B. Business Impact

Accounting for Sustainability: Current Initiatives to Standardize ESG Reporting

ESCP Impact Paper No 2021-18-EN

Paul Pronobis & Francesco Venuti
ESCP Business School

ESCP RESEARCH INSTITUTE OF MANAGEMENT (ERIM)

ESCP Impact Paper No. 2021-18-EN

Accounting for Sustainability: Current Initiatives to Standardize ESG Reporting

Paul Pronobis
ESCP Business School

Francesco Venuti
ESCP Business School

Abstract

Given the growing quality and quantity of sustainability reports produced by companies all over the world, one of the biggest problems affecting the readers and the users of this information is comparability. This comparability issue is grounded in a lack of standardization. The current paper discusses the current developments in sustainability reporting which aim to standardize the measurement and disclosure of environmental, social, and corporate governance impacts (ESG) of corporate actions.

Keywords: CSR, ESG, Non-Financial Reporting, Sustainability Reporting,

Accounting for Sustainability: Current Initiatives to Standardize ESG Reporting

Recent decades have seen an increase in CSR disclosure mandates for both financial and non-financial firms (KPMG, 2013). This global trend is driven by sociopolitical pressure and NGOs concerned with the broader impact of corporate activities. CSR disclosure regulations are a means of requiring firms to provide information about the environmental and social impact of their operating, investing, and financing activities. The purpose of these regulations is to encourage firms to increase their environmental and social engagement (GRI, 2016). Even if some models and standards are very popular, comprehensive, and widely adopted (GRI, <IR>, SASB, TCFD, etc.), there are no universal standards, at the moment. Consequently, companies keep measuring and reporting on their sustainability performance according to the different specific frameworks or standards that they select. As such, having quite a large number of institutions that almost independently develop frameworks and standards for their sustainability report, reduces comparability while increasing complexity and confusion for companies, markets, investors and all the stakeholders (Barker et al., 2020).

In September 2020, five Framework and Standard-setting Institutions of international significance (CDP, CDSB, GRI, IIRC and SASB) published a "statement of intent" to work together towards comprehensive corporate reporting[1]. Through this collaboration, those five institutions intend to provide:

- Joint market guidance on how their alrady existing frameworks and standards can be effectively implemented and applied in a complementary and additive way;
- A shared vision of how these elements might complement generally accepted financial accounting principles (Financial GAAP) and serve as a natural starting point for progress towards a more structured, organized, and comprehensive set of organic corporate sustainability reporting principles; and
- A commitment in the drive towards this goal, through an ongoing programme of more intense collaboration, and willingness to engage closely with other interested international stakeholders.

Beside these recent developments, initiatives have also been started within the IFRS foundation (IASB SSB), and the European Union (EU Task Force on Non-Financial Reporting Standards). The following paragraphs briefly discuss those initiatives aimed at standardization of ESG reporting practices.

The IASB SSB

IFRS (International Financial Reporting Standards) are international standards on financial reporting issued by the International Accounting Standards Board (IASB), an independent institution which represents the standard-setting body of the IFRS Foundation. IFRS are a set of principles that companies in IFRS-adopting Countries must follow when they prepare and publish their financial statements, ensuring a standardized way of measuring and disclosing companies' financial performance. IFRS Standards are currently required in about 150 jurisdictions all over the world and are "permitted" in many more countries. The IFRS Foundation is worldwide recognized as one of the most significant and relevant standard setters for accounting principles.

In September 2020, the IFRS Foundation proposed the creation of a specific Sustainability Standards Board (SSB) and "tested" this option by publishing a Consultation Paper on

[1] https://www.sasb.org/blog/progress-towards-a-comprehensive-corporate-reporting-system

Sustainability Reporting. Through this Consultation Paper, the Foundation wanted to assess whether and to what extent the IFRS stakeholders think the Foundation can contribute to the development of sustainability reporting standards. In March 2021 a public statement was issued, explaining the intention of the IFRS Foundation to publish a feedback statement that summarizes the results of the first Consultations (that ended in December 2020), where "an urgent need for global sustainability reporting standards" was confirmed as well as the intention of the IFRS Foundation to "play a role in their development" [2,3].

In the first part of this document issued by the IFRS Foundation, the assessment of the current situation on sustainability reporting can be synthesized as follow:

1. Sustainability reporting is increasing in importance for almost all the stakeholders involved, including investors and communities, central banks, regulators, public policy makers, auditing firms and other service providers);
2. Given the large differences in scope and motivation, an "urgent need" to improve both the *consistency* and the *comparability* in sustainability reporting is perceived by all the stakeholders. A largely accepted set of consistent and comparable standards would be extremely helpful for companies to improve transparency and the quality in the external communication of their sustainability initiatives, strengthening trust, with a positive effect on the entire markets and also on the increasing demand of the "society" about ESG information;
3. For many years (sometimes even decades), many institutions have already been succesfully providing sustainability reports adopting specific reporting frameworks, standards and metrics. Some of these frameworks overlap, "but ultimately each standard/framework-setter is seeking to produce specific products for its own stakeholders. [...] Target audiences for standards also vary. Diverse approaches and objectives pose the threat of increasing fragmentation globally. The potential of fragmentation and the growing demands from stakeholders demonstrate the need for a global framework to provide greater comparability and reduce the complexity of approaches and objectives [...] a wide range of voluntary frameworks and standards are in use and that preparers are faced with opting to report using multiple standards, metrics or frameworks with limited effectiveness and impact, a high risk of complexity and an ever-increasing cost".

Additionally to these background points, in these first documents, the IFRS Foundation has also identified some criteria and priorities to be considered if a Sustainability Standards Board were to be established by the IFRS Foundation. These basic criteria and choices refer mainly to four aspects:

1. *Climate-change priority*: global sustainability-reporting standards for climate-related information has to be considered the most pressing concern as climate risk is a financial risk of growing importance for almost all stakeholders and especially to investors and prudential regulators. However, the concept and the scope of 'climate-related information' has yet to be defined with precision. Additionally, the starting point has been identified in the prototype built on the TCFD recommendations.
2. *The concept of materiality*: it is crucial as it is related to determining the objectives of sustainability reporting, what information is needed, and who are the primary stakeholders that will use the information disclosed by companies. In identifying the qualitative characteristics of relevant sustainability information, it could be useful to also consider what has already been done by the existing frameworks such as the TCFD (Task Force on Climate-related Financial Disclosures), the SASB, the International <IR> Framework and the Sustainable Development Goals Disclosure

[2] www.ifrs.org

[3] IFRS Foundation Consultation Paper on Sustainability Reporting—September 2020

recommendations (SDGD). However, in order to guide its work on consistent and comparable sustainability reporting, the Sustainability Standards Board should probably develop a conceptual framework of its own, in analogous to the already existing Conceptual Framework for Financial Reporting.

3. *Single vs. multi-stakeholder approach*: a decision is needed on whether to adopt a single-stakeholder approach (i.e. focus on producing information only about the relevant effects for the prime audience for financial reporting) or a multi-stakeholder approach (i.e. focus on all the issues that are material to multiple stakeholders' understanding of a company's effect on its environment). The GRI (Global Reporting Initiative), for example, adopts a multi-stakeholder approach as it focuses attention on a vast range of sustainability issues that matter to society as a whole. In order to balance efficiency and reasonable timing, the Sustainability Standards Board of the IFRS Foundation would initially focus its attention on the sustainability information most relevant for the decisions of the « primary stakeholders », identified in the investors, lenders and other creditors (« other market participants »). However, the SSB approach is defined as « gradualistic » and the focus (at least at the beginning and in the early stages) on the single-stakeholders approach is justified with the complexity of the issues, the desire of avoiding eccessive delays in the publication of the standards, and the similarities with the current mission of the IFRS Foundation.
4. *Need for external assurance*: in order to achieve practices that will be worldwide accepted, shared, and consistent, external assurance should be provided to the sustainability information reported by companies. Therefore, the assurance framework for sustainability information should be similar to that already issued for financial statements.

The issue of « materiality », which is directly linked to the identification of the primary stakeholders, remains debated. At the end of May 2021, a white paper commissioned by the GRI was published[4]. The paper discussed the application of the materiality principle in sustainability reporting. Its conclusion strongly support the adoption of double-materiality, which means reporting on both how sustainability factors are affecting the reporting entity (or could potentially affect it in the future) and the impacts of the entity's operations on society and the environment. According to this white paper for the GRI, many insitutions, by prioritizing « financial materiality », affect negatively their triple bottom lines (both their profitability and their sustainable development).

It will be crucial to understand, from future developments and implementation, how the IFRS Foundation will therefore be able to actually determine sustainable reporting standards, given its worldwide recognized experience and competence in the definition - in general - of reporting standards, which will lead, on the one hand, to the reduction of the level of complexity and, on the other, to the increase of consistency in sustainability reporting.

The EU Task Force on Non-Financial Reporting Standards (PTF-NFRS)

In the European Union, a fundamental framework already exists concerning non-financial information (non-financial reporting - NFR) and is represented by the EU directive EU 2014/95. In 2018 the Non-Financial Reporting Directive (NFRD) came into effect in all EU member states. The 27 EU Countries have already endorsed the Directive into national law, with significant impact mainly (but not only) for large corporations and companies above certains thresholds.

[4] https://www.globalreporting.org/about-gri/news-center/why-double-materiality-is-crucial-for-reporting-organizational-impacts

The NFRD requires companies to publicly disclose the impacts on their business activities at least on a list of issues such as environmental matters, social and employee aspects, human rights, anti-corruption and bribery issues, diversity management, in documents such as annual reports, sustainability reports, and integrated reports.

According to the NFRD, companies are free to choose the framework that they prefer, but they are required to clearly disclose which one was adopted, if any. The GRI is definitely one of the most comprehensive (it covers almost all the issues required by the Directive) and it has been largely adopted, but it is absolutely not the only one. In this way, the lack of comparability, standardization, metrics, and a-priori consistency is still a major issue.

In June 2020, the EU Commission, via the EFRAG (The European Financial Reporting Advisory Group, which is an association that ultimately provides advice to the European Commission in the field of financial reporting), requested a specific Task Force on Non-Financial Reporting Standards (PTF-NFRS) to explore the possibility of elaborating EU standards on sustainability reporting in a revised NFRD. On March 8th 2021, the Task Force on PTF-NFRS published its Main Report with six technical appendices, recommendations and 54 proposals.

The first point examined by the Task Force consider the terminology. At the moment, there is no unique definition and terminology, not even within the EU market. Therefore, the report clearly disapproves of the quite common practice of using the word "NON-financial information", a negative terminology that "defines the scope by what it does not", sounding "diminishing" to the ambition of sustainability reporting. Therefore, the report concluded that an explicit "reference to '*sustainability information*' would better capture the interactions between the reporting entities and their stakeholders and their mechanisms of value creation that are not covered by financial reporting". In this way, they suggest that the possible new EU Standards will use "*sustainability reporting*" as common terminology, to completely and fully replace the largely adopted "non-financial reporting" (or even other definitions).

Additionally, the general criteria provided by the EU task force suggest that EU Standards should follow some major 'conceptual guidelines', which at least partially differ from (sometimes even contrast with) the choices of the IFRS SSB described above. The major elements of these guidelines can be summarized as follows:

1. Balance and mix a principle-based approach with a rule-based approach (with some practical regulatory rules), especially helpful to translate principles into practice. Traditionally, the EU has shown a preference for principle-based frameworks, which are also better consistent with the predominance of civil law legal systems among the European Countries. More specifically in the field of financial reporting, the IFRS are traditionally identified as a principle-based system, opposed to the US GAAP system which is generally recognized as more rule-based approach (more consistent with the US common law legal system). However, for this specific situation, the task force suggested a more balanced position. The final proposal recommended to adopt « a general principle-based approach » combined with some detailed prescriptions (rule-based);
2. A multi-stakeholders approach, that will meet the needs of an inclusive wide range of stakeholders. In this way, the task force suggested to adopt a double-materiality principle, in line with the position of the GRI and differing from the IASB SSB choices;
3. Cover simultaneously three different layers: sector agnostic (reporting requirements that apply to all companies regardless of the sector in which they operate, in order to maximize cross-sector comparability), sector-specific (as a natural and necessary complement to obtain an adequate level of details in each specific sector), and

entity-specific (relevant to the particular and unique circumstances of each specific reporting entity);
4. Cover the three basic ESG topics in three main areas: strategy, implementation, and performance measurements (metrics);
5. Balance retrospective and forward-looking information to ensure that "transition trajectories" are adequately covered in the sustainability reports.

In conclusion, EU sustainability standards are necessary to meet the political ambition and pressing timetable of the European Green Deal. However, it is also important to ensure consistency of reporting rules as well as coordinating the development of EU sustainability reporting standards with existing and emerging global initiatives.

Outlook

The impact of sustainability reporting standards will obviously be significant over the next few years for many different stakeholders at different levels and positions. First of all, for managers and executives, as they will be able to better incorporate sustainability issues into their companies' strategies and decisions. Also, Boards of Directors will benefit from sustainability reporting standards as they will see sustainability no longer as a «side issue» that has to be done mainly because they are forced to or because it is required. They will hopefully start to consider sustainability issues as a major item on their agenda in which the entire top management has to focus and get actively involved, not delegating it simply and only to a specific appointed committee. Their goal is to represent their strategic integration choices of sustainability in business processes and to ensure the governance of sustainable value creation processes over a medium to long term horizon. This means considering constantly not only the financial aspects, but also everything else related to the E, S and G area.

Companies that manage and disclose better sustainability issues will probably be also much more attractive to investors, recognizing in this activity a source for a competitive advantage. And beyond the obligations, many companies optionally draw up non-financial disclosures in order to be more accountable with respect to investors, banks, regulators, customers, and many other stakeholders. Many companies have already started appointing CSOs (Chief Sustainability Officers) to work closely with the CEO, the CFO, and the CRO. Integrating ESG reporting in the company DNA will be much more effective if executives' compensations are tied to sustainability metrics. Today, executives are still largely remunerated only in terms of financial performance. Recently[5], Canada's six largest banks have added ESG components to their CEO's compensations, but a broad 2020 study found similar situations in only 9% of the 2,684 companies of the FTSE All World Index. Analysing different geographical area, a recent report[6] showed that in Australia 81% of companies in the ASX 100 incorporate sustainability metrics in their executive compensations, while in the UK it is only 72%. In continental Europe the percentage is even lower (only 66% of CAC 40, DAX 30, SMI 20), while in the US it drops to just 56% of the companies in the S&P 100. Global standards that are rigorously consistent and comparable for measuring sustainability will probably push these percentages up and will make it possible for them to be effectively and regularly included in managers' incentives as well as in the determination of the compensation of executives and board members.

Investors will also demand sustainability reporting for better evaluating the financial performance of the companies and they will probably ask for the same clarity, consistency, and standardization as they are now used to receiving in financial reports. Finally, from a more concrete perspective, sustainability reporting represents the natural evolution of

[5] Kevin Orland, CEO Pay Tied to ESG Sets Canadian Banks Apart From the Crowd, Bloomberg, March 18th, 2021
[6] 2021 and beyond: Global executive incentive trends

financial reports and will attract/require many employees, professionals, and investments from companies over the next decades. The real challenge will be also to convince companies that they can leverage a long-term integrated strategy to reconcile their financial performance with social and environmental sustainability, ensuring the creation of enduring value for all their stakeholders (Busco et al, 2020). A standardized and largely adopted set of standards for sustainability reporting will definitely boost these process with benefits for all the stakeholders.

References

Barker, R., Eccles, R. G., and Serafeim, G. (2020), The Future of ESG Is ... Accounting?, Harvard Business Review, 2020.

Bowen, H., (1953), Social Responsibilities of the Modern Businessmen, New York, Harper.

Brunelli, S., Falivena, C., Carlino, C. and Venuti, F. (2021), Accountability for climate change: a research synthesis through the lenses of the integrated thinking approach, Meditari Accountancy Research.

Busco C., Granà F., Izzo M. F., (2020), Sustainable Development Goals and Integrated Reporting, Routledge.

De Bernardi P., Venuti F., Bertello A., (2019), The Relevance of Climate Change Related Risks on Corporate Financial and Non-Financial Disclosure in Italian Listed Companies, in: De Vincentiis P., Culasso F., Cerrato S. (Eds), The Future of Risk Management, Volume I. Palgrave Macmillan, Cham.

Eccles R., Krzus M. P., (2010), One Report. Integrated Reporting for a Sustainable Strategy, Wiley.

Freeman, R. E. (1984), Strategic Management: A Stakeholder Approach, Business and Public Policy, Pitman series.

Friedman, M. (1970), The Social Responsibility Of Business Is to Increase Its Profits, The New York Times, Sept. 13, 1970.

Grana F., (2020), Redesigning Organizational Sustainability Through Integrated Reporting, Routledge.

GRI, 2016, Combined report 2014-2015 leading for a new era of sustainability, Global Reporting Initiative.

KPMG, 2013, The KPMG survey of corporate responsibility.