Due Process Oversight Committee of the International Accounting Standards Board (**DPOC**)

IFRS Foundation

7 Westferry Circus

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16th May 2024

For the attention of Teresa Ko, Chair of the DPOC & Henry Rees, Head of Governance, IFRS Foundation

Copies to Andreas Barckow (IASB Chair), Linda Mezon-Hutter (IASB Vice-Chair) and Paul Munter (IOSCO observer)

Dear Teresa & Henry

Two submissions to IFRIC on Climate-Related Commitments (IAS37)

Due process issues relating to the choice of the first fact pattern and drafting of the final agenda decision

This letter is sent under paragraph 9.1 of the IASB's Due Process Handbook (**Handbook**). It concerns a series of governance issues that—

(a) began with the choice by IASB staff to put forward a fictitious fact pattern (the **Fact Pattern**) for the first IFRIC discussion that did not represent the reality of the first submission—and built in two 'outs' which together meant that this Fact Pattern would inevitably fail one or both recognition criteria under paragraphs 14 (a) or (b) of IAS37; and

(b) built two further 'outs' and anomalies into the final agenda decision (the **Decision**),

and the effect of these in combination in creating added confusion on this 'hot topic' (an ironic choice of words).

There were three outcomes possible from the two submissions—greater clarity that a provision should be recognised, greater clarity that it should not or greater confusion—the very worst outcome of much greater confusion has been achieved by the IASB. Our analysis is that the choice of the Fact Pattern by IASB staff directly caused and led to this.

The outcome of this series of governance issues is a Decision which can be evidenced to be confusing and, in the words of XRB New Zealand in its comment letter, is '*not useful*'. Specifically it is not useful in enabling primary users to make decisions on how to account for commitments to reduce emissions made in FY's 2020-2021 and affirmed to FY 2023, particularly within the oil and gas and hard to abate sectors (what we call **Real World Commitments**).

We have been made aware of Andreas Barckow stating in the IASB's April podcast (at 6.30 onwards) and of the IASB's briefing the press that Rethinking Capital chose the Fact Pattern. **Rethinking Capital did not choose the Fact Pattern and was not consulted by IASB staff before it was chosen.** We would not have chosen this Fact Pattern had we been consulted because the focus of the two submissions was on Real World Commitments—we would only have chosen anonymised real world fact patterns from the oil and gas and hard to abate sectors and made this point to IASB staff.

This letter calls for an investigation of these issues by the IFRS Foundation Trustees—in particular to answer whether a guiding hand was applied from within the IASB to lead to this outcome. And for this investigation to be overseen by the Monitoring Board of the IFRS Foundation as a 'hot topic' and matter of public interest.

It also suggests that of the options available from this point, the most practical in reducing confusion is to repeat the process while leaving the Decision intact—beginning with the fact pattern of Real World Commitments from the second submission and with a strong focus on governance, independence and oversight.

The letter explains why this outcome of greater confusion was both expected and anticipated. This results from this insight provided by an influential person within accounting standard setting, that—'***The purpose of financial statements today is not to represent the commercial reality'*** and the logical conclusion that flows from that insight.

It ends with a searching question for the IFRS Foundation trustees—to ask what is the Foundation's purpose if not to collaborate in solving the problem of the upside down incentives that pervade today's natural and social systems?

1. The series of governance issues

The series:

1.1 Began with the choice of IASB staff to put forward the fictitious **Fact Pattern** for the first IFRIC discussion that did not represent the reality of the first submission—and built in two 'outs' which together meant that this Fact Pattern would inevitably fail one or both recognition criteria under paragraphs 14 (a) or (b) of IAS37. The Fact Pattern and the two 'outs' are further explained in paragraph 2 below.

1.2 Contains two drafting points and anomalies in the **Decision** where the final wording further confuses the analysis (**Decision Drafting Points**)—the points being:

(a) that affirmative actions are powerful evidence that the entity itself recognises that it has created a constructive obligation made by Brian O' Donovan on 5th March which became that affirmative actions may represent an intention to create a constructive obligation in the final approved Decision (**Point 1**); and

(b) that if a provision is recognised then investments purposed to meet the commitment can be recognised as assets—where the final wording in the Decision reverses the principle of asset treatment from the previous version—a change that was not discussed by the Committee (**Point 2**).

1.3 Ended with the IASB stating in its April podcast (at 6.30 onwards) and briefing the press that Rethinking Capital chose the Fact Pattern when it did not—and the IASB's press office generally briefing that nothing is expected to change as a result of the Decision and provisions will not be generally recognised— in and of itself a strange action by a principles-based standard setter committed to ensuring that its Standards are accessible to decision-makers.

2. Choosing the Fact Pattern and the two 'outs'

<u>Rethinking Capital did not choose the Fact Pattern and was not consulted by IASB staff before it was chosen</u>. Added to this, we would not have chosen this Fact Pattern had we been consulted because the focus of the two submissions was on how Real World Commitments should have been accounted for under IAS37 and other Standards from FY's 2020-21 when they were first made. As such we would only have chosen anonymised real world fact patterns such as those of bp or Shell or the hard to abate sectors and made this point to IASB staff.

Having not been consulted before the Fact Pattern was chosen and the staff note issued, we exchanged emails with Bruce Mackenzie on 22nd November 2023 to object to this Fact Pattern—but were recommended to allow the IFRIC process to continue against the alternative of withdrawing the submission.

The two outs in the Fact Pattern against the Real World Commitments described in the First Submission

Fact pattern	Comparison against Real World Commitments	Explaining the two 'outs'
In 20X0 an entity, a manufacturer of household products…	Real World Commitments in the first submission were in the oil and gas and hard to abate sectors which represent the emissions most needed to be reduced by 2030.	Immediately the Fact Pattern leads the discussion away from the real issue at hand of Real World Commitments and sets up the 'outs.'
…publicly states its commitment: (a) to reduce its current greenhouse gas emissions by at least 60% by 20X9; and (b) to offset its remaining emissions in 20X9 and thereafter, by buying carbon credits and retiring them from the carbon market.	Real World Commitments publicly stated a commitment to reduce emissions over time in a series of annual emission reduction targets. Offsets and carbon credits are one means but not the primary purpose stated in Real World Commitments—to reduce emissions.	This is the first 'out' which inevitably fails the recognition criteria of paragraph 14 (b) of IAS37—if the entity fails to meet its emission reduction target it acquires carbon credits as a replacement asset—there is therefore no outflow of economic resources.

With its statement, the entity publishes a detailed plan setting out how it will gradually modify its manufacturing methods between 20X1 and 20X9 to achieve the 60% reduction in emissions by 20X9.	In Real World Commitments, entities in the oil and gas and hard to abate sectors made a series of affirmative actions—'derived from the entity'. Examples of affirmative actions are in the first submission and included the established pattern of a transition plan, negotiation of the plan with investors to set acceptable returns, publishing the plan, updating it and publishing annual updates—and most importantly committing capital expenditure to meeting it.	The Fact Pattern creates the second 'out' of a detailed plan which never changes. This must inevitably fail the past event-present obligation criteria under paragraph (a) of IAS37 because there is no past event to the statement and plan published together. The plan never changes and is never affirmed and affirmative actions are disregarded.
The modifications will involve investing in more energy-efficient processes, buying energy from renewable sources and replacing existing petroleum-based product ingredients and packaging materials with lower-carbon alternatives. Management is confident that the entity can make all these modifications and continue to sell its products at a profit.	In Real World Commitments, entities in the oil and gas and hard to abate sectors made a series of affirmative actions—'derived from the entity'. Examples of affirmative actions are in the first submission and included the established pattern of a transition plan, negotiation of the plan with investors to set acceptable returns, publishing the plan, updating it and publishing annual updates—and most importantly committing capital expenditure to meeting it.	This strengthens the first 'out' which inevitably fails the recognition criteria of paragraph 14 (b) of IAS37—because the entity can complete its program and still sell its products at a profit—there is therefore no outflow of economic resources.

3. Anomalies in the Decision Drafting Points

The choice of the Fact Pattern by IASB staff meant that subsequent points in the Second Submission were not discussed though it was accepted to contain '*many good points*' according to KPMG's Brian O' Donovan in the 5th March IFRIC meeting. The exception discussed being explained by Brian—that '*affirmative actions by a company* are *powerful evidence that the company itself accepts that it has created a constructive obligation'.*

The two further 'outs' and anomalies drafted into the Decision that create greater confusion for primary users are:

3.1 Point 1 on affirmative actions expressed clearly by Brian O' Donovan was put forward and agreed by IASB staff to '*flow through the decision*' but was distorted in the Decision, introduced with references only to:

*'In addition to publishing the transition plan, the entity takes several other actions that publicly affirm **its intention to fulfil its commitments'** and*

*'depends on the facts of the commitment and the circumstances surrounding it, **including any actions the entity has taken that publicly affirm its intention to fulfil the commitment'.***

The point that Brian O' Donovan made was that affirmative actions are powerful evidence that the entity itself accepts that has created a constructive obligation—because they 'derive from the entity's actions' as required by the definition of a constructive obligation. The concept of intentions also adds to and varies IAS37.

3.2 Point 2 on how expenditures made to meet the provision was altered from the clarity of:

"The Committee observed that expenditure is recognised as an asset, rather than as an expense, only if it gives rise to—or forms part of the cost of—an item that qualifies for recognition as an asset in accordance with an IFRS Accounting Standard."

To these confusing words that even undermine a basic principle of accounting—that when a provision is recognised, then investments to meet it 'unwind' the provision over time, IAS19 being an example—

"The Committee observed that if a provision is recognised, the corresponding amount is recognised as an expense, rather than as an asset, unless it gives rise to—or forms part of the cost of—an item that qualifies for recognition as an asset in accordance with an IFRS Accounting Standard."

4. Rethinking Capital's analysis

4.1 To our knowledge, IFRIC has not previously considered a fictitious fact pattern, nor was it asked to consider a fictitious fact pattern by the IASB in July 2023.

4.2 The Fact Pattern distorted the IFRIC discussion from the outset and focused it on the two 'outs' built into the Fact Pattern. In the limited time for discussion, the substance of Real World Commitments was not possible.

4.3 The two 'outs' in the Fact Pattern meant that the key concrete point made by IOSCO's Paul Munter in the first IFRIC meeting was not able to be considered in the Decision—that when the threshold to be a constructive obligation has been passed then a decision on recognition of a provision must be made **at that time**—in particular the probability of outflow economic resources is to be assessed when the threshold has been crossed.

4.4 The Fact Pattern meant that points from the Second Submission that logically flow from Paul Munter's point were not discussed though it was accepted to contain '*many good points*' according to KPMG's Brian O' Donovan.

4.5 The exception being Point 1 explained by Brian O' Donovan from minutes 6.55 to 8.43 of second IFRIC meeting available here—that '*affirmative actions by a company* are *powerful evidence that the company itself accepts that it has created a constructive obligation*' which was not properly reflected in the Decision as described above.

4.6 The wording in Point 2 was designed to create confusion—lawyers use this drafting approach to bury an issue.

4.7 These events cannot be explained or passed off as random and unconnected—indicating that a guiding hand may have been deliberately applied to create the outcome of greater confusion to perpetuate the status quo.

5. Evidence of confusion

Rethinking Capital has created its own interpretation of the Decision to enable primary users and our community and stakeholders to understand it and to make their own decisions—as boards, asset owners, investment managers and the net zero movement few of whom are accountants. It focuses on the Decision being not useful when applied to Real World Commitments.

The overwhelming reaction is confusion. We even asked a psychologist and lawyer to read the Decision—and received the analysis that the logic and wording seems designed to cause confusion and perpetuate the status quo.

Even between the audit firms, there is confusion. The positive reaction supporting our interpretation that cuts through the confusion is KPMG's analysis which guides that the accounting to be done must logically follow the story being told by the company https://kpmg.com/xx/en/home/insights/2023/07/climatechange-emissions-schemes-net-zero-ias37.html. While PwC's here in the first five minutes focuses on the Fact Pattern.

The issue of how to account for Real World Commitments, this 'hot topic', has therefore been made more rather than less confusing by IFRIC and the IASB's press briefings—and therefore less accessible and understandable to management, boards and investors who must now make a new decision in preparing for FY'24 year ends.

6. Call for investigation to be overseen by the Monitoring Board and to repeat the submission

These issues are also part of a broader pattern of strange events that occurred from our first responding to Bruce Mackenzie's LinkedIn post saying '*Any questions for the Interpretations Committee*' in August 2023—in and of itself a strange event when put into the context that the IASB had just asked IFRIC to ask the question of itself.

In the context of such a critical issue for tackling the climate crisis, and a 'hot topic', this letter calls for a transparent investigation of these events by the DPOC and IFRS Foundation trustees under the three guiding principles of the Handbook. And because it is a hot topic and in the public interest, this letter also calls for this investigation to be overseen under the public interest duty and rights of the IFRS Foundation's Monitoring Board.

Of the options available to reduce confusion from this point, the most practical in reducing confusion is to repeat the process while leaving the existing Decision intact—beginning with the fact pattern of Real World Commitments from the second submission and with a strong focus on governance, independence and oversight to avoid the risk and perception of conflict of interest.

7. Why was this outcome expected and anticipated?

Sadly the outcome of greater confusion was both expected and anticipated. It is generally known that the constructive obligation technical debate was '**killed for political reasons**' within the TCFD.

And more broadly, the submission must be placed in the context of the fierce resistance of the accounting profession to the recognition of intangibles—described by NYU Stern Professor Emeritus Baruch Lev (to whom the investigation should talk) in The End of Accounting as a '**conspiracy of silence**'. In truth, IAS37 is only the tip of the tip of the iceberg in showing that assets and obligations that exist in reality but not properly reflected in today's financial statements.

This begins with understanding one of the deepest insights confidentially explained to us by a Standard setter—***'that the purpose of financial statements today is not to represent the commercial reality but to be comparable and for tax'***–this simple insight leading to a logical conclusion that financial statements today are arguably equally materially inaccurate, equally untrue and unfair and equally not compliant with IFRS Standards—but they are comparable.

The equivalent of a Gordian Knot exists at the centre of accounting and audit practices today. Made less confusing, IAS37's application to Real World Commitments can begin the process of finding the end of the knot.

8. A final strategic and searching question for the IFRS Foundation trustees and Monitoring Board

'The portion of the world's economy that doesn't fit with the old model just keeps getting larger. That has major implications for everything from tax law to economic policy, to which cities thrive and which fall behind. But in general, the rules that govern the economy haven't kept up. This is one of the biggest trends in the global economy that isn't getting enough attention' Bill Gates, reviewing Capitalism Without Capital: The Rise of the Intangible Economy

Bill Gates is rare in his insight of a root cause at the heart of today's inequities. Previous shifts in the way that value is created in the economy have also required new accounting to recognise the new assets creating value.

Now that IFRS Foundation trustees know that the failure of accounting to keep up with today's shift is creating systemic adverse effects and that upside down incentives pervade today's natural and social systems, it must face a deep and searching question—**what is our purpose if not to do whatever we can now to solving these problems**?

In answering that question, it becomes apparent that it is incompatible at this moment in history for those that set and interpret accounting standards to be mixed with those that audit compliance with them—shown by five of the fourteen IFRIC members (36% of its votes) being represented by the firms. Mixing in being funded 13.5% by those firms creates unneeded suspicion—and finding alternative funding sources like FASB's levy should be considered.

9. Publication

We are conscious that though an investigation goes to the accountability and transparency of the IASB, it may cause personal scrutiny of individuals involved in the issues to be investigated. As such, although letters to the DPOC are required to be published, under certain conditions we can agree to keep this out of the public domain.

Yours faithfully

Andrew Watson,

Founder and Director, Rethinking Capital Limited

