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Via email: commentletters@ifrs.org

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IASB Horizon Scanning: Restarting Project on Pollutant Pricing Mechanisms

Dear IFRS Foundation Trustees,

With EUR 963bn in assets under management across major asset classes (as of 30 September 2024), DWS is one of the largest asset managers in Europe in the retail and institutional markets. Operating across Europe, the Americas, and Asia, we are a global asset manager. We are a fiduciary partner to our clients and seek to contribute to a sustainable future: for instance, we are a founding member of the Net Zero Asset Managers Initiative and an early PRI signatory since 2008.

We are writing to recommend that IASB restart work to develop accounting standards for corporate assets and liabilities under regulated emissions trading schemes.

There continues to be a need to strengthen efforts by corporations to disclose the effects of climate-related and other uncertainties in financial statements. For several years, European investors have been calling on companies and accountants for better, more consistent financial disclosures to provide Paris-aligned accounts[1]. For instance, one of the indicators in Climate Action 100+'s investor evaluation of companies' progress focuses on whether climate risks are incorporated in financial accounting and auditors' reports[2]. Of the 138 companies assessed, 33% partially met some criteria and 67% did not meet any criteria while only 2% of companies assessed showed improved reporting compared to the 2023 assessment[3].

In principle, we agree with the Exposure Draft on Climate-related and other uncertainties and its proposal of providing illustrative examples of how companies should use existing IASB Standards to disclose climate-related risks, opportunities, and uncertainties. Cascading these examples into practical industry specific cases would also be useful (without going into explicit sectoral guidelines).

However, the Exposure Draft misses a major source of climate-related financial materiality: regulated carbon markets and tradable credits under energy technology regulations[4]. There is a clear need for accounting requirements. Our research[5] shows that currently there is a lack of comparability and transparency of companies' accounting for carbon allowances and obligations in financial statements.

We therefore call for the IASB to restart the development of a carbon allowance accounting standard.

[1] IIGCC (2020), Investor Expectations for Paris-aligned Accounts; IIGCC (2022) Letters to UK's largest audit firms on climate risk

[2] Methodology: www.climateaction100.org/net-zero-company-benchmark/methodology/#accounting

[3] Climate Action 100+ (October 2024) Net Zero Company Benchmark

[4] For example, tradable electric vehicle credits under vehicle efficiency regulations, renewable transport fuel obligations etc

[5] DWS CROCI (April 2023) Carbon allowances and financial accounts

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OECD[6] concludes that "an increase in the introduction of new carbon pricing instruments is expected over the next five years". Given that carbon markets and carbon border taxes[7] are becoming increasingly important to the task of achieving Net Zero emissions, we emphasise the importance of developing an accounting standard that creates a level playing field for how corporate balance sheets value and report on carbon emission allowances and other environmental technology regulatory credits. This will contribute to providing a "true and fair" picture of corporates' real financial performance, risks and opportunities in the environment in which they operate.

A recent DWS report[8] undertook a carbon price stress test of major equity indices, concluding that higher carbon prices could significantly impact company equity value by -10% to -15% for the MSCI World index, based on a carbon price of USD 150/tCO2 or USD 300/tCO2.

However, for 20 years, accounting standards have failed to develop a standard for how companies account for carbon allowances and other green credits in their financial statements. Efforts to develop such an accounting standard were started and stopped multiple times due to other accounting standard priorities. Over the several years that it will likely take to develop a carbon allowance accounting standard, the geographic and sectoral coverage and financial materiality of regulated carbon markets and carbon border taxes are very likely to grow.

We highlight that the European Securities and Markets Authority (ESMA) issued a public statement[9] also calling for the development of a carbon allowance accounting standard. The European Sustainability Reporting Standards (ESRS) states that companies regulated by the EU ETS "may disclose the potential future liabilities" (AR46)[10], but this is not an accounting standard. In addition, the Financial Accounting Standards Board (FASB) decided[11] to develop an environmental credit accounting standard.

Even in the absence of an accounting standard, we also call for the IASB Exposure Draft on Climate-related and other uncertainties in financial statements to include illustrative examples of corporate financial statement disclosure of carbon allowances.

It is important to investors to have minimum transparency regarding carbon allowance-related assets and liabilities. DWS's CROCI[12] team published its guidelines[13] for treating emission allowance related items from the financial statements into our measurement of companies' real profitability and valuation. These recommendations could be drawn on by IASB to develop a draft carbon allowance accounting standard. ESMA's public statement also recommended ways that corporates could consider how they can account for and disclose carbon allowances in the absence of a carbon accounting standard.

[6] OECD (November 2024) Pricing Greenhouse Gas Emissions

[7] https://carbonpricingdashboard.worldbank.org/

[8] DWS Research Institute (October 2024) Stress testing equity markets with higher carbon prices

[9] ESMA (October 2024) Clearing the smog: accounting for carbon allowances in financial statements

[10] European Commission (December 2023) Commission Delegated Regulation (EU) 2023/2772

[11] FASB (June 2024) Accounting for environmental credit programs

[12] CROCI is a proprietary equity valuation model of DWS and around EUR 6bn assets follow its CROCI investment strategies. The CROCI model was created in 1996 in the context of equity research with the main objective of analysing and calculating a meaningful and comparable return on capital and price/earnings ratios for each stock under coverage.

[13] DWS CROCI (April 2023) Carbon allowances and financial accounts

We note that the vast majority of European emission allowance trading in secondary markets takes place through derivatives. This reflects the annual EU Emissions Trading System (ETS) compliance cycle where non-financial sector firms hold long positions (for compliance purposes) while banks and some investment firms hold short positions. According to insights from ESMA's report on the EU ETS[14], many companies maintain derivative positions and opt for physical delivery of ETS at the conclusion of the compliance cycle. Accounting for these derivatives would be covered by existing accounting standards (IFRS 9). However, we highlight the importance of having minimum transparency standards about underlying carbon emissions and allowance related assets and liabilities.

We also recommend illustrative examples be published on the role of auditors and their role in confirming support for the company's approach and consistency with other statements. IASB could collaborate with relevant auditing standard-setting bodies to establish clear expectations for auditor scrutiny of climate-related disclosures. Beyond finalising the illustrative examples, IASB should consider how to best promote their adoption by companies, auditors, and regulators.

Thank you for the opportunity to provide input.

Kind regards

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<u>Disclaimer</u>

As one of the leading asset managers (EUR 963bn under management, as of 30 September 2024) and a fiduciary partner for our clients, DWS aims to be a trusted and responsible partner for decision-making in public institutions. Transparent dialogue with decision-makers plays a central role in this. We regularly take part in public consultations on legislative projects and public our views on current and social issues in statements.

This letter serves as a basis for discussion of the present topic with the relevant stakeholders and, regardless of their experience, is not intended for investors. With this analysis and letter, we want to contribute to an objective and constructive discourse. We emphasise that despite careful consideration, these assessments, analyses and positions may be subject to change over time.

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[14] ESMA (October 2024) EU carbon markets 2024