards used by almost all major corporations in the European Union and more than 90 other countries,<sup>3</sup> suggest that the general purpose financial statements prepared using their standards must only meet the information needs of the suppliers of capital to a company for the purpose of assisting them in their decision-making on whether to engage with the reporting entity, or not. All other uses of data and users of financial statements are



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incidental, in the opinion of the IFRSF, to this purpose and, as such, are effectively excluded from consideration (IFRS 2018a para 1.2 and para 1.10, IFRS 2018b). The consequence has been the growth in what was once called corporate social responsibility (CSR) reporting and what is now more commonly called environmental, social and governance (ESG) reporting (Thistlethwaite 2011; Murphy & McGrath 2013).

With regard to environmental reporting, the latest and now most widespread form of reporting has been promoted by the Task Force on Climate-related Financial Disclosures (TCFD 2017). Launched by the Financial Stability Board of the Bank for International Settlements in 2017, around 80% of world's largest corporations have now signed up to TCFD standards but fewer than 25% of these provide any meaningful range of reporting, as yet. As a result, Carney (2019) has suggested is that the voluntary TCFD approach might not be a sustainable model for climate change reporting. We suggest that climate change reporting should now be fully integrated into financial reporting and not be incidental or ancillary to it.

### 3. For whose benefit changed is required

The TCFD has made clear that it has accepted the IFRSF view that financial reporting should be for the benefit of the suppliers of capital to a company (TCFD 2017). We disagree. The proposal that we make here is radical. Building on the ground-breaking and world-leading, for the time, opinion on the purpose of accounting of the UK-based Accounting Standards Steering Committee published in 1975 (ASSC 1975) we suggest that there are at least six clearly identifiable groups of stakeholders with interest in the financial reporting of every reporting entity:

1. The suppliers of capital to a reporting entity;
2. The reporting entity's trading partners;
3. Its employees;
4. Its regulators;
5. Its tax authorities;
6. All within civil society with whom it interacts.

This approach contrasts quite profoundly with that of the IFRSF, whose suggestion that accounting be solely concerned with the information needs of the suppliers of capital to a company reflects the prevailing economic narrative of the last forty years. Our suggestion is, however, timely. The US-based Business Round Table, comprising the CEOs of most major US corporations,<sup>4</sup> announced in August 2019 that it was changing its mind on what it considers the primary purpose of a corporation. Since 1978 it has said that this purpose had been to maximise profits. It now considers that corporate relationships with customers, suppliers, employees, and communities are as important as meeting the needs of the suppliers of capital to a company (BRT 2019). In addition, the European Parliament reaffirmed its own commitment to country-by-country reporting for tax, which embraces this logic, in October 2019,

voting to adopt that form of public accounting for multinational corporations by a margin of 572 to 42 during that month.<sup>5</sup> Our approach may be radical, but it reflects changing thinking in the business and political arenas: it is accounting that is out of step.

Adoption of this broad-based approach necessarily changes the disclosure required from any form of climate change reporting. This will require additional reporting in the case of climate change related issues on:

- a. What the issues that the entity is facing are;
- b. Where, geographically, those issues arise;
- c. How they impact the communities that host the reporting entity's activities in the locations in question;
- d. How the reporting entity will respond to those issues, by location;
- e. How that response will impact those communities;
- f. When that impact might arise.

The entity wide approach that the TCFD proposes (TCFD 2017), which is at present commonplace in ESG reporting, would not address these stakeholder needs. Civil society pressure has shown that the conventional consolidated financial statements produced using IFRS reporting did not provide sufficient information to meet stakeholders' needs on taxation issues (Murphy 2003, Cobham et al 2019; Seabrooke & Wigan 2016). This is now the situation for climate change reporting. The concern of many of the stakeholders is not with the overall impact of climate change on the entity that is reporting, but is instead with the impact that the emissions that the reporting entity is creating in the locality where they are based. The material issue for most stakeholders of most reporting entities is, then, geographic and local. Mandatory financial reporting on climate change, when undertaken in the public interest (as is necessarily the case for the published, audited financial statements of a corporation), must be developed to take these issues into account.

#### **4. The financial implications of climate change**

'Sustainable cost accounting' can address the deficiencies in the approach of organisations like the TCFD if imposed as an accounting standard to ensure that it was mandatory, comprehensively applied, and audited. Sustainable cost accounting is essentially quite straightforward, and as we note below, little more than a development of existing accounting standards with a particular purpose in mind. It suggests that large businesses should prepare a plan to show how they would manage their transition to being net zero carbon emitters. This requirement is consistent with the expectation that economies as a whole achieve this state, which many governments have now committed to. The plan would apply to the business and its supply chain. In effect, this would extend the demand to many smaller businesses but without requiring accounting disclosure from them, a concept already familiar in many CSR approaches. Sustainable cost accounting requires that a precautionary principle be applied: in other words, the plan could only rely upon those technologies

known to exist at the time and that have been proven to work. This would encourage the development of new technologies that might reduce the cost of the transition to being net zero carbon at the first possible opportunity: the accounting is in this way seen as a promoter of desired change. And for reasons of stakeholder accountability already noted, the plan would have to show where the impact of the changes would arise geographically.

This plan would have to be costed. That cost would then be included, in full, in the accounts of the reporting entities to which sustainable cost accounting would apply on the date that it first applied. There are three issues to note. Firstly, this cost would not reflect the price of carbon, unlike almost any other proposal on this issue. Nor does it include the cost of offsets. The cost is that which the entity will have to pay to adapt its processes to be carbon neutral. That is in internal measure of expenditure entirely under its own control. The problem of carbon pricing that undermines other proposals on this issue is removed as a result. Second, the cost must be provided up front or the incentive to change behaviour is deferred. With an upfront provision being made revision as a result of investment in new technology can then be measured as a gain in future periods: the system has an incentive to improve performance engineered into it. Third, there will be inherent uncertainty in such plans: auditors will have to exercise prudent judgment when appraising them.

If it became apparent, as a result of this exercise, that the reporting entity subject to sustainable cost accounting could not achieve the objective of becoming net zero carbon that fact would have to be noted in sustainable cost accounting. The result would be ‘carbon insolvency’. If in this state a company would have to also prepare a plan to restore the solvency required to become a net zero carbon emitter by, for example, either foregoing future dividend payments or raising additional capital. Alternatively, if neither was thought possible because of the scale of the cost facing the company to achieve this transition then an orderly winding up of its affairs, over time to ensure that a fair transition could be made, might be required instead. In all cases an audit to verify the data would be required.

These apparently radical ideas actually appear consistent with existing IFRS standards. For example, International Accounting Standard 36 (IAS36 2004) on the impairment of the value of assets requires provision when ‘significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated’. The impact of climate change might represent this ‘significant change’ and so require impairment of the value of assets that are carbon emitting. In addition, the provisions of International Accounting Standard 1 (IAS 1 2007) requires an entity to consider whether it is a ‘going concern’, which involves appraisal of whether it can trade into the future. It suggests that “an entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trad-

ing, or has no realistic alternative but to do so”. Unless an entity can suggest how it can meet the costs of becoming net carbon zero compliant then it follows that the current technological, market, economic and legal environment means that it has no realistic alternative but to cease to trade. Sustainable cost accounting requires that a company test this hypothesis, and publish the results in an audited form.

## 5. The consequences of Sustainable Cost Accounting

It has been suggested that the present financial reporting of many of the world’s major corporations is incomplete because they do not take their use of natural resources into account. The result might be considerable misallocation of resources within the world’s economies. The Bank of England has estimated that up to US\$20 trillion might be at stake as a result (Partington 2019). Sustainable cost accounting addresses this very real issue. That this will have significant consequences for many companies and those that depend upon the dividend income that flow from them including, for example, pensions fund (some of which have long been aware of climate change, see Hebb 2008) does not alter this fact but restates the significance of the crisis that global heating presents. The reality that our management of long-term obligations on existing bases is no longer possible. Sustainable cost accounting both makes this clear and suggests how capital should be reallocated to meet needs. This makes it a matter of significance in the current climate debate.

## Noter

1. The terms climate change, global warming and global heating are used interchangeably in this paper, recognising that there is as yet no consistency in their use.
2. In the interests of full disclosure it should be noted that Richard Murphy is a director of the Corporate Accountability Network and Leonard Seabrooke is a member of its advisory panel. The Corporate Accountability Network is actively developing sustainable cost accounting proposals (CAN 2019a, 2019b).
3. [https://www.ifrs.com/ifrs\\_faqs.html#q3](https://www.ifrs.com/ifrs_faqs.html#q3)
4. <https://www.businessroundtable.org/about-us/members>
5. <https://www.accountancydaily.co/eu-push-public-country-country-reporting-multinationals>
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