Normative accounting for intangibles—'Tackling the root cause of the climate crisis'

A briefing note for non-executive directors and boards on applying normative accounting for intangibles in net zero transition decision governance and reporting

Summary

Rethinking Capital is a thinktank working on technical accounting solutions for climate action. It has set up working groups named The Catalysts to explore the financial, mindset and other benefits of its net zero decision governance and reporting framework. The framework applies normative accounting and governance to enable informed decision-making on the intangibles impacted by a net zero transition commitment. It is designed to tackle the root cause of the climate crisis—being upside down accounting incentives and, by cause and effect, an upside down transition mindset.

This is a fresh, new, back to basics accounting approach to any commitment to achieve '*net zero by 2040*' or '*a 50% reduction in Scopes 1 and 2 by 2030'* for example. At its heart is the simple application of double-entry bookkeeping to recognise each £1 of capital allocated into building sustainable relationships with the environment, nature, people and society as investments into intangible assets on the balance sheet and to revalue the impacts of that investment.

Its six features and benefits for non-executive directors and boards are:

1. **The best available tools for the job.** Better informed decision-making enabled by properly accounting for and governing the intangible assets, obligations and risks impacted by the net zero transition commitment.
2. **Many key financial metrics will materially improve.** As the company allocates capital into and achieves its net zero transition commitment over time, each of profitability, shareholder equity, earnings per share, return on equity and debt to equity ratios will materially improve.
3. **Creates positive, immediate and certain incentives**. Giving the financial incentives to invest into meeting the transition commitment and further incentives to speed it up—flipping today's upside down incentives.
4. **Should remove the risk of personal liability**. Because using tools that don't recognise the commitment as an obligation and don't recognise the impact on intangibles is <u>like being handed a grenade to fix a tyre puncture</u>.
5. **Transparency of the important management decisions**. Using management accounts to inform and report decisions to allocate capital to the transition in annual budget setting and strategic planning.
6. **Accountability to internal and external stakeholders**. Showing stakeholders that the board and management are taking conscious decisions to govern the intangibles impacted by their net zero transition commitment.

Questions for non-executive directors and the board

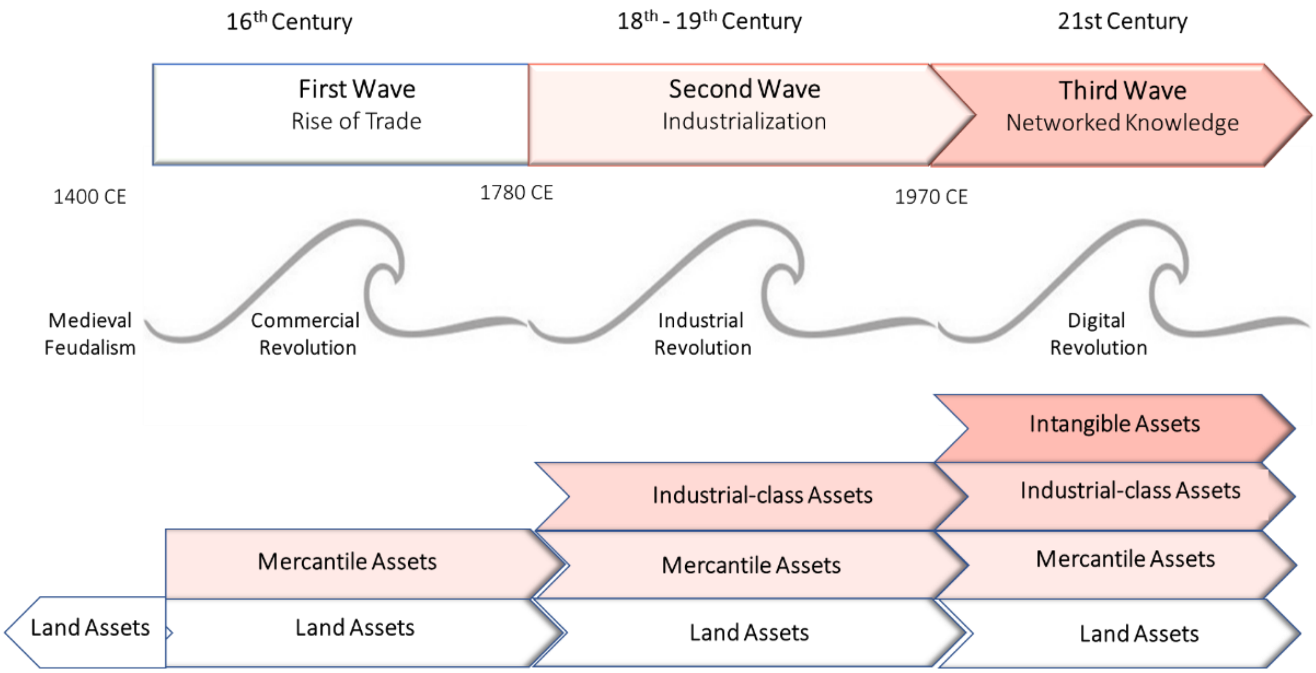
These benefits raise some searching questions for non-executive directors and for boards—and for management:

- Using the framework, what more could be learned about the financial impact of the transition on all assets and obligations? With strong incentives, what decisions become possible in strategic planning and budgeting?
- Without financial statements that show the impact of the transition on all assets and obligations, how can any informed decisions be made to allocate capital into meeting the commitment? Or to choose not to meet it?
- Why would a director choose to use tools known to be unfit for the task? Surely it has to be for the board to decide what's a transition asset, obligation and risk and how these are best accounted for and governed?
- What does it mean for directors personally if they choose to use tools that create more damage to the environment? Would it mean that fiduciary duties and duties of care are already being broken?
- With the climate crisis here and now, what small but important part can non-executives play?

1. Context: About Capitalism's Third Wave & Intangibles

Capitalism's Third Wave

Changes on the scale being experienced today are nothing new—though their threats are. Western capitalism has evolved through a series of changes in its engine of growth that have gone hand in hand with a series of asset revolutions. Each wave is associated with changes in the economy, in society and in the relationship between both.



The shift that society and the economy are going through in the Third Wave is characterised by innovation driven by people through networks made possible by digital connectivity. In reality a whole new economy has burst into life. And the Third Wave has generated many new classes of intangible resources, assets, obligations, liabilities and risks.

Bill Gates describes the shift in his review of Capitalism Without Capital: The Rise of the Intangible Economy:

> *'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 cities 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.'*

Gates' insight that the rules that govern the economy haven't kept up is rare because it hints at a root cause behind today's natural and social inequities. When applied to the net zero transition, the implications become clear. Because at present, accounting practice globally chooses to treat climate risks and liabilities, even net zero commitments, as externalities, rewarding doing nothing. While forcing transition innovation and investments to be expensed through the income statement, effectively penalising investments into programs that have the intent and purpose of meeting the transition commitment. This also results in operating cash outflow classification that further reinforces the impression that the board, investors and other stakeholders should not view them as investments into the future.

It becomes clear the net zero transition incentives are, quite literally, upside down—as is the net zero transition mindset. Flipping these incentives is one of the problems that normative accounting for intangibles will solve.

A detailed Rethinking Capital paper on the Third Wave is available. *It is based on the book Futuromics by co-founder Robert McGarvey and describes the profound economic and social benefits unleashed by investors first accounting for hidden value in the First and Second Waves. It's also a story of hope in providing a roadmap for change today.*

What are intangibles?

Defining terms is important in understanding intangibles and their unique features. In particular that each has dual characteristics, being either a value creating resource or a value eroding liability and risk depending on how it is governed—a trade secret, for example, is only an asset while it remains a secret.

Question	Answer
What are intangibles?	Intangibles are the resources becoming recognised as vital to creating value in today's knowledge-based economy. In reality, every company has lots of them. They include: 1. The assets used in and resulting from innovation. These include the best creative minds, knowledge and past experience, learning from failure, research collaborations at scale, prototypes, patents, software, data sets, AI (artificial intelligence) and designs. 2. Softer relational resources including belief systems, culture, relationships, reputation and the obligations to society and stakeholders that go to make up the social license. The Securities & Exchange Commission, the, IFRS, the International Sustainability Standards Board (ISSB) and the European accounting standards body EFRAG, are all looking into better reporting of the value of intangibles in financial statements. *Rethinking Capital's taxonomy of intangibles the Intangibles Tree™ is available. It provides a standard language and a system design for how they combine to create value.*

2. Choosing to use the wrong tools creates personal risk—'like being handed a grenade to fix a tyre puncture'

Choosing to use financial statements and tools that aren't fit for the task creates personal risk. The best analogy is '**like being handed a grenade to fix a tyre puncture, by the person from roadside assistance'**—in that the task is hard and stressful already, but using the wrong tools will make the situation much worse and will for certain harm the user.

First because accounting for the intangibles associated with a net zero transition commitment is simply not being done within today's financial statements. For some reason, today's financial statements don't recognise a net zero commitment as an obligation even though each one creates valid expectations with stakeholders—including the public at large. And must, somehow, be recognised and valued if current standards were being correctly applied.

Second because, for other reasons, the serious investments into innovations needed to meet the net zero commitment are being expensed. Even though their specific intent and purpose is to meet that commitment.

Third because mitigating the probability and impact of risk to reputation must be managed. Every company has a reputation with each of its stakeholders—with its people, society and the public at large, with its investors, young people, and with environment and nature. As the example of Harvey Weinstein shows, risk to reputation accumulates over time and is at risk of failure because of past decisions. As Harvey also shows, plotting the probability and impact of risk to reputation on a risk register can't be done subjectively. And also shows that decisions to trade off short term benefits for long term sustainability will increase the risk of immediate and catastrophic failure over time.

Knowing this, the right and duty of non-executives is to hand back the grenade and demand tools fit for the task.

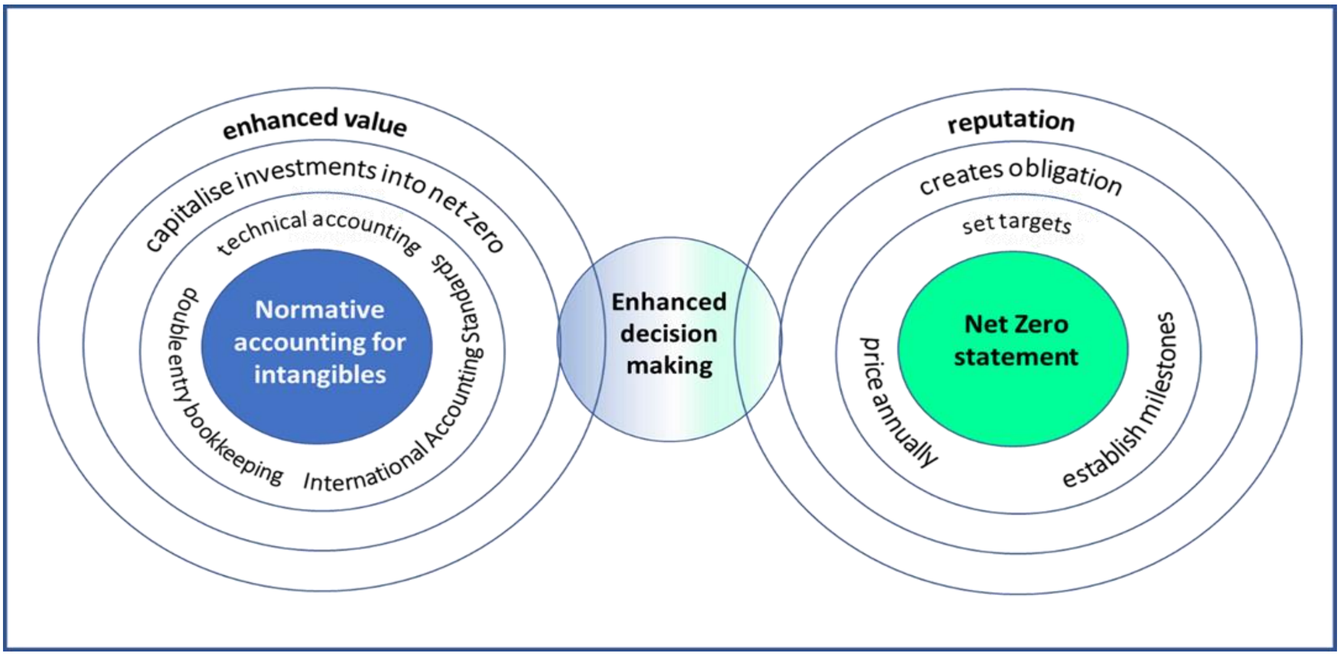
3. Applying normative accounting for, and governance of, intangibles to a net zero transition commitment

Normative accounting for intangibles is one part of a decision governance framework that enables directors, management and stakeholders to make better informed decisions about a net zero commitment and sustainability in general. The same logic has been adapted for decisions to invest into nature and circular as inter-connected systems.

The framework recognises the commercial reality that boards already know—that meeting the company's and board's commitment to get to net zero can be very difficult and expensive. It's difficult and expensive because really committing to the transition means rethinking strategy, business models and supply chains. It also means diverting valuable people and time away from the operations of the business and risk of loss of focus.

And because, despite these hardships, stakeholders still expect it. People, investors and society expect companies and boards to stand behind commitments made since 2020 after BP became one of the first to commit to getting to net zero by a future date over time. It must follow, logically and intuitively, that investing to meet a transition commitment is creating positive value for investors and all stakeholders—not the other way round.

The framework uses simple tools already familiar in business, including the balance sheet and risk register. It begins by recognising that the company's net zero commitment has created an expectation with multiple stakeholders—and as such has converted an externality into an obligation.



A 4 x 4 risk register is applied to manage risk to reputation, with an objective setting for probability and impact.

The framework then uses technical accounting to recognise the intangible assets and obligations impacted by a net zero transition commitment and into building equitable relationships with each stakeholder impacted. At its heart is the simple application of double-entry bookkeeping to recognise each £1 of capital allocated into building an equitable relationship with the environment and nature as stakeholders as investments into intangible assets on the balance sheet. Therefore, from the first creative spark in the innovation process to the implementation of solutions, investments are capitalised pound for pound. The economic and other effects of each £1 in reducing negative impacts on the environment and nature by reducing emissions are then measured and revalued or impaired over time.

Not meeting the commitment increases risk to reputation and as such has the opposite accounting effects.

Technical papers and a presentation are available. *These explain the history and purpose of normative accounting in accounting theory. An important feature is that the framework applies simple technical accounting and double-entry bookkeeping and is informed by existing International Accounting Standards including IAS37, IAS38, and those named on pages 37 and 38 of the TCFD Guidelines. The possible effect in credit rating analysis is explained in this paper by Rethinking Capital technical accounting contributor Imre Guba, of S&P and an expert member of the TCFD Taskforce.*

4. Legal and risk analysis

To meet both fiduciary duties and the duty of care, directors and management must always use the best available tools—in this case to govern the net zero transition commitment. It must be clear that commitment has created valid expectations with stakeholders—including the public at large—and therefore has to be properly recognised, somehow, in financial statements as an obligation. Non-executives have the right and the duty to demand this because if not recognised then non-executive directors risk crossing the bridge into personal liability.

Directors and management must also be able to show that conscious decisions have been taken to govern all assets, risks and obligations impacted by choosing to meet the commitment—or not to meet it. This will evidence the discharge of fiduciary, employment and other duties of care and again reduce the risk of personal liability—or not.

A Legal and Risk briefing note by is being prepared*. This gives an options, pros and cons analysis to enable internal counsel and risk officers to brief directors and makes a recommendation to test using these tools. The paper will also explain how the framework is equally applicable to any decision maker with a fiduciary duty or a duty of care—including investors, insurers and leaders of national or local governments who have made a transition commitment.*

