International Paper Company

USA, Paper

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Report date: February 19 2021
AGM: May 9 2021</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td rowspan="2">Climate Action 100+ company, so seen by investors as key to driving global net zero emissions.</td></tr>
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<tr><td colspan="7">Summary view:
• As a producer of renewable fibre-based packaging, pulp and paper, the company faces risks to the cost and availability of raw materials, not least wood fibre, from issues including wildfires, floods, droughts, range of species, and spread of disease or insect epidemics. Its new Vision 2030 commitments will focus on 100% sustainably managed forests and 100% reusable, recyclable or compostable products, as well as beginning to target Scope 3 emissions.
• While wide-ranging risks also include transition issues arising from potential new environmental requirements, discussions of climate change matters are not apparent in the financial statements or auditor's report.
• As new commitments turn into more concrete plans for activities and their associated costs, information on associated R&D, capex, other costs and the impact on margins etc would help investors to monitor this aspect of progress.</td></tr>
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Background

The Business.

- International Paper (IP) is a global producer of renewable fibre-based packaging, pulp and paper, operating through the following segments: industrial packaging, global cellulose fibres, and printing papers. Group sales in 2020 were 78% US, and 73% industrial packaging.
- The company has announced plans to spin-off its printing papers segment into a standalone publicly-traded company. It plans to retain a 19.9% share at separation, expected to be in Q3 2021. The company explains the spin-off as allowing more focus on the corrugated packaging and absorbent cellulose-fibres business.
- Variable interest entities (VIEs) materially impact the group accounts, for example VIE assets represent 22.4% of group assets. The company's VIEs relate to the sale of forest/timberlands, in 2006 by IP and in 2007 by Temple-Inland, acquired by IP in 2012. The instalment notes received from the sales were used as collateral for borrowings from third-party lenders, effectively monetizing the sales. The special purpose entities used for this are consolidated as VIEs under US accounting requirements, increasing group assets by $7.1bn and liabilities by $6.3bn at the end of 2020. Assessing these structures is beyond the scope of this analysis, but we draw attention to their existence given their size within group accounts.
- Essential raw materials include wood fibre purchased in the form of pulpwood, wood chips and old corrugated containers, and chemicals including caustic soda and starch. Energy sources for operating mills include biomass (72% in 2019), natural gas (19%), electricity and fuel oil. At the end of 2020, IP's own forest resources appear to include 314,000 acres in Brazil, and harvesting rights in Russia relating to 862,000 acres.
- Reported emissions for 2019 include 9.1m MtCO2e for Scope 1, and 3.4m MtCO2e for Scope 2. Scope 3 emissions are not quantified in the company's 2019 Global Citizenship Report.

Approach to climate change.

- The 10-K indicates that as part of the company's Vision 2030, it has committed to incremental reductions of GHG emissions. It also asserts that the goal is consistent with the Paris Climate Agreement, but without detailed explanation.
- The Vision 2030 programme follows the Vision 2020 programme. 2020 sustainability reporting is not yet available, but the 2019 Global Citizenship Report (and other documents) indicated the following goals:
  - 35% reduction in Scopes 1, 2 & 3 GHG emissions (appears to be versus 2017);
  - 25% reduction in water use (also vs 2017) and water management plans at all mills;

- Source 100% of fibre from sustainably managed forests or recovered fibre, while safeguarding forests, watersheds and biodiversity;
    - Conserve and restore 1m acres of ecologically significant forestland; and
    - Advance circular solutions throughout the value chain and create innovative products that are 100% reusable, recyclable or compostable.
- Disclosure of risk factors points to a range of physical risks to its operations or those of its suppliers, and risks to the cost or availability of raw materials, energy and transportation, all of which relate to climate issues such as the productivity of forests, wildfires, floods, droughts, distribution and abundance of species, spread of disease or insect epidemics, hurricanes, earthquakes, hailstorms snow and ice storms, etc.
- Risks related to legal proceedings and compliance with current or future environmental and other requirements are also noted. The company confirms that it has incurred and expects to continue to incur, significant capital, operating and other expenditures in complying with applicable environmental laws and regulations.

Accounting: judgements and consistency with other reporting

Accounting judgements		Significant concerns

- There is no explicit reference to climate change in the notes to the US GAAP financials. It is not apparent that any consideration of climate has been built into the numbers.
- Useful lives of PP&E with a carrying value of $12.2bn vary from 20-40 years for buildings and 3-20 years for machinery and equipment. 2020 depreciation roughly implies average lives of 28 years, and 10 remaining[1].
- Goodwill subject to impairment testing has a carrying value of $3.3bn. There was no impairment recognised in 2020, and it appears that no assumptions are disclosed.
- Commitment disclosures address the existence of guarantees in connection with sales of businesses, property, equipment, forestlands and other assets; and environmental and legal proceedings associated with existing requirements and specific actions taken against the company. For many of these, the company considers that any additional costs would not have a material effect on the financial statements, however for some proceedings it indicates that it is premature to predict the outcome.
- The company has significant defined benefit pension plan obligations, and plan assets set aside to fund these were valued at $12bn at the end of 2020. The asset mix was 40% equities and 48% fixed income (including government securities of 15-28% depending on the makeup of reverse repurchase agreement obligations, which does not appear to be disclosed). The degree to which plan assets are insulated from climate risk is not clear.

Consistency with other reporting		Significant concerns

- Hints of costs related to climate and the environment are provided in other reporting (for example the 2019 Global Citizenship Report notes $70m invested in 2019 for capital projects to control releases into the air and water, and to assure environmentally sound management and disposal of waste). Nonetheless it is concerning that separate disclosure is not more apparent in the financials, given the extent of risks identified and commitments made.
- As new commitments turn into more concrete plans for activities and their associated costs, information on associated R&D, capex, other costs and the impact on margins etc would help investors to monitor this aspect of progress, particularly as attention is turned to Scope 3 emissions and Paris alignment.

[1] In the absence of better data, implied lives are roughly estimated using depreciation expense and, for average lives - start of year productive asset values, for remaining lives – ending values net of depreciation.

Climate assumptions in accounts: visibility and Paris alignment

Visibility of climate assumptions in accounts		Significant concerns

- There are no apparent climate-related assumptions. There is thus no sensitivity analysis.

Paris alignment		Significant concerns

- With no visibility, there can be no alignment with the goals of the Paris Agreement.

Audit: visibility in CAMs and consistency check

Audit firm: Deloitte & Touche LLP	Responsible partner: Randy John Stokx
Audit standards: PCAOB standards	

Visibility in Critical Audit Matters		Significant concerns

- There is no explicit reference to climate change in the auditor's report.
- The audit opinion refers to two CAMs: Goodwill – Printing Papers Reportable Segment, and Retirement Plans – Plan Assets.
- The goodwill CAM was identified specifically related to the Brazil Papers and European Papers reporting units due to a substantial decline in demand for printing papers and ongoing uncertainty over the impact of the COVID-19 pandemic. Estimates of future cash flows would inherently have taken a view on the risk of climate change and steps to address it, but no assumptions are mentioned. Fair value specialists are said to have assisted on assumptions of the discount rate and multiples used for valuation, but no climate expertise is noted.
- The pension CAM relates to $2.5bn in investments whose value is determined based on net asset value (NAV), determined by the Pension Plan's third-party administrators of fund managers. These valuations are subjective and involve unobservable inputs. The auditor was assisted by professionals having expertise in alternative investments.

Consistency check		Significant concerns

- PCAOB audit standards require the auditor to read other information that is presented together with financial statements and the auditor's report thereon. The auditor's report is silent on the outcome of the review, which implies that no material inconsistency was identified in the other information within the 2020 10-K.
- Given the company's position of risk associated with climate change and steps being taken toward greater sustainability, this contrasts with the lack of any mention in the financials or the auditor's report.

The Climate Accounting Project is an independent investor-led project to reinforce the statements of the IASB and IAASB that material climate change issues are incorporated within their standards. This analysis seeks to understand the extent to which companies and auditors are delivering against this aspect of these standards and similar local standards.		**Key**
		Good practice
		Few concerns
		Some concerns
		Significant concerns

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