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Oil and gas companies may be overstating their financial position by ignoring decarbonisation, new research suggests

Overly optimistic commodity price assumptions that fail to take account of the international commitment to phase out fossil fuels may be skewing oil and gas company reported results, and affecting investors' ability to make informed decisions, according to new analysis.

Sarasin & Partners has just released a paper examining the long-term oil price assumptions underpinning company balance sheets, and the firm believes that these assumptions may be linked to a problem of systemic overstatement of capital and performance.

Natasha Landell-Mills, Head of Stewardship, commented: "Investors need reliable accounts in order to ensure that capital is not being misallocated in the oil and gas sector as it grapples with decarbonisation – and particularly the global commitment to reach net zero emissions by roughly 2070. Our concern, broadly speaking, is that oil and gas companies may be overstating their capital and performance due to overly optimistic price assumptions. This is clearly not in shareholder interests, as it puts both capital and dividends at risk. It also runs contrary to efforts to combat climate change."

In their latest financial statements, the eight listed European oil and gas companies reviewed use long-term oil price assumptions of $70 to $80 per barrel from 2020/21, rising by 2% per year thereafter. Not only are these assumptions above price scenarios that correspond with the Paris Climate Agreement, they are also higher than the assumptions the companies are using when building their own strategies and capital expenditure plans. Shareholders need to understand these apparent inconsistencies: if $40 to $60 is appropriate for designing strategies or approving capital deployment in an uncertain and shifting energy market, why then are accounts – that are supposed to be prudent – using $70 to $80 per barrel?

Daniel Wiseman, Companies Lawyer at ClientEarth, said: "The law here is clear. Company annual reports and accounts must give a 'true and fair view' of the financial position of the company. This means that key inputs and assumptions in the accounts, like future oil demand and prices, must be reasonable and balanced, and critical sensitivities should be explained in the notes."

Stephanie Pfeifer, CEO of the Institutional Investors Group on Climate Change (IIGCC), explains: "Investors are acutely aware of the exposure companies in the energy sector have to climate change and the low-carbon transition. There is no sidestepping the responsibility of companies to accurately factor material climate change issues into their financial reporting. With an increasing number of energy companies signing-up to better reporting using TCFD guidelines backed by Mark Carney, those staying on the side-lines will be increasingly noticeable by their absence."

Laura Devenney, Senior Associate, Carbon Risk of Ceres, commented: "Many U.S. oil and gas companies are rhetorically acknowledging the risks of climate change, but the robustness of their assessments and related disclosures is still lacking. Investors, at minimum, require more clarity around companies' long-term price assumptions. As the energy transition accelerates and the timeline for action tightens, how will the market know that these companies are prepared to adapt and thrive?"

The paper also draws attention to the inconsistency between the emphasis placed on decarbonisation as a strategic risk in the companies' annual reports, and the lack of comment by the Audit Committees and auditors on how they have considered falling demand in the financial statements. Likewise, decarbonisation is rarely mentioned in UK-listed companies' assessment of oil and gas companies' long-term viability.

Wiseman added: "Oil and gas majors are slowly waking up to the realities of the energy transition and adjusting their strategies accordingly. But if this awareness is not reflected in company accounts, we're looking at a conspicuous disconnect which should raise concerns for investors and trigger a second look by regulators. Auditors too could be on the hook if they are not testing the numbers carefully."

The paper ends with a series of recommended actions to help ensure a smooth transition to a global clean energy economy consistent with the Paris Accord.

The recommendations include:

- Directors of oil and gas companies need to satisfy themselves the key accounting assumptions are prudent in a world that is transitioning to zero net emissions. Sensitivity analysis to lower oil prices should be disclosed to shareholders;
- External auditors need to strengthen their stress tests taking account of decarbonisation, and provide additional disclosures to shareholders to justify their opinion that company accounts provide a true and fair view of the entities' economic health, as well as a sound basis for dividend payments;
- Regulators need to clarify director and auditor duties for disclosure of key accounting judgements, as well as foreseeable losses and liabilities under accounting and capital maintenance laws;
- Accounting standard setters should be encouraged to support comparable and prudent reporting that takes account of decarbonisation aligned with the Paris Agreement;
- Shareholders must demand more transparency, and should vote against directors and auditors at companies with opaque and aggressive accounts that put shareholder capital at risk due to failures to take account of global decarbonisation.

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