


ACCOUNTING

SUSTAINABILITY BRIEFING PAPER 5



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ACCOUNTANTS AND ACCOUNTING

The health of an organisation can no longer be accounted for purely through financial metrics and as a result accounting must adapt.

While preparing and maintaining financial books and basic forms of accounting have existed for centuries, the accounting profession now involves much more than this and continues to evolve. It is in the context of this evolution that this paper considers how sustainable development is affecting the accounting profession, and indeed what contribution accounting can make to sustainable development.

A basic function of the accounting profession is to inform the management and owners of an organisation of the value of assets and liabilities, as well as to provide information about cash and resource flows. In short, it provides information on the financial health of an organisation. However, the health of an organisation can no longer be accounted for purely through financial metrics and as a result accounting must adapt.

“ Your profession [accounting] is one of the key pillars of our economic stability and prosperity, but to ensure that our descendants can experience something of that stability and prosperity there is a very real urgency to adapt our accounting procedures to the critical challenge of minimising the wasteful damage done to the fragile world around us, through man’s increasingly short-term perspective ”

HRH The Prince of Wales, 2005

Accountants, for good reasons, have generally been more comfortable dealing with readily quantifiable financial metrics and have tended to be historic in their focus, handling the future with some reluctance. We now understand, however, that there are additional non-financial costs and benefits to be accounted for. There is a need to look at all resource flows and not just cash flows.

ACCOUNTING AND SUSTAINABLE DEVELOPMENT

Organisations need to account for anything that can affect valuation and/or resource flows. It is becoming increasingly urgent that accounting plays an effective role in measuring and communicating the risks, benefits, and therefore value, to the organisation and society associated with non-financial aspects.

Organisations need to account for anything that can affect valuation and/or resource flows. We face significant challenges across all kinds of issues including sustainable wealth creation, climate change and the use of scarce resources such as water and energy. As a result, it is becoming increasingly urgent that accounting plays an effective role in measuring and communicating the risks, benefits, and therefore value, to the organisation and society associated with non-financial aspects. At the moment, few have incorporated costs related to factors such as deforestation, deterioration of arable land, or the destruction of traditional communities. Financial accounting still struggles with the valuation of intangibles and the internalisation of environmental and social costs. Although narrative and sustainability reporting are attempting to address these issues, further progress on measurement and accounting is required to fully understand and incorporate relevant sustainability risks, opportunities and, ultimately, their impact on the bottom line.

As societal awareness of the importance of sustainability issues has increased (in particular the impact of climate change), public bodies and companies have also become more aware and responsive. The result has been increasing discussion of how best to account for and communicate sustainability performance; or to put it another way, how accounting can help provide a more balanced and complete picture of overall value and performance. Existing financial accounting systems, to some extent, have started to account for environmental and social accounting considerations. The IASB has covered elements of environmental and social accounting in its mainstream standards. IFRIC 5 (Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds) and IAS 37 (Provisions and contingent liabilities) refer to environmental issues. In many cases, however, this is insufficient and alternative accounting approaches have been developed to provide a broader perspective and longer timeframes than currently provided.

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Although such concerns are not new, as initiatives such as the Dutch National Accounting Matrix for Environmental Accounts (NAMEA) established in 1989 show, there appears to have been an upsurge in non-financial and forward-looking accounting and reporting initiatives in recent years. The UNCTAD ISAR work on 'Accounting and financial reporting for environmental costs and liabilities' and more recently the 'Manual for the preparers and users of Eco-efficiency indicators' were important developments, as was the EC White Paper on Environmental Costs and Liabilities. In the last few years the Accounting for Sustainability project has done useful work to help enhance the accounting and reporting model to provide a more holistic picture of the impact of an organisation's actions. It has not tried to create a new accounting model; rather it aims to make better use of existing financial and non-financial information.

What is clear is that unless innovative, practical and robust systems can be developed to enable broader and longer-term factors to be presented more effectively in organisational accounts, decision-making will continue to be unable to reflect crucial sustainability concerns.

Case Study – The IFAC Sustainability Framework

- In a move that further underlines the growing importance of sustainability to the accounting profession, IFAC recently launched a Sustainability Framework. This is a new web-based tool designed to help professional accountants in any sector to integrate sustainability into their jobs.
- The framework is based on the premise that the role of the accountant is changing and that professional accountants need to adapt to a world in which sustainability is the key to long-term business performance. The framework addresses several areas of an accountant's possible roles: business strategy, internal management, financial investors' perspective, and other stakeholder perspectives.
- While all four areas are important, it is the internal management section that is most relevant to this paper, as it encourages the introduction of sustainability and environmental accounting into existing accounting and information systems. The first aspect highlighted is that simple sustainability-focused accounting systems can help identify 'quick wins' in relation to minimising waste and cutting costs.
- Accounting can play a far more strategic role when an organisation moves from compliance to a performance-based view of accounting for sustainability impacts. Performance evaluation and measurement foster accountability for performance, and provide feedback on the impact of sustainability initiatives. Redefining existing recorded costs can help to distinguish between types of cost and allow greater understanding of environmental and social costs. Another consideration stressed by the framework is the importance of developing the right metrics based on a comprehensive understanding of the material impacts on social and environmental aspects.

FULL COST ACCOUNTING

Full cost accounting seeks to identify, quantify and internally allocate all costs associated with an organisation's activities, operations, products and/or services, including environmental, social and other external costs.

Traditional financial accounting records the financially related stocks and flows of an organisation in the form of the profit and loss account and the balance sheet. Sustainability accounting, by contrast, includes measurement of social, environmental and other intangible resources (such as human capital and intellectual property) to provide a more complete picture.

Present financial accounting and measurement do not capture all of the consequences of an entity's actions. Externalities – costs and benefits that do not accrue directly to the organisation – are not included in the financial accounts. If prices do not include all the costs and benefits, how can the market give the signals that will allow the most appropriate economic, social and environmental decisions? Sustainability accounting addresses the type of impact (environmental, social or economic), the location of the impact (under the control or just influence of the company) and the timing of the impact (a snapshot or a period of time).

Full cost accounting describes how goods and services should be priced to reflect their true costs (including environmental and other social costs). It seeks to identify, quantify and internally allocate all costs associated with an organisation's activities, operations, products and/or services, including environmental, social and other external costs. Full cost accounting embodies several key concepts that align it to standard accounting techniques, as well as other concepts that clearly distinguish it. It includes accounting for costs rather than merely outlays; this includes hidden costs and externalities, overheads and indirect costs, past and future outlays, and costs according to product lifecycles.

The attraction is that full cost accounting information can improve decisions associated with an organisation's environmental and social performance objectives. Full cost accounting is clearly a multi-disciplinary activity and therefore requires scientific, technical, and operational knowledge in addition to accounting expertise.

Case Study – BP Sustainability Assessment Model

- British Petroleum (BP), the world's largest oil and gas corporation, developed the Sustainability Assessment Model – a four step full cost accounting approach to evaluating the contribution of various proposed activities (projects) to the sustainable development agenda. The first step defines cost object (i.e. the object of the costing) - the project is defined as a discrete project guided by a project team. The scope is set and defined to track the impacts of a project over its full life cycle, extending beyond those impacts directly controllable by the project team. The impacts of the cost objective are identified under four headings (economic, resource use, environmental and social). Finally the impacts are converted into a common measurement base: money. A variety of monetisation approaches may be adopted. This approach has been used by BP to move from identifying an opportunity, evaluating the viability of that opportunity, to undertaking the activities necessary to complete the project.

“ Organizational choices are the epicentre of wider impacts. Full cost accounting links those impacts to the point of origin and thereby raises questions of both responsibility and controllability. These are uncomfortable questions but ones that must be addressed for sustainable development to become a reality ”

Professor Jan Bebbington, professor of accounting and sustainable development director, St Andrews University

ENVIRONMENTAL ACCOUNTING

Environmental accounting techniques involve identifying, analysing, managing and reducing costs associated with raw materials, utilities, services and waste, with the aim of saving money and reducing negative environmental impacts.

Environmental and sustainability accounting is based on the premise that, as good environmental and sustainability management becomes increasingly important, so will accounting techniques that can help support this. The term 'environmental accounting' can be used to cover a range of different techniques and activities. Most of these are ways of adapting or extending conventional accounting in one way or another to help management address the challenges and opportunities posed by environmental issues. This moves environmental issues from a focus on compliance and control to mainstream decision making associated with performance and value. Environmental issues represent both an opportunity and risk for many businesses. Through environmental accounting, an organisation can accurately identify and measure investments and costs related to environmental considerations, allowing it to improve the efficiency of its activities and decisions.

Environmental accounting techniques involve identifying, analysing, managing and reducing costs associated with raw materials, utilities, services and waste, with the aim of saving money and reducing negative environmental impacts. Two accounting skills are particularly relevant here:

- Costing – it is essential that the environmental costs of products and services are understood and allocated properly, so that they can be managed, and prices can be set at an appropriate level.
- Investment appraisal of projects - accountants have an important role to play in ensuring that all relevant environmental costs are considered in project proposals.

Numerous public sector, private sector and international initiatives have addressed environmental accounting. The Environmental Management Accounting Network, UNCTAD ISAR (guidelines on reporting environmental costs and liabilities), the EC (white paper on environmental costs and liabilities) and the US Environmental Protection Agency (EPA) among others, have all advanced practice in this field. Recognising the increasing importance to business of environmental issues and of costing environmental aspects of operations, IFAC produced an international guidance document on Environmental Management Accounting in 2005, which consolidated the best existing information in a format suited to accountants.

Case Study – Environmental Accounting in Japan

Japan has a long association with environmental accounting. In 1998, the Japanese Institute of Certified Public Accountants published a report *Use of Environmental Cost Information for Environmentally Conscious Management*, which was followed up a year later by *Guidelines on Measurement and Reporting of Environmental Cost*.

In 2005, the Ministry of the Environment (MoE) published revised and enhanced Environmental Accounting Guidelines. These further support the introduction and implementation of environmental accounting and address a range of topics including the costs of environmental conservation, the benefits associated with such conservation, and the economic benefits of environmental conservation. In addition, the guidelines provide explicit format structures for environmental accounting.

The guidelines have been used by Japanese companies to identify cost savings and economic benefits. For example, in its 2008 environmental accounting report, Fujitsu stated costs of 19.4 billion yen, but economic benefits amounting to 31.7 billion yen (actual benefits + estimated benefits not directly measurable in monetary form) with the prevention of pollution and the efficient use of resources accounting for the majority of those benefits.

SOCIAL ACCOUNTING

Although there are numerous approaches to social auditing, one common feature is the concern to address the material sustainability issues and information needs of both the entity and its stakeholders through dialogue and engagement.

Social accounting is a systematic means of accounting for the social impact of an organisation. It can be compared to the way financial accounting provides the means to account for an organisation's financial performance. While we have centuries of experience of financial accounting, with the result that methods and standards are well established and widely understood, the science of social accounting is young. In the corporate sector, social accounting is used to collect and report information in CSR or sustainability reports.

Although there are numerous approaches to social auditing, one common feature is the concern to address the material sustainability issues and information needs of both the entity and its stakeholders through dialogue and engagement. The AA1000 Assurance Standard places the principle of Inclusivity at the heart of its work and ensures that stakeholders are adequately involved in collecting and interpreting material information.

Traidcraft was one of the pioneers of social accounting in the UK, having published its first independently audited social report in 1993. Traidcraft's social accounts are based on a step by step approach that includes defining the social objectives and ethical values of the organisation, clearly identifying and profiling its stakeholders. Moreover, this has involved establishing indicators by which performance against the objectives and values can be measured, measuring performance against the indicators, and gaining stakeholders' views about the organisation's performance.

“ The social impacts of organisations underlie some real social issues – such as obesity, ill-health and community regeneration. The profound effects organisations have on society are becoming increasingly obvious. From the point of view of stakeholders, social accounting is therefore a critical part of delivering accountability and transparency. From the organisation's point of view, social accounting helps to identify and manage social risk ”

Adrian Henriques, professor of accountability, Middlesex University Business School, and social auditor

CARBON ACCOUNTING

The central aim of carbon accounting is to measure CO₂ equivalent emissions and this has become increasingly important since the Kyoto Protocol was ratified.

With climate change high on the sustainability agenda, it is unsurprising that carbon accounting has been an area of considerable activity for both accounting and non-accounting organisations. The central aim of carbon accounting is to measure CO₂ equivalent emissions and this has become increasingly important since the Kyoto Protocol was ratified. Companies with global operations have to respond to an array of state, national and/or regional regulations and requirements that address greenhouse gases. Carbon accounting, however, has yet to witness the development of a single internationally recognised model. Nevertheless several important guidelines and initiatives are in place or are being developed in this area.

The World Business Council for Sustainable Development (WBCSD) and World Resources Institute (WRI) GHG protocol and ISO 14064 are two of the major carbon accounting frameworks. The WBCSD GHG Protocol Corporate Standard focuses on accounting and reporting for GHG emissions at the company or organisational level. Reductions in corporate emissions are calculated by comparing changes in the company's actual emissions inventory over time, relative to a base year. Focusing on overall corporate or organisational level emissions has the advantage of helping companies more effectively manage their aggregate GHG risks and opportunities. It also helps focus resources on activities that result in the most cost effective GHG reductions. ISO 14064 provides a framework for organisations to quantify and report on greenhouse gas emissions and removals.

ISO's goal in developing the standards is to provide a set of unambiguous and verifiable requirements or specifications to support organisations and proponents of GHG emission reduction projects.

More recently the accounting standards organisations have become more active in this space. The first outcome is a joint project between the IASB and the FASB to develop comprehensive guidance on accounting for emissions trading schemes, which aims to address the following questions:

- Are emissions allowances assets?
- What is the corresponding entry for an entity that receives allowances from government free of charge?
- How should allowances be accounted for subsequently?
- When should an entity recognise its obligations in emissions trading schemes and how should they be measured?
- What are the overall financial reporting effects of the above decisions?

In addition to this, the IAASB is developing a carbon assurance standard. This is likely to look at emissions information in the form of an entity's 'carbon inventory', whether it is created for use in an emissions trading scheme or elsewhere. It will also explore the need for guidance regarding assurance about carbon offsets. A draft proposed new International Standard on Assurance Engagements (ISAE) is expected to be presented in mid-2009.

Case Study – Australia National Carbon Accounting System

Established in 1998, the National Carbon Accounting System (NCAS) is a world-leading system developed to account for greenhouse gas emissions from land based activities. It aims to provide a complete accounting and forecasting system for human-induced sources and sinks of greenhouse gas emissions. The NCAS accounts for these activities through a highly integrated system that combines mapped information from thousands of satellite images, land use and management data, climate and soil data, as well as ecosystem modelling.

The National Carbon Accounting Toolbox (NCAT), derived from the NCAS, allows carbon accounting from land based activities at the project level. The NCAT is open-source and allows users to track carbon dioxide emissions and removals.

Whilst both the NCAT and NCAS have been developed over a number of years, the Australian government is further developing the system and toolbox to account for non-carbon dioxide emissions such as methane and nitrous oxide. The NCAS is currently being applied to the international arena in collaboration with the Clinton Climate Initiative.

ROLE OF THE ACCOUNTANT

The accountant's role in sustainability accounting and reporting is crucial to improving transparency and maintaining stability in capital markets.

Transparency

While full cost accounting is a multi-disciplinary activity, bringing together data and information from a range of sources with different parameters, accountants are best placed to use their experience of making economic decisions based on statements and applying a market value to potential social and environmental impacts and opportunities.

If accountants can ensure the integrity of the data and reporting of this information, social and environmental impacts will increasingly be recognised and valued as key long term performance indicators. This provides decision makers with a more comprehensive assessment of value, which in turn allows for more certainty in decision making.

Stakeholder dialogue

Stakeholder engagement is a well accepted corporate practice that helps inform business decision making by taking into account potential impact on, and influence of, different groups of people.

The accountant's role in this is to provide rigour, impartiality and a clear link to the transparency of the decision making process. Engaging stakeholders in dialogue on the non-financial elements of the business helps accountants determine the materiality of the issues and whether they create risks to or opportunities for the sustainability of the business which should be disclosed. This process does not abrogate any decision making from the business owners.

Understanding the needs and interests of stakeholder groups should also ensure that any reporting will meet those needs; accountants can use the multi-stakeholder process to frame reporting recommendations.

Regulations and tax

As the pace increases at which UK and EU taxes and subsidies are changing (particularly with regards to environmental taxes), accountants are needed to decode the measures so that they can best respond and manage their tax obligations. The list of potential taxes and penalties related to sustainability which could affect a business continue to grow: a climate change levy, landfill tax, waste and water pollution permits, carbon disclosure and tax considerations for any carbon trading scheme, to name a few. Businesses will rely on accountants to provide critical operating information on how to account as well as compliance and penalties.

As more responsibilities are put on organisations to meet public need, with increased incentives to change business behaviour and internalise most of the costs associated with production and 'doing business', the accountancy profession has a role in contributing to the development of new policy workable for business.

Standards and Guidelines

Global, national and industry specific voluntary codes have been developed to encourage businesses to adhere to certain standards; helping to identify market leaders and contributing to reputation management. A primary role of the accountant is to be aware of the guidelines commended by their professional institute, interpreting them for their business.

However, in order to make sure they are more than a 'box ticking' exercise, accountants have a role to play in integrating reporting systems into existing information management structures, collecting data and maintaining audit trails (e.g., from different tier suppliers to the business), providing assurance, and assisting boards in fulfilling their duties when making public statements about meeting standards.

The accountancy profession has a history of changing and adapting to meet market needs. Global markets are undergoing major change in response to a lack of transparency and extreme risk taking. Accountants are responding by ensuring their professional standards are utilised to meet society's changing needs, to rebuild trust in our capital markets and to respond to an increasing awareness of the linkages between social, environmental and economic exposure.

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