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The truth is stark: companies are hiding the real cost of the net-zero transition. Without honest accounting, capital is misallocated, pensions are at risk, and businesses will fail. Sustainable cost accounting is the solution.

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This is the transcript:

We need to account for climate change.

We are not.

The fact that we are not is going to create the biggest financial crisis for private markets that the world might ever have seen sometime in the next decade or so.

In this video, I want to talk about how we need to put the cost of climate change on the balance sheet of the largest private companies that we all deal with, so that we understand the risks that are inherent within them, and the risks that are inherent in saving in the shares of those companies as the basis for our pensions, because it's my suggestion to you that those risks are enormous, and quite a lot of the companies that we are used to dealing with right now are, in fact, climate or carbon insolvent.

The simple fact is most companies are not yet ready for net-zero.

And current accounting, they're allowed to produce under existing accounting regulation, hides that truth from you, from me, from financial markets, and most particularly from the pension funds, who are forced by law to save your pension contributions in the shares of those companies so that you are put at risk as a consequence of this failure of those companies to account for the net-zero risks that they face.

And my suggestion is that without honesty, we are going to face economic collapse as well as ecological collapse. And that's a double whammy that we could avoid if only we accounted for the cost of the net-zero transition.

And the reason for this is that we aren't allocating capital efficiently.

Let's be clear about what accounts are for. The International Accounting Standards Board - who are basically refusing to engage with climate change in any reasonable way because the standards that they are producing are, in the kindest possible interpretation, greenwash- if only they followed their own maxim that the purpose of accounts is to provide financial markets with the information that they need to allocate capital efficiently, then they would be demanding that the cost of the transition to net-zero should on the balance sheet of companies, but they're not. And so there's a conspiracy going on against us, and that is a conspiracy of denial about what the true costs are.

And yet those costs are going to be incurred.

Let's be clear, since 2017, there has been a legal requirement for the UK to meet a net-zero target by 2050. This is Theresa May's legacy, and nobody has changed it.

What is more, at the COP26 Global Summit on Climate Change held in Glasgow two or three years ago, the commitment was made to ensure that this will happen on a global basis.

Companies, therefore, have no choice but now meet net-zero targets. They either do so, and change their production processes, their products, their supply chains, and their markets, or they will fail. It is very simply the case that that is the choice they have before them.

And in that situation, what accounting must tell us is who can survive the transition to net-zero, and who can't? In other words, who will be going concerns into the future? And who will be consigned to the dustbin of history?

But at the moment that isn't what accounting does. And that's why I came up with something called sustainable cost accounting. I first wrote sustainable cost accounting in 2019, and unfortunately, the whole COVID era has made development of this idea slower than I would like.

But let's just talk about what sustainable cost accounting does. What it essentially does is bring the cost of becoming net-zero onto a company's balance sheet. It does this by demanding that any company affected, and that will basically mean big companies, must prepare a plan to become net-zero.

And then they have to cost that plan, showing when the money will be incurred, what it will be incurred on, and what the total costs might be. And that figure they then have to on their balance sheet.

And there's nothing surprising about this. For example, companies involved in the nuclear industry do, at present, have to put a cost on their balance sheet for the cost of cleaning up a nuclear power station at the end of its life. And most mining companies do, under the terms of their contracts, have to do the same because it's normal now that when a company ceases mining they are required to reverse the damage they've caused to the environment.

So those are the precedents. We know that it is possible to account for damage to the environment created by nuclear power and by mining. Now we have to account for the cost of dealing with the damage caused by climate change.

And this, therefore, in exactly the same way as those two issues, nuclear power and mining require, means that companies have to recognise their cost, not when it's incurred, but at the time that they are undertaking the projects.

So, sustainable cost accounting requires that a company does estimate its true costs in the future of tackling climate change and then track the changes in that cost over time. In other words, reporting how much it's spent to tackle the problem and how its estimates of cost have changed over time, so that we get a figure from the companies of their true financial capacity to manage this critical issue.

Now, there are some important points to note. First of all, sustainable cost accounting covers all the emissions of a company. In other words, it covers scopes one, two, and three of emissions. That is the company's own emissions; the emissions within its supply chain, i.e., in the products that it buys; and also the implicit emissions in the products and services it sells.

I always give as an example of the importance of this last one, Gatwick Airport. If you go to Gatwick Airport, although I haven't been recently, but when I last went, there was a big sign up saying, "Gatwick Airport, a net-zero airport". They ignored the fact that their whole business model was, of course, about putting aircraft down runways at considerable cost to the environment because the aircraft in question were run by somebody else, and so they said, "Not our responsibility, gov. That's down to them."

No, it isn't. If you enable an emission, then the requirement of sustainable cost accounting is that you change your business process so that the emission does not take place.

And this is not double-counting any more than a business selling something from one business to another business, but not to an end consumer, is double-counting the cost of production.

It's an output of one business.

It's an input into another business.

And sustainable cost accounting works in exactly the same way. This is about the microeconomic accounting for climate change, and therefore, both have to be counted.

But net-zero does mean that businesses now have to think 'beginning to end' about what their business process is because it's no good saying that's somebody else's responsibility anymore. That's how we got into the mess. Sustainable cost accounting requires that a company accept its responsibility for the beginning to end of its processes.

This is not what is happening in the processes demanded by the International Accounting Standards Board. It has a standard on making provisions called IAS 37, and that's not good enough.

Why? First of all, because that lets the company decide when to make the provision. But this isn't possible with regard to climate change. The law says the change must take place. The law says that reality must be respected, and the reality is that COP26 said that companies must be net-zero. Therefore, there isn't a choice about making a climate change provision. If there will be a cost, the provision must be made, and IAS 37 doesn't require that, and so I wrote a new standard to replace it.

There are other things that are deeply wrong about IAS 37 as well. For example, it allows a company to discount the future value of the liabilities that it puts on the balance sheet.

In other words, it says that if a cost is incurred in five years' time, we are allowed to presume that the cost is lower than it is now because there will be money saved by deferring the expense for five years. I'll give you an example. If a company has to spend £1 million in five years' time, and its cost of capital, the cost that it has of borrowing money, is 6%, then that figure of £1 million will be put on the balance sheet in IAS 37 provisions at the discounted value of £747,000.

But this is not the way that things work with regard to climate change. If we defer spending on climate change now, as is becoming commonplace, the cost eventually will go up. We know that. There will be more damage to correct in the first instance, and secondly, the scale of the problem will, as a consequence, be bigger and therefore the spend that will have to be undertaken will be larger. And so, instead of discounting future costs, I suggest in sustainable cost accounting that the value of future costs should be compounded.

In other words, instead of reducing the cost to be put on the balance sheet, because a cost is deferred, the cost should be increased. So that figure of £1 million now deferred for five years would not be £747,000 as conventional accounting says, but would instead be £1,338,000.

Now people will scream and shout and say that this is unfair, but this is a reflection of the real world, and if accounting doesn't reflect the real world, what is it for, is my question?

But more than that, this is about using accounting as an instrument for change, recognising that all accounting by definition is political. And what it says is that a company must be incentivised to make the change as soon as possible to minimise the cost. This is accounting as it should be.

There are some other things within sustainable cost accounting, which will no doubt not appeal to some critics. And I'm going to highlight them because I think they're they're not weaknesses.

The first one is that sustainable cost accounting will not allow for mythology. No claim can be made in the company's plan for a transition to net-zero for technologies that are currently unproven. And there are a number of technologies that are currently unproven that could be claimed for this purpose. For example, the company could claim that nuclear fusion is going to solve all its energy costs, the only slight problem being, we don't know whether nuclear fusion is going to work or not.

Perhaps even more relevant is the fact that the company could claim that carbon capture and storage is the solution to all its woes, and some industries are undoubtedly doing that. But the fact of the matter is that, yet again, carbon capture and storage is, in effect, an unproven technology. And as a consequence, no claim for these can be made in the plan.

Only real, proven solutions to get to net-zero will be acceptable in that plan. And if it isn't possible to get there, I'll come to the consequences quite soon.

You can put the cost of investing in those solutions in the plan. And then if you prove that they work, for example, that carbon capture and storage does, contrary to all my expectations, actually deliver, then you could allow for that in your plan and take the benefit by reducing the liabilities that you might have in your balance sheet. But until you prove your point, then prudence should apply. There will be no benefit that you can claim.

And, in addition, offsetting, which was for a while the complete in vogue way of trying to deal with the consequences of climate change for industries like airlines, will not be allowed. I went to a conference not long ago, where it was explained that if Shell wanted to offset all the emissions that it makes, it would need to forest a landmass the size of India. It's not going to happen.

So let's not permit offsetting unless the company can prove it already owns the land to actually undertake the activity, and that it will be new activity that it's undertaking, which will therefore generate the offset. And in most cases, it can't do that.

Why are existing accounting standards failing, then? Well, first of all, because they're saying that climate change costs might be immaterial. And that's because they're using the assessment of materiality - which is 'significance' in plain English - that is used in financial accounting. But that ignores the fact that sustainability obligations are material over the long term, and most accounting only considers materiality and the concept of going concern over the short term. And I'm aware there have been some recent changes in this area, but nobody really thinks that accounts are going to consider a period much beyond 12 months, even so.

But the truth is that climate change is going to happen over a period of 25 or more years now, and we recognise that in law. And so, there's this massive conflict between existing accounting standards, which only consider micro, tiny, time horizons, and the needs of sustainability, which require us to consider long-term requirements.

The consequence is that the International Accounting Standards Framework for disclosure, the 'Sustainability Standards' as they call them, are little more than the lowest common denominator of reporting and are a greenwash. And in many cases, frankly, it does not even provide any useful information because the company establishes its own rules for reporting and mysteriously does quite often comply with them.

There's then this other concept that we need to talk about, and that is what is called a going concern. Going concern is the appraisal that an auditor is required to undertake on a company to decide whether it is likely to survive over future reporting periods. Now, as I've said and as is the case in current accounting, it is normally assumed that a going concern is only appraised over a period of 12 months or so. That is obviously inappropriate in the case of sustainable cost accounting, so we will have to have a revised going concern principle inside this whole idea. And this will then require that auditors consider whether or not the company can survive into the period to 2050.

And that takes us into another whole area, which is to appraise whether or not the company has got the financial resources available to it to actually ensure that it can finance the cost of its climate transition.

But before discussing that in more detail, let me just make the point to all those accountants who say that I'm asking for something that is too difficult to manage, and that is to say that the double entry for this is not hard. In fact, it's incredibly simple.

All that this reporting standard that I am talking about will require is initially two entries in the balance sheet of a company.

One will be an entry to the shareholders' funds of the company, which will be a debit reserve, which, in other words, recognises the future costs. If, for some reason, the company thinks it's going to benefit from climate change, and I'm not sure how that would be, but let's presume that there might be a company somewhere that would try to claim that, they aren't allowed to take the benefit because prudence would not allow them to anticipate the income.

So the only thing that can happen is that a debit, or a loss representation, can be included in the shareholders' funds of a company, reducing the net worth of the company as a consequence. And the costs in question, which we've already been discussing, would be reflected as a liability on the balance sheet. Every action has a reaction. In accounting, this would be the debit, and the liability would be the credit.

And then every year after that, we would add a third statement of financial movement during the course of the year to the accounts. We already have a profit and loss account or an income statement. And we have a statement of recognised gains and losses.

Those two reflect, first of all, the physical capital maintenance concept of old, the historic cost accounting capital maintenance concept in the profit and loss account or income statement, and on the second part, the financial capital maintenance concept, which is implicit within International Financial Reporting Standards, in the statement of recognised losses. I've now introduced a sustainable capital maintenance concept into the accounts. And the third report that I would want would be the movement in that reserve during the course of the year to show has the estimate of cost gone up, or been reduced, with explanations of course, and how much has actually been spent out of the reserve to achieve the goal of avoiding what is carbon insolvency?

And carbon insolvency is a key concept within sustainable cost accounting. If the cost of the transition to net-zero within a company exceeds the current value of its net assets - in other words, its shareholder funds - then the company will necessarily be potentially carbon insolvent. In other words, it can't command the capital that it needs to survive for the long term in its current state.

It must therefore declare how it is going to actually find the money that it needs to survive. Because if we assume that the purpose of corporate reporting is to show how the company is surviving - as that is what shareholders as investors want to know will happen - then they need to know the consequences for their future ownership of the fact that carbon insolvency has been recognised. And there might be a number of ways in which that will happen.

For example, dividends may need to stop.

Or new capital might be required. In other words, new shareholder funds might be needed.

Or new borrowing might be needed, but that is not capital. Remember, borrowing is not itself capital.

So effectively, the shareholders are going to be to asked to stump up more to ensure that this company is capable of surviving in a net-zero world.

Now let's also be clear that carbon insolvency is not something that is going to require a company to go bust immediately, because of course things will change over the next 20, 25 years, or however long we are considering. That is important to note. But what it does do is put a red flag on this company, saying, 'It could be in trouble if no action is taken'. And that is the precise point of sustainable cost accounting. It is to create that red flag to tell people, 'This company could be in trouble tomorrow if it doesn't take action today to deal with the real problems of carbon, which it is facing.'

So what are the consequences of all this? There's no point in doing all this accounting, not that it is very complicated, without there being benefits. And the point is that we want to really understand how healthy are the companies that we are now dealing with when it comes to the risk of being carbon insolvent.

Our economy has been built on the basis of false assumptions of financial strength by ignoring the whole issue of climate change, and that is wrong. The old myths of capital maintenance, whether they be physical capital maintenance or financial capital maintenance, are just false. They don't reflect current risks.

So, without reform, we will face potential mass business failure, to add to the fact we'll also be facing ecological failure. So if we don't properly reallocate capital now to tackle these issues and ensure that we do so in a way that guarantees not just survival of the planet, but survival of the business environment in which we are living. We are not going to get the outcomes that we want.

Climate breakdown is accelerating. We can all see that we cannot afford delay. We cannot pretend old models work anymore. We must face the reality of radical accounting changes as a result. And my challenge is this: accounting must stop colluding with the denial of climate change because that is what it is doing.

Sustainable cost accounting reveals the truth about net-zero and the commercial world, and the reality of what is going on in the world's financial capital markets.

It would show which companies can survive and which cannot.

Radical honesty is essential if we are to adapt to the challenges we face.

Without it, we face very real risks.

And so we have to demand real accounting and not greenwash.

We have to demand the disclosure of carbon insolvency.

We have to demand that regulators and auditors act now.

And we must recognise that we cannot manage what we face unless we choose to measure it. In other words, we have to put the cost of net-zero onto the balance sheet of companies, and only when we do so will we get to the point where our corporates might survive.

What do you think? Do you think we should require that companies account for the cost of climate change? There's a short poll below. Let us know.

Poll

[poll id="201"]

Background data

This paper, which was completed in January this year, provides some background, **in the appendices,** **to what is being discussed here.**

Taking further action

If you want to write a letter to your MP on the issues raised in this blog post, there is a ChatGPT prompt to assist you in doing so, with full instructions, **here.**

One word of warning, though: please ensure you have the correct MP. ChatGPT can get it wrong.

Comments

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