Why we need sustainable cost accounting

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I have already published the Corporate Accountability Network's two page summary of sustainable cost accounting. A longer briefing note has also been prepared by me for the Corporate Accountability Network. It's available here, and goes into much more detail as to what sustainable cost accounting is and why it needed.

The critical few paragraphs that justify this approach to accounting in the era when we realise that managing carbon emissions is more important than making profit as conventionally defined might be the following:

Accounting should be the lens through which we view the commercial world. It is, of course a company's right (within the limits of regulation) to project their own image of the contribution that they claim to make to the world that we live in. But the whole reason for requiring audited accounts from those entities is that it is known that companies might, if given a free hand, represent matters in a way that is not the whole truth. This is why one of the traditional underpinnings of accounting was what was called the stewardship concept[i]: the directors of a company were required by accounting regulation to prepare a true and fair report of their management of the assets entrusted to their care, which had to be subject to audit to substantiate its veracity.

Once it was sufficient to think that this issue only related to the financial assets over which those directors might command control. Most companies were small. Their reach was limited. Their power to influence macroeconomic events was negligible. Their impact on the world beyond their own enterprise's (literal) gates appeared to be small. But that is no longer true. The number of large companies in the world has shrunk considerably in size[ii], but each of them is very much larger than those they might be compared with in the past. Many of them trade, quite literally, around the globe. Their sales frequently dwarf the entire incomes of the countries in which they trade[iii]. They do have significant macroeconomic power, not least to determine the income of governments through the taxes that they decide to pay, or not, by location[iv]. And their command of resources stretches far beyond national boundaries.

In this situation a system of financial accounting first imagined in the late nineteen sixties[v], that has come to deliver a limited range of data for a very limited range of stakeholders[vi] has reached the end of its useful life. As already noted in this paper, the time has come for accounting to recognise all the stakeholders of the world's reporting entitles. And those entities have to account for the stewardship they undertake over all the resources that they command in the course of their activities. This is why we have proposed sustainable cost accounting. It is now necessary that corporate accounting for the resources that are used by a reporting entity and the consequences that flow from that use be brought within the mainstream of financial accounting and out of the ghetto of voluntary, unregulated, unaudited and peripheral reporting that seeks to emphasise that this issue is not one of primary concern to major reporting entities.

We are aware that simple as it appears to be sustainable cost accounting will have significant impact on the corporate world. That is its intention. It is well known that what we measure is what comes to matter to us[vii]. The environment has to matter more to the corporate world than it does at present. But there is more to this desire than that: the fact is that at present the 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 is the 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[viii].

So, whilst we know that the world cannot burn most of its known oil reserves it remains the case that its oil companies are amongst the largest corporations in the world[ix]. The manufacturing of cars remains a massively important activity, attracting enormous resources when it is now known that those same cars cannot be used if we are to meet the world's climate targets. And the same if even more true of aircraft manufacture, and of the airlines that use them. Less immediate obvious, but as important, is the transformation required in the world's agricultural systems and in all the support services that maintain them.

It is, of course, true that none of these changes need happen. But what we now know is that climate science is settled on the fact that if we do not change then there will be continued global heating[x] with the resultant risk of a climate catastrophe. This is a risk that governments and many in civil society, in all its forms, think should not be taken. The result is that the time has come for business to recognise its responsibilities on this issue. This is why we propose the use of sustainable cost accounting and that it become an accounting standard.

We are aware of the consequences of what we are suggesting. For example, many companies will have considerable difficulty producing a plan to become net zero carbon emitters when legally required to do so, but if that is the case then that is something that their stakeholders need to know.

In addition, we are also aware that many corporations will have to cease paying dividends to fund their carbon transition. This will, in turn, have an impact on all those who depend upon that dividend income including, for example, pension funds. This, however, is part of the crisis that global heating does, in any case, present: our management of long term obligations on existing bases is no longer possible and sustainable cost accounting both makes this clear and suggests how capital should be reallocated to meet needs.

In summary, it is our contention that hard as the consequences of sustainable cost accounting will be for some companies and sectors, and for those who have depended upon them what it does is draw attention to an issue that we all actually know to be true now, which is that the world's corporations are using the natural resources of our planet in ways that are unsustainable.

In that case accounting has to change because we need a clear, audited, enforced and unambiguous indicator of the process of change that business must go through to support continued human life on this planet. Sustainable cost accounting can do that by indicating who can, and cannot, use capital to best effect in this changed environment. That is precisely why it is needed, however uncomfortable the consequences might be.

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[i] The idea has moved on somewhat now, and is little emphasised, overall https://www.icaew.com/technical/corporate-governance/codes-and-reports/uk-stewardship-code

[ii] https://www.ft.com/content/0c9c0b64-9760-11e9-9573-ee5cbb98ed36

[iii] https://www.businessinsider.com/25-giant-companies-that-earn-more-than-entire-countries-2018-7?r=US&IR=T

[iv] https://www.oecd.org/tax/beps/

[v] https://www.icaew.com/library/subject-gateways/accounting-standards/knowledge-guide-to-uk-accounting-standards

[vi] https://www.iasplus.com/en/standards/other/framework

[vii] We accept that there are also issues arising from measurement — but that is not the case being addressed here at present https://medium.com/coffee-and-junk/campbells-law-goodhart-s-law-when-you-are-measuring-to-fail-c6c64923ad7

[viii] https://www.theguardian.com/environment/2019/apr/17/mark-carney-tells-global-banks-they-cannot-ignore-climate-change-dangers

[ix] https://www.carbontracker.org/terms/stranded-assets/

[x] https://report.ipcc.ch/sr15/pdf/sr15_spm_final.pdf