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Counting emissions along with dollars

How the Swiss Connection for Climate Accountability could help reduce global emissions with an international GHG accounting standard

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Executive Summary

English How environmentally friendly a company is on paper too often depends on its location or on the method used to assess it. Sustainable investing is challenging due to a lack of standardized methods and comparable data. Greenhouse Gas (GHG) accounting - a set of rules to account for a corporation's GHG emissions - could make sustainable investing more transparent. It enables investors to decide on the basis of a quantitative metric. Current private and national approaches in GHG accounting are only of limited use to investors because these initiatives are in most cases voluntary, limited to a single country, or applicable to specific economic sectors only. This paper proposes that Switzerland should promote transparent, sustainable investing internationally through a multi-stakeholder coalition called Swiss Connection for Climate Accountability SCCA. The SCCA has two goals: First, for the international community to request a report from the IPCC on the potential for a global GHG accounting standard. Second, to adapt existing GHG accounting methods for use as top-down standards to provide to the Swiss and European market independent, accessible information on corporate environmental performances. This approach gives the opportunity to require GHG emissions disclosure on the basis of a recognised, uniform standard. It has the potential to bring GHG accounting in line with financial accounting, and it would provide a basis for increased innovation and academic education.

Deutsch Wie umweltfreundlich ein Unternehmen auf dem Papier ist, hängt zu oft von seinem Standort oder von der Methode ab, mit der es bewertet wird. Nachhaltiges Investieren ist nach wie vor herausfordernd, weil es an standardisierten Methoden und vergleichbaren Daten mangelt. Greenhouse Gas (GHG) Accounting, also die Buchhaltung von Treibhausgasemissionen eines Unternehmens, könnte nachhaltiges Investieren transparenter machen. Es ermöglicht Investoren, auf der Basis einer quantitativen Grösse zu entscheiden. Die derzeitigen privaten und nationalen GHG-Accounting-Ansätze sind für Investoren nur bedingt nützlich, da diese Initiativen in den meisten Fällen freiwillig, auf ein Land beschränkt oder nur auf bestimmte Wirtschaftssektoren anwendbar sind. Dieses Paper schlägt vor, dass die Schweiz transparente nachhaltige Investitionen auf internationaler Ebene durch eine Multi-Stakeholder-Koalition namens Swiss Connection for Climate Accountability SCCA fördert. Die SCCA hat zwei Ziele: Erstens, dass die internationale Gemeinschaft beim IPCC einen Bericht über das Potenzial für einen globalen GHG-Accounting-Standard fordert. Zweitens, dass bestehende GHG-Accounting-Methoden angepasst werden, um dem schweizerischen und europäischen Markt unabhängige Informationen über die Umweltauswirkungen einzelner Unternehmen zu liefern. Dieser Ansatz ermöglicht es, zu verlangen, dass Firmen ihre Treibhausgasemissionen mit einer einheitlichen, anerkannten Methode offenlegen. Ausserdem könnte die Buchhaltung der Treibhausgasemissionen mit der Finanzbuchhaltung in Einklang gebracht werden und ein Standard wäre eine Grundlage für mehr Innovation und neue Ausbildungen.

Français Ce qui détermine à quel point une entreprise est respectueuse de l'environnement sur le papier dépend trop souvent de son emplacement ou de la méthode utilisée. Investir de manière durable est un défi de taille, notamment à cause du manque d'harmonisation entre les méthodes ainsi que du peu de données comparables. Toutefois, un ensemble de règles pourrait permettre des investissements durables plus transparents : il s'agit de la comptabilisation des gaz à effet de serre (GES). Cette méthode permet aux investisseurs de prendre des décisions sur la base de mesures quantitatives. Comme ces initiatives sont le plus souvent volontaires, limitées à un seul État ou applicables seulement à un secteur économique particulier, les approches actuelles, tant privées que nationales, en matière de comptabilisation des émissions de gaz à effet de serre (GES) ne sont que d'une utilité limitée pour les investisseurs. Le présent document invite la Suisse à promouvoir à l'international des investissements transparents et durables, en passant par une coalition appelée Swiss Connection for Climate Accountability (SCCA) qui regroupe de multiples acteurs. Le SCCA a deux objectifs : premièrement, permettre à la communauté internationale de demander au GIEC un rapport portant sur la possibilité d'établir des standards globaux de comptabilisation des GES. Deuxièmement, offrir la possibilité d'adapter les méthodes de comptabilisation des GES existantes, afin de fournir au marché suisse et européen des informations accessibles et indépendantes sur les performances des entreprises en matière de respect de l'environnement, en utilisant ces normes de manière top-down. Cette approche permet d'exiger la divulgation des émissions de GES sur la base de normes reconnues et uniformes. Elle pourrait permettre d'aligner les pratiques concernant la comptabilisation des GES sur celles de la comptabilité dans le domaine des finances et constituer ainsi une base pour davantage d'innovation et d'éducation.

1. Introduction

Sustainable investing is stuck in a situation of incomplete information. This is one reason why it has not yet unfolded its potential to reduce corporate emissions.

A majority of millennials want their investment decisions to express environmental, social and governance (ESG) values. Institutional investors that practice sustainable investing now include some of the world's largest, such as Norway's Government Pension Fund Global. Investors, in general, are adapting their priorities, and fortunately for them, scientific evidence indicates that sustainable assets not only reflect ESG values but also tend to produce higher (or at least equal) financial returns.[1]

Whether this new paradigm ultimately achieves its goal, namely driving a tangible improvement in corporate environmental footprints, is contested. One reason for conflicting evidence might be that sustainable investing has not yet unfolded its full potential. It is still relatively difficult to tell environmentally sustainable companies apart from others. Investors find sustainable investing challenging,

and they are particularly concerned about a lack of comparable data.[2] One factor of a company's environmental impact is the number of greenhouse gases (GHGs) it emits. Knowing this factor would make it possible to classify companies' environmental performance relative to their peers, giving investors the necessary instrument to make number-based decisions. Numerous initiatives have tried to establish methods of calculating and reporting this critical information. However, the current variety of approaches and results makes it hard to establish a benchmark and keeps the market stuck in a situation of incomplete information.

The international community should push for a standard accounting method for corporate GHG emissions to provide comparable and transparent data. The Swiss government is in a unique position to enable the creation of such a standard. First, this policy brief explains how GHG accounting operates and what the current challenges are. Second, it outlines Switzerland's interests in engaging in this particular climate action field and how such an engagement could look. Third, this brief develops leads and ideas on how GHG accounting could be enhanced.

2. Existing standards and potential for improvement

The existing variety of methods to measure corporate emissions prevents investors' from comparing corporations independently.

GHG accounting is similar to financial accounting. The International Financial Reporting Standards (IFRS) purpose is to bring transparency, accountability, and efficiency to financial markets around the world. The IFRS allow investors to allocate their capital more efficiently because they can base their choices on comparable and transparent company reports. Firms have corresponding incentives of reporting in line with the IFRS: they can increase liquidity and reduce capital costs.[3] Analogously, GHG accounting increases transparency and comparability of companies' GHG emissions. Investors can more easily integrate the emissions criterion into their investment decisions. Firms have a corresponding opportunity to reduce costs of capital by improving and reporting their environmental performance.[4]

2.1 The Greenhouse Gas Protocol

The first GHG accounting standard, called Greenhouse Gas Protocol (GGP), was introduced in 2001 by the World Resources Institute (WRI), a non-profit organization, and the Geneva-based World Business Council for Sustainable Development (WBCSD), an organization of over 200 leading businesses. The GGP is a global standardized framework to measure and account for GHG emissions from private and public sector operations. Multinational firms and organizations have widely adopted the GGP.[5] The precise method of accounting is, however, up to the individual company.[6] It can either use calculation tools provided by the GGP or devise its own data collection and processing tools, which can subsequently become GGP approved. Including indirect emissions in a report is voluntary,[7] as is the use of the GGP in the first place. The GGP cannot require a company to measure or disclose its GHG emissions. It is an instrument made by companies and NGOs for companies and NGOs. That is not a problem in itself, but the resulting variety of accounting methods and incompleteness of disclosure go at the expense of investors' interests.

2.2 The 2-Degrees Investing Initiative

Another major actor is the "2-Degrees Investing Initiative", which was pointed out as particularly progressive by an interviewee of this paper. The think tank aims at aligning finance with the 2015 Paris Agreement's climate goals. It organizes its work around three main objectives: improving the financial sector's ability to measure its contribution to climate change, identifying barriers and opportunities for sustainable investing in current investing processes, and influencing regulatory frameworks for the benefit of 2-Degrees investing. The think tank has achieved considerable success by analyzing whether the investment portfolios of Swiss pension funds and insurances are in line with the Paris Agreement.[8] There is, again, no requirement for institutional or public investors to participate in such efforts, which leads to fractured data availability and a corresponding difficulty of assessing non-participating corporations.

2.3 En route for convergence?

Several countries have implemented mandatory and voluntary corporate GHG accounting methods. Most approaches are based on

a similar logic and structure. Some countries even adopted the GGP or collaborated directly with the 2-Degrees Initiative.[9] To date, the European Union Emissions Trading Scheme (EU ETS) is the most extensive system of its kind, and the largest attempt at harmonizing national approaches. For the trading scheme to work, participating companies must account for their emissions with a standard method. This enables emissions trading, peer comparison, and stimulates competition for a less polluting economy. However, the EU ETS only covers the industrial sector, including power stations, manufacturing plants, and aviation activities.[10] Thus, it only accounts for 45% of European emissions and cannot fully exploit its potential. Despite a degree of convergence, governmental approaches continue to be diverse, especially from a global perspective.

Besides the examples portrayed above, numerous other coalitions, alliances, and groups try to establish GHG accounting and climate disclosure standards. Additionally, in recent years, many financial institutions have been producing broader climate-risk-analyses, including soft factors like management, governance, and long-term investments. While this multitude of approaches and varying national legislations result in potentially more accurate assessments of individual companies and sectors, they go at the expense of comparability and transparency. How environmentally friendly a company is on paper too often depends on its location or on the method used to assess it.

This paper argues that incomplete information inhibits a more dynamic market for sustainable assets. Regulation should provide standardized data to enable investors to stimulate the race for carbon-neutral corporations. GHG accounting is an ideal starting point because emissions are a quantifiable metric, and methods to account for this metric already exist.

3. Why Switzerland?

It makes sense to take up the cause of sustainable investing for a country whose image is shaped by the banking industry, but which also wants to be more strongly associated with sustainability in the future.

The Swiss banking industry holds a globally leading position and is adapting to a world where ESG criteria become increasingly important. As an intermediary between investors and companies, banks have a crucial role in making GHG accounting an accessible and intelligible tool. Swiss banks confirm the difficulty of obtaining reliable and comparable ESG information and are consequently in favor of more standardized methods of disclosing corporate emissions. GHG accounting and sustainable investing are unique opportunities for banks to realign corporate strategies, and to play an essential role in the popular fight against climate change.

Besides banks, major Swiss companies and numerous large multinational corporations based in Switzerland express their desire for more transparency regarding corporate environmental

information. They do this by supporting alliances such as "We Mean Business", a coalition of over 1000 companies aimed at accelerating the zero-carbon transition and advocating for climate risk disclosures to investors and other stakeholders.[11]

Commitment to GHG accounting would directly link to existing governmental activity. After ten years of negotiations, Switzerland joined the EU ETS on January 1st, 2020 moving the Swiss government to a position to help shape the scheme's future. Better accounting for corporate emissions is crucial in extending the EU ETS to more economic sectors and in leveraging market forces for positive change. On a global level, Swiss efforts to implement the Paris Agreement often count on market-based solutions. One example is the collaboration mentioned above between the Swiss government and the 2-Degrees Investing Initiative.[12] Better accounting for corporate emissions is crucial in extending the EU ETS and leveraging market forces for positive change. In sum, there is momentum, and the Swiss government could seize it.

4. Swiss Connection for Climate Accountability

An IPCC report on GHG accounting can bring the topic on the international agenda. An amended EU ETS can be the key for more sustainable investments in Switzerland and Europe.

The Swiss government could connect the Geneva-based organization WBCSD behind the GGP, the 2-Degrees Initiative, and leading banks and businesses to establish the *Swiss Connection for Climate Accountability (SCCA)*. The SCCA is a group of diverse stakeholders connected, rather than associated or organized, by a common conviction that more transparent and standardized climate accountability is necessary. The word "connection" signals openness, focus, and a low degree of institutionalization. The SCCA's goal is twofold:

1. **For the international community to request a comparative report on corporate GHG accounting methods at the Intergovernmental Panel on Climate Change.** The IPCC's mandate and its excellent international reputation, make it the institution

to provide independent knowledge for climate policymakers. Even though being inherently descriptive rather prescriptive, IPCC reports have significantly influenced international agreements. The request for a report on GHG accounting would be the first step towards a potential agreement on a global standard.[13]

2. Extend standardized corporate GHG accounting to more sectors to potentially expand the Swiss and EU ETS. Existing private accounting methods for sectors like finance or services could serve as a basis to a more standardized, top-down method taking into account investors' and the public's interests. Like the EU ETS that started with a pilot phase during which participants were supposed to familiarize themselves with its features and functioning, the SCCA could test accounting methods for the service sector and conduct feasibility studies with the long-term goal of proposing an amendment to the EU ETS.

4.1 Mandatory disclosure

Evidence from financial accounting suggests that mandating is more effective than counting on voluntary adoption. In 2005, more than 100 countries started legally requiring a particular category of companies - often publicly listed and relatively large - to report financial accounts following the IFRS. The expected effects of a globally more harmonious disclosure regime were decreased transaction costs, more efficient capital allocation, more transparency, and more trust. Extensive research generally confirmed these expectations. Following the IFRS's adoption, the firms' cost of capital decreased, market liquidity, and equity valuations increased. However, this was only the case in countries with vigorous enforcement and strong incentives to comply. Maximizing the benefits from the IFRS required widespread integration into national legislations and rigorous enforcement.[14]

Mandated public climate accountability is crucial for overcoming the comparability problem because a benchmark is only credible if its underlying data completely reflects a sector. Evidence indicates that under a voluntary regime, some firms only report incomplete GHG data as a symbolic act to maintain legitimacy in the face of public pressure.[15] Simultaneously, high performers are more likely to be penalized under a voluntary system because their relative emissions

might appear higher than they are. Only with a comprehensive and accurate model of corporate emissions can sustainable investment be genuinely effective.

4.2 Integrated reporting

Large companies are in most countries required to publicly disclose their financial accounts in a corporate report respecting the IFRS. Under a mandated GHG accounting regime, an integrated report could combine different business activity accounts within the same formal framework, disclosing emissions alongside finances.[16] One of the advantages of integrated reporting is the enabling of synergies, which means bringing into line accounting methods and concepts. The SCCA should follow the guiding principle of coherence between financial accounting and GHG accounting. This could entail:

- Choosing the equity share over the control approach in GHG accounting (i.e. whether a company is responsible for the GHG emissions of an asset to the degree that it owns or controls it) because financial accounting is based on the concept of equity share (ownership).
- A balance sheet could include a company's direct emissions (Scope 1) and its electricity consumption emissions (Scope 2). Positive emissions would figure as liabilities, whereas negative emissions would figure as assets. Such inclusion could facilitate trading GHG emissions. Indirect Scope 3 emissions could be virtually included in a company's balance sheet, which means that they would be listed on a company's report, but they would not be included in the legally relevant sum of emissions.[17]
- Scope 3 emissions account for most of a product's total emissions but it is generally difficult to attribute them to a specific actor. Depending on the accounting logic, the buyers or producers of a product must bear responsibility for the resulting emissions. As long as this is not clear, there is a risk of double counting, i.e. two companies reporting the same emissions. An international standard could potentially resolve this issue.

4.3 Promoting innovation

One of GHG accounting's major weaknesses is the difficulty of defining boundaries for Scope 3 emissions. Besides standardization,

innovation is critical to overcome this weakness. Establishing a GHG accounting standard should be accompanied by mechanisms to incentivize innovation. Creating an academic degree in sustainable finance in collaboration with Swiss institutions of higher education may be a way of doing this. Some Swiss institutions offer sustainable finance courses and are planning to introduce new specializations for existing banking and finance degrees.[18] There is, however, no institution currently offering a Bachelor's or Master's degree in sustainable finance.

5. Conclusion

An instrument that allows investors to discern reliably between climate-friendly and –unfriendly companies is essential in fighting climate change.

An instrument that allows investors to discern reliably between climate-friendly and –unfriendly companies is essential in fighting climate change. A global GHG accounting standard could be the necessary tool, allowing for universally comparable and transparent emissions reporting.

An alliance of governmental, business, and NGO actors called Swiss Connection for Climate Accountability could:

1. Advocate that the international community requests a report on corporate emissions reporting from the IPCC to generate independent knowledge on the potential for a global GHG accounting standard.
2. Adapt existing accounting methods for use as top-down standards to provide to the market independent, accessible information on corporate environmental performances and to potentially amend the EU ETS.

This policy paper proposes the following additional measures to develop GHG accounting:

- **Make GHG accounting mandatory for a particular category of companies to maximize its effectiveness.** As mandatory adoption of the International Financial Reporting Standards lead to increased liquidity and decreased capital costs, mandating GHG accounting is likely to create a situation of more complete and more accurate information, leveling the playing field for investors and the public.
- **Bring GHG accounting in line with financial accounting with integrated reports.** Integrated reporting proposes to report different accounts of business activity within a single formal framework, which has the potential of enabling synergies and conceptual parallels between financial and GHG accounting. Besides, integrated reporting would also facilitate sector-specific adaptations.
- **Overcome GHG accounting's current weaknesses by developing mechanisms to incentivize innovation and academic education.** Calculating Scope 3 emissions is, for example, challenging and often unreliable. Mechanisms to incentivize innovation and collaboration with institutions of higher education might spur new methods to overcome existing shortcomings.

Endnotes

1 (Bassen, 2015) “Roughly 90% of studies find a nonnegative ESG–CFP relation. More importantly, the large majority of studies report positive findings. We highlight that the positive ESG impact on CFP appears stable over time.”

2 According to (Schroders plc, 2018) 77% of institutional investors find sustainable investing challenging. 48% of institutional investors are concerned about a lack of data and transparency.

3 (Daske, Hail, Leuz, & Verdi, Adopting a Label: Heterogeneity in the Economic Consequences Around IAS/IFRS Adoptions, 2011) The authors distinguish between “label” and “serious” adopters of the IFRS, and they find that the consequences of adopting the IFRS depend on how seriously firms implement the accounting standards. Only serious adopters will increase liquidity and decrease the cost of capital.

4 (Task force on Climate related Financial Disclosures, 2018) Michael R. Bloomberg states that: “Increasing transparency makes markets more efficient, and economies more stable and resilient.” (UBS Sustainable Investment Research, 2018) Michael Balding, head of Sustainable and Impact Investing at UBS, states that: “Greater disclosure leads to more and better data which can allow investors to make more informed ESG investment decisions.”

5 (Green, 2010)

6 (World Resources Institute, World Business Council for Sustainable Development, 2004) Under the equity share approach, a company accounts for GHG emissions from operations according to its share of equity in operation. Under the financial control approach, a company accounts for GHG emissions from operations over which it can direct the financial and operating policies. Under the operational control approach, a company accounts for GHG emissions from operations over which it has full authority and control.

7 (World Resources Institute, World Business Council for Sustainable Development, 2004) chapters 3, 4.

8 (2-degree Investing Initiative, 2019)

9 (Kauffmann, Tébar Less, & Teichmann, 2012)

10 (De Clara & Mayr, 2018) “More specifically, the EU ETS covers sectors and gases where emissions can be easily measured, reported, and verified with a high level of accuracy.”

11 (We Mean Business, 2019)

12 For an overview of Swiss obligations and actions regarding climate change: (Swiss Ministry for the Environment BAFU, 2018)

13 The IPCC cannot, however, adopt standards related to climate change. This task would theoretically fall to the United Nations Framework Convention on Climate Change UNFCCC. However, it is unrealistic for the UNFCCC to reach a consensus on its own.

14 (Daske, Hail, Leuz, & Verdi, Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences*, 2008) “We find that, on average, market liquidity increases around the time of the introduction of the IFRS. We also document a decrease in firms’ cost of capital and an increase in equity valuations, but only if we account for the possibility that the effects occur prior to the official adoption date.” Later generally confirmed and refined by (Hitz, Kaumanns, & Lehmann, 2016)

15 (Liesen, Hoepner, Patten, & Figge, 2013) “Results are also consistent with legitimacy theory arguments in that firms may be using incomplete reporting of GHG data, presumably due to the voluntary nature of the disclosure practice, as a symbolic act to maintain legitimacy in the face of the exposures. We conclude that bringing corporate GHG emissions disclosure in line with recommended guidelines will require either more direct stakeholder pressure or, perhaps, a mandated disclosure regime.”

16 (Eccles, 2014) The authors describe integrated reporting and explain why it could be a superior mechanism to perform the information function of reporting.

17 (World Resources Institute, World Business Council for Sustainable Development, 2004) The idea of integrating emissions accounting into financial accounting is from the GGP. The distinction between actual and virtual integration is the author’s work. The GGP differentiates these three scopes. Scope 3 indirect emissions are a complex concept that still lacks clearly defined boundaries and methods of calculation. Nevertheless, it is important to account for

Scope 3 emissions because they constitute the bulk of emissions for many companies. Virtual integration is a provisional measure that has the advantage of anticipating possible future means of calculation, by implementing the practice of accounting in the present and enabling continuous improvement within an established framework.

18 The University of Zurich is, for example, planning a corresponding specialization in one of its banking and finance Master's programs. The University of Bern offers a 4 ECTS course on sustainable finance.

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