International Public Sector Accounting Standards Board ('IPSASB')

277 Wellington Street West, Toronto, ON M5V 3H2, Canada

28th February 2025

Dear Sirs

IPSASB SRS Exposure Draft 1, Climate-related Disclosures

Comment Letter by the Rethinking Capital community

This comment letter is being sent on behalf of the members of the Rethinking Capital community. It comments on the IPSASB SRS Exposure Draft 1, Climate-related Disclosures (**Exposure Draft**). Our response is in five parts—

1. About Rethinking Capital & our mission of Accounting for Reality.

2. Tackling upside down incentives as the root cause of the climate and biodiversity crises.

3. Breaking the Tragedy of the Horizon—the risk of 'getting lost heading in the right direction' realised.

4. Specific comments on the Exposure Draft—necessary but not sufficient.

5. The IAS37 and IAS38 bridgehead into IPSAS31 and IPSAS19.

Our conclusion is an ask of IPSASB to continue to co-ordinate thinking and work plans in FY25.

1. About Rethinking Capital & our mission of Accounting for Reality

In saying *'Accounting is the DNA of capitalism'*, on 5th August 2024, the Royal Society of Arts CEO Andy Haldane started the FT conversation Rethinking Capital has wanted since 2020—when first hearing the words '***the purpose of financial statements today is not to represent reality***' from a very senior figure in global accounting.

Our campaign for a proper conversation then began. The accounting reality Rethinking Capital has worked for 24 years to represent is the knowledge economy that exploded into life after 1990, when software and the Internet catalysed new ways of creating value—and new intangible assets and social obligations were created. Vast hidden value and obligations exist in reality, but aren't recognised in accounting practice.

John Plender's article on 14th August 2024 continued the FT conversation. Starting with '*Accountancy matters, not least because it changes behaviours*'. Wisdom like this comes from deep accounting thinkers like Professors Ian Ball ('*the purpose of accounting is to use numbers to achieve desired outcomes*'), historian Jacob Soll and Tom Scott.

We believe the accounting profession decided to stop trying to account for this new intangible reality in 2002 in the aftermath of the Enron Scandal—removing the asset and obligation DNA strands—and, in those decisions, made saving tax and saving a Planet fit for our future incompatible.

We also believe IOSCO has quietly accepted that a market in which actors are equally uninformed is 'efficient'—and can override its Objectives & Principles of Securities Regulation of fairness, investor protection, transparency and financial stability by managing systemic climate and other risk. IOSCO has powers to act but has chosen not to.

In the context of the Exposure Draft's focus on climate as the priority, this proper conversation has begun by focusing on accounting for the reality of a just transition to a green economy. As Andy Haldane says, '*With…progress towards net zero slow, it is an ideal time…to reconsider whether accounting standards support green growth objectives*'. And as John Plender says, '*externalities have to be internalised*'.

In a world where extreme heat is shaping economies and become the norm the conversation asked what problems are caused by not accounting for reality? No benefits of not accounting for reality could be identified.

What problems are caused by not accounting for reality?

Four were explained in our presentation to Lord Mayor Michael Mainelli's Coffee Colloquy on 18th July 2024 at Mansion House, London—reading from Rethinking Capital's collaboration proposal to the six CEO's of the global audit firms on 6th June 2024—further explained in this Lord Mayor's Knowledge Miles webinar on 8th August—

'In the context of a just transition to a clean, green economy, the systemic negative implications include—

- Upside down incentives applied to an emissions reduction commitment, aligned to the opposite of Paris Goals.
- Material understatement of true business performance and returns from an emission reduction strategy.
- A market not pricing in systemic climate risk and its exclusion from portfolio theory and strategic asset allocation decisions.
- A flawed premise for the ESG backlash—because if their purpose isn't to represent reality, then how can it be stated that, in reality, returns are lower? What if, in reality, returns are materially higher?

Our mission is therefore to refresh accounting and double entry in a body of work now named Accounting for Reality—technically normative accounting for intangibles—informed by existing IFRS and IPSAS Standards. And by the work of UBC Professor Richard Mattessich in the 1984 paper 'On the evolution of Theory Construction in Accounting' a copy of which is attached.

2. Tackling upside down accounting incentives as the root cause of the climate and biodiversity crises

We first wrote about the insight of '*upside down accounting incentives*' in 2021 in the paper Constrained by Accounting. And have since described this as the true root cause of the systemic inability to tackle the climate and biodiversity crises.

To explain—applied to say Anglo American's commitment to a '*30% reduction in Scopes 1 and 2 emissions by 2030'*, the incentives to meet it are upside down—accounting practice chooses to treat the commitment as an externality, and meaning investments purposed to meet it, such as innovation and carbon credits, must be accounted for as costs rather than assets.

The same upside-down incentives apply in the public sector to emission reduction commitments by countries, cities and other entities that could apply the IPSAS Standards in their net zero decision making. Indeed today, 92% of GDP and 88% of emissions worldwide are now covered by such commitments—but to our knowledge not one recognised as an accounting liability, removing accountability and meaning investments purposed to meet it can't be recognised as assets.

Most crucially meaning that since COP21 in Paris in 2015, accounting practice has chosen to create an incentive system aligned to the opposite of Paris Goals.

It must become clear that no amount of disclosure or narrative reporting can tackle upside down accounting incentives. This is like bringing a knife to a gunfight.

This means that the Exposure Draft is necessary but not sufficient. To be sufficient, IPSASB and the World Bank must build the bridge into accounting. It will also mean that the Exposure Draft could add to the confusion in the short-term unless IPSASB's strategy includes to build the bridge into accounting.

3. Breaking the Tragedy of the Horizon—the risk of 'getting lost heading in the right direction' realised

Mark Carney's 2015 speech Breaking the Tragedy of the Horizon weeks before Paris is one of climate action's pivotal moments—when climate risks were expressed to be systemic risks to financial stability. Ending with—*'By managing what gets measured, we can break the Tragedy of the Horizon'.* The premise that managing what gets measured will Break the Tragedy of the Horizon is this—

'The right information allows sceptics and evangelists alike to back their convictions with capital. It will reveal how the valuations of companies...might change over time... and will help the market adjust efficiently' and

'Crucially, it would also allow feedback between the market and policymaking…Policymakers could learn from markets and adapt their stance, with better information allowing more informed reactions, and supporting better policy decisions including on targets and instruments.'

The speech recognises that the then 400 initiatives intended to provide better information had created the risk of '*getting lost in the right direction*'. And so the proposal made by the Financial Stability Board to the G20, its Paris contribution, was '*more be done to develop consistent, compatible, reliable and clear disclosure*'. That recommendation led to the setting up of the Taskforce for Climate-Related Disclosures (TCFD) in 2016 and the June 2017 publication of the TCFD Guidelines—which refer to IAS37 accounting on page 37. TCFD use has become the market norm. At its last Status Report in 2023, TCFD reported having more than 4850 supporters including investors representing $217 trn assets under management.

The G7 endorsed TCFD in 2021. In the G20, TCFD become a legal requirement law for listed and large companies located or operating in the UK in 2022. Among others, Brazil, the European Union, Hong Kong, Japan, New Zealand, Singapore, France, Mexico and Switzerland require TCFD aligned disclosure. The US SEC's Enhancement and Standardization of Climate-Related Disclosures for Investors are underpinned by TCFD but the reach of the State of California's climate disclosure laws (SB 261 and SB 253) gives a US foothold for companies located or operating in the State and will, de facto, be country-wide.

The years since Breaking the Tragedy have proven science to be accurate. So what went wrong? Why haven't we Broken the Tragedy yet? Was the logic wrong? Or has the right '*better information to allow the market to take a view'* not yet been provided? These questions probably keep Mark Carney awake at night—but even on 18th October 2024 in the first ten minutes of this UnCommons podcast with Nate Erskine-Smith, Mark remains committed to the logic.

Right logic, incomplete information

'Rethinking Capital's proposals have the potential to significantly improve the information available to management in allocating resources and managing operations. The proposals should also significantly improve the information available to external stakeholders for decisions concerning their investments in and support of a reporting entity. These benefits will require further development of the mechanics of the reporting process to make the information sufficiently precise and objective for the needs of both management and external stakeholders'.

Professor Tom Scott, former board member International Accounting Standards Board & Professor of Accounting & Finance, University of Waterloo

We're confident that it's the second—that the logic was and remains solid but that the information provided so far is incomplete, missing one vital piece. That piece is accounting.

Despite being first recognised at Kyoto in 1997, there's been a collective failure to internalise critical externalities, notably carbon, and create the required transition incentives. Accounting is essential to internalise the carbon externality when applied to emissions reduction commitments—say bp's 2021 commitment to reduce Scopes 1 and 2 emissions by 50% by 2030 in line with science-based targets and Paris Goals. The constructive obligation in IAS37 (and its IPSAS equivalent IPSAS31) is the accounting tool to do so. Accounting is also essential to create the incentives to transition and to accelerate it. IAS38 (Intangible Assets) and its IPSAS equivalent IPSAS19 is the accounting tool to do so—enabling recognition at cost of creation and active market revaluation to enable the market to take a view of best estimate.

The third element is the integration of these two standards into normative accounting for intangibles—an alternative fair view prepared as supplemental information to enable better informed decisions.

If they'd known in 2015 what's now known, what would Mark Carney and the Financial Stability Board have suggested?

Mark and colleagues at the Bank of England and on the Financial Stability Board could not have known in September 2015 that two existing IFRS and IPSAS Standards and an update of double entry could be used to create the '*better information to allow the market to take a view'* in normative financial statements.

He also couldn't have known that in 2024, the IASB would confirm that IAS37 can be applied to a net zero commitment to internalise the externality. This was confirmed by two submissions by Rethinking Capital to the Interpretations Committee of the IASB (**IFRIC**). The April 25th decision explained in paragraph 5 below contains the principle to flip the incentives—**when a provision is recognised, investments purposed to meet it can also be recognised as assets**. Or that this third related submission on IAS38 would be made to recognise investments purposed to meet a commitment, including nature-based solutions (enabling nature to be put on the balance sheet) as intangible assets and create incentives.

Had these things been known in 2015, it's logical to assume that the Financial Stability Board would have recommended to the G20 that TCFD be centred around IAS37 and IAS38 and IPSAS 31 and 19—and COP21 in Paris would've required commitments made after Paris to be accounted for applying IAS37 and IAS38 and IPSAS 31 and 19 as part of TCFD.

Now we know these things, it's logical to assume that the Financial Stability Board should mandate IAS37 and IAS38 and IPSAS31 and 19 normative accounting and swiftly accelerate it into law—creating the stimulus for the market to demand and signal for its use for testing.

4. Specific comments on the Exposure Draft—necessary but not sufficient

We have no specific comments on the Exposure Draft. It is a solid piece of thinking and can take public-sector disclosure onto an equivalent level as the ISSB's S1 and S2 Standard and current TCFD disclosure without IAS37 disclosure.

Based on the above analysis however, the Exposure Draft and any resulting Standard or Guidance Note must be necessary but not sufficient to tackle the root cause of upside down accounting incentives.

5. The IAS37 and IAS38 bridgehead into IPSAS31 and IPSAS19

IASB member Nick Anderson is one of many who say the problem isn't accounting standards but that accountants and auditors are choosing not to follow them. The same analysis can be applied to the choice not to follow or apply the IPSAS Standards.

However, a real world right and duty to demand Accounting for Reality arrived in 2024 because of the decision by the International Accounting Standards Board on 25th April. This interpreted IAS37 to a commitment to reduce carbon emissions—say Anglo American's 2021 commitment 'to reduce Scopes 1 and 2 by 30% by 2030 in line with science-based targets'.

The IASB's decision resulted from two submissions by Rethinking Capital to explain that a quantified accounting entry (a provision) should be recognised for a short term emissions reduction commitment, a transition plan and affirmative actions as a 'constructive obligation' under IAS37. Page 3 of the decision contains the core principle to flip the incentives—when a provision is recognised, then investments purposed to meet it can also be recognised as assets.

IFRS rules mean a new decision on how to account for these short-term (typically 2030) commitments **must be made** in FY24 year-end preparations. This has far-reaching effects for the fiduciary, employment and other rights and duties of those who must make this new decision—boards, asset owners and asset managers must actively lead the decision governance and reporting. And making informed decisions means to compare different accounting treatments.

The first is the accounting status quo—commitments remain externalities, investments remain costs. In the second range of 'normative' treatments, the commitment and actions to affirm it are recognised as a provision—**'internalising the externality'**. And each $1 invested purposed to meet the commitment (carbon credits, innovation, etc) is recognised as an asset on the balance sheet—growing in value as the commitment is met and emissions averted.

This second range makes net zero profitable and unlocks material hidden returns from a program to reduce carbon emissions over time. Meeting its commitment Anglo-American would increase balance sheet assets by around $495m—and materially improve its key financial metrics (profit, EPS, ROE, debt to equity ratios)—increasing to $1.5bn if accelerated. It would be taken into account in credit rating explained by S&P paper and give accountability.

Auditors, investors, insurers and boards are being convened to ask for two scenarios, one backwards, one forwards, to be run in FY24 year-ends—as supplemental TCFD disclosure with which to make better informed decisions.

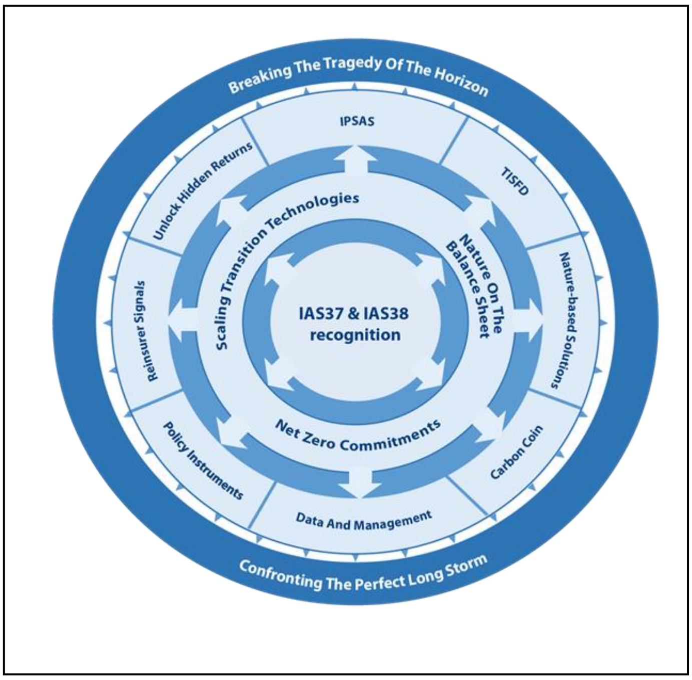
After the decision, the IFRIC member for BDO and PwC's representative recommended we propose a collaboration to efficiently implement the decision to the six CEO's of the firms on the Global Public Policy Committee. A second collaboration proposal was made on 24th January to the GPPC and the Net Zero Financial Services Provider Alliance.

Recognising that IAS37 is mentioned on page 37 of the TCFD Guidelines, UNPRI support was given in its September Signatory General Meeting—*'the PRI supports the IASB decision and believes that this provides important clarification to the market that climate related commitments like net zero commitments can create a constructive obligation to be recognised in financial statements. This should give investors better information to consider in their decision making'.*

Positive discussions to signal for IAS37 disclosure in FY24 year ends have been held with the EU and governments in countries in which TCFD is a legal requirement. The EU proposal also explains how accounting for reality can much simplify CSRD and ESRS disclosure and mitigate financial stability risk.

This opened up the bold ask of G20 leaders made by King Charles' Sustainable Markets Initiative, Rethinking Capital, CISL and TNFD in November in the G20 Nature Investment Roadmap—('the Ask')

'To mandate IAS37 and IAS38 normative accounting disclosure into law as supplemental information to TCFD reporting for climate-related disclosures, to begin with FY24 year ends.'



This visual demonstrates how the adoption of IAS37 and IAS38 can drive systemic change—the IPSAS application should occur by cause and effect when it becomes obvious to the market that the same principles can be applied to public sector emission reduction commitments.

Conclusion and our ask

We recommend and ask that IPSASB continue to co-ordinate thinking and work plans with the Rethinking Capital community in FY25.

Yours sincerely

Andrew Watson

Co-Founder, Rethinking Capital

