INNOVATING FOR
CORPORATE SUSTAINABILITY
MANAGEMENT

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To the IFRS Foundation:

We are a U.S.-based non-profit NGO with strong credentials in the field of non-financial performance accounting in business, and whose work over the years has been international in scope since 2004. For the past sixteen years, we have been active the development of tools, methods and metrics for sustainability accounting in business, and are perhaps best known for our conceptions of Context-Based Sustainability and multicapitalism.

With that brief background in mind, we are pleased to provide you with our comments and feedback in response to the *Consultation Paper on Sustainability Reporting* you published in September of this year. Accordingly, you will find our submission attached.

Sincerely,

Mark W. McElroy, PhD
Founding Director

CSO Response to IFRS Questions for Consultation

Submitted by the Center for Sustainable Organizations (CSO)

December 31, 2020

Question 1

Is there a need for a global set of internationally recognised sustainability reporting standards?

1. (a) If yes, should the IFRS Foundation play a role in setting these standards and expand its standard-setting activities into this area? (b) If not, what approach should be adopted?

There is a need, yes, for such a set of reporting standards, but not until an underlying set of sustainability *accounting* standards (and principles), more broadly construed, have first been developed, including for *measurement*. In this regard, all of the sustainability-related *reporting* standards created thus far have been premature in that reporting standards should logically *follow* measurement standards, not *precede* them.

Indeed, even more fundamental to both measurement and reporting is the prior determination or development of underlying *generally accepted accounting principles*, which in the case of non-financial performance are still missing (i.e., what we might refer to as GAAP-NF). For all of the same reasons this would be problematic in the case of financial reporting, so too should it be seen as an untenable for non-financial, or sustainability, reporting.

To the extent, then, that there is a demand for non-financial or sustainability reporting standards, it would be better to think of this as a demand for sustainability *accounting* standards in general, since the need we are faced with does not only start and end with reporting. Rather, it applies to accounting in all of its dimensions, just as it does in the case of financial reporting. Reporting is just the tip of the iceberg.

This leads us to our response to your question of what approach should be adopted. The approach we would recommend would be to first resist the temptation to jump headlong into the business of defining a reporting standard and fall back, instead, to the unfinished business of determining what the underlying accounting principles should be, insofar as sustainability accounting more broadly construed is concerned. This must also include treatment of measurement, since reporting only makes sense after standards for measurement, and performance itself, have first been defined.

Our very strong advice, therefore, would be that the IFRS Foundation re-think and re-frame this effort so as not to just focus on the development of sustainability *reporting* standards, but to develop sustainability *accounting* standards instead, starting with what we might call GAAP-NF (generally accepted accounting principles for non-financial performance). The fact that this has never been done perhaps explains why there is so much confusion, complexity and disconsonance in the current mix of standards and frameworks in the world, for how could there not be? None of them were ever developed on a foundation of generally accepted (non-financial) accounting principles!

We believe a case can be made, then, that the IFRS Foundation is both uniquely qualified and well positioned to create precisely the kind of GAAP-NF framework we have described above. We

therefore suggest you proceed by re-defining your project in the ways we are calling for. Yes, you should undertake an effort to develop standards for sustainability reporting, but don't stop there – expand the project to include non-financial accounting in all of its dimensions, not just reporting. Make it your business, that is, to create a set of *generally accepted (non-financial) accounting principles* (GAAP-NF), of which reporting is only a part. [For more information on what GAAP-NF might consist of, see this working paper of ours (CSO's) on that topic: Recommendations for Non-Financial GAAP (GAAP-NF).]

Question 2

Is the development of a sustainability standards board (SSB) to operate under the governance structure of the IFRS Foundation an appropriate approach to achieving further consistency and global comparability in sustainability reporting?

Yes, but only in a way that makes it clear that the IRFS Foundation is bringing something new to the table that isn't already there. In our mind, that would be the equivalent of what we refer to above as GAAP-NF, and also a set of standards for not just reporting, but measurement as well. The last thing the world needs right now is another sustainability reporting standard that lacks any sort of conceptual grounding in generally accepted non-financial accounting principles (GAAP-NF), if only because no such principles exist. This is no time to repeat the conceptual mistakes of others in this important area.

Question 3

Do you have any comment or suggested additions on the requirements for success as listed in paragraph 31 (including on the requirements for achieving a sufficient level of funding and achieving the appropriate level of technical expertise)?

While sustainability accounting (SA) may be new to the IFRS Foundation and to business in general, it is certainly not new to the sustainability community itself, the roots of which are long and deep. Indeed, the principles and practice of SA have arguably been in development since at least the middle of the twentieth century, long before the launch of GRI at the turn of the century. It was almost seventy years ago, for example, when such leading economists as Kenneth Boulding and others began to openly think in terms of impacts on all vital capitals – not just economic – as a basis for ascertaining sustainability performance. [For a bibliography of key references in the capital theory literature – which is arguably core to sustainability accounting practice today – see here: Capital Theory References.]

In order to be successful with this initiative, it will therefore be very important for the IFRS Foundation to undertake an effort to familiarize itself with core principles of SA that have long been established in the field, many of which are still not recognized or correctly represented in the leading reporting standards and frameworks in place today. Here again, the failure of others to adequately plumb the depths of the subject and finish the job, as it were, of completing the development of GAAP-NF is a mistake that should not be repeated by the IFRS Foundation.

Indeed, the IFRS Foundation should itself take steps to learn, refine and formally codify non-financial accounting principles as a pre-condition for assuming the position of leadership (and funding) it seeks. Otherwise, we will end up with nothing more than yet another groundless standard that

cannot possibly comport with generally accepted sustainability accounting principles, since no such standards have yet been formally defined!

Question 4

Could the IFRS Foundation use its relationships with stakeholders to aid the adoption and consistent application of SSB standards globally? If so, under what conditions?

If by 'stakeholders' you mean members of the financial accounting community, then, no, we do not think the IFRS Foundation should turn too heavily to that constituency. Why not? Because that is precisely the community that has arguably made such a mess of non-financial reporting standards thus far. Sustainability accounting, frankly, does not fall within the remit of financial accountants. In its purest sense, for example, it neither narrowly serves the needs and interests of shareholders, nor does it rely on monetization as a tool for expressing performance. What the IFRS Foundation must strive to do, therefore, is transcend the needs and interests of shareholders only and focus, instead, on the needs of stakeholders; all while finding a way to come to terms with the fact that achieving strong performance in the case of non-financial impacts may very often come at the expense of financial performance. The IFRS Foundation, that is, must make it clear that it is prepared to walk away from the doctrine of shareholder primacy!

Here we would suggest you begin to think in terms of how, where, and by whom the non-financial sustainability performance of organizations (or their performance in general) will be managed in most companies in the future; and what other constituencies (i.e., stakeholders), therefore, it might make sense to invite to the table. Financial and non-financial performance are simply two sides of a 'performance' coin, the total management of which will very likely not fall to those responsible for just one or the other. Instead, both financial and non-financial management will most likely report to a more broadly defined 'performance management' function, probably under the leadership of a Chief Performance Officer. That is the new community the Foundation should get to know, cultivate, and align itself with in the process of developing reporting standards, including the generally accepted non-financial accounting principles that should come before them. The academic community in this space, too, should be included!

And so given the extent to which non-financial, sustainability reporting standards and frameworks have been so narrowly led by, and tailored to, the pecuniary needs and interests of the financial community, here again we see an historical mistake that the IFRS Foundation should take great care not to repeat (i.e., it should not undertake an effort to create a set of non-financial, sustainability accounting standards that are either too narrowly designed for, or by, the financial community itself; we've had twenty years of that already and it hasn't worked)!

Question 5

How could the IFRS Foundation best build upon and work with the existing initiatives in sustainability reporting to achieve further global consistency?

As we have suggested above, it is arguably the case that none of the existing initiatives in sustainability reporting have based their work on pre-existing, underlying sustainability accounting principles, which at least informally exist having been in development for close to a century now. Thus, the IFRS Foundation has an opportunity to bring something new and unique to the table that every one of those initiatives desperately needs: *generally accepted non-financial accounting*

principles (GAAP-NF). This could further support the integration of existing initiatives by providing neutral criteria, so to speak, under which elements of the pre-existing standards and frameworks could be integrated into a new standard as appropriate.

Question 6

How could the IFRS Foundation best build upon and work with the existing jurisdictional initiatives to find a global solution for consistent sustainability reporting?

Here we would offer the same answer as we have above for the various standards and frameworks that already exist. None of the jurisdictional initiatives, too, make reference to underlying generally accepted non-financial accounting principles. And so by taking steps to create such a set of principles, the IFRS Foundation could add significant value and direction to them all. It could revolutionize the field by doing something it is uniquely qualified to do – develop and codify accounting principles as a basis for guiding practice!

Question 7

If the IFRS Foundation were to establish an SSB, should it initially develop climate-related financial disclosures before potentially broadening its remit into other areas of sustainability reporting?

First, we believe credible standards and reporting frameworks for climate-related reporting already exist in the form of the Greenhouse Gas Protocol for measurement, and the TCFD framework for risk-related reporting. We do not think it makes sense to reinvent these things, since that would only add to the confusion surrounding climate-related non-financial reporting.

Next is to simply repeat what we have said above, which is that the IFRS Foundation should not make the same mistake others already have in their premature development of reporting standards (i.e., to skip or gloss over the need to first propose and settle on a set of underlying sustainability accounting principles). That, and not climate-related reporting, should be the first order of business here.

We also chafe at the idea of having a standards-maker, like the IFRS Foundation, insert itself into the business of making organization-level materiality determinations. That would be a mistake of strategic proportions, we think. What's more, we don't need a standards-maker to tell us how material climate issues are to the performance of organizations in the twenty-first century. What we need, instead, is a new approach to making materiality determinations that is itself grounded in generally accepted (non-financial) accounting principles; preferably based, in turn, on the right blend of stakeholder theory and multi-capital accounting [See here for just such an approach recently put forward by the United Nations: Making Materiality Determinations: A Context-Based Approach].

Question 8

Should an SSB have a focused definition of climate-related risks or consider broader environmental factors?

Once generally accepted sustainability (non-financial) accounting principles are defined, the environmental focus should absolutely go beyond climate to include water, waste, and biodiversity, among other things. The precise scope of treatment should be a function of organization-specific

materiality assessments, however (as indicated above), and should not be predetermined. The IFRS Foundation's standard should be constructed accordingly (i.e., broadly, and not only environmentally so).

Indeed, when all is said and done the focus of the IFRS Foundation's work should be triple bottom line in scope (social, economic and environmental), since that is in fact how the performance of organizations is now commonly understood. To focus only on environmental areas of impact would leave unfinished business on the table – yet another mistake made by others in the past that the IFRS Foundation should not repeat. Otherwise, it should drop the pretense of purporting to propose the formation of a more broadly construed Sustainability Standards Board (SSB), since sustainability is by no means limited to the environmental dimension of performance, much less to climate or any other short list of ecological issues.

Question 9

Do you agree with the proposed approach to materiality in paragraph 50 that could be taken by the SSB?

While we understand the distinction between materiality determinations focused on (1) risks from the world to the organization (outside-in), and (2) risks to the world from the organization (inside-out), we question whether or not a new focus on the former (outside-in) is necessary at all. The latter, yes, but does the former really bring anything new to the table that isn't already there?

Most if not all publicly traded companies already address non-financial risks to their organizations in their annual reports. In the most recent annual (10K) report filed by Procter & Gamble, for example, for the year ending June 30, 2020, the following types of risk factors were reported:

1. the vicissitudes of international markets
2. uncertain economic conditions
3. disruptions in credit markets
4. disruptions in supply chains
5. cost fluctuations
6. changing consumer habits
7. new and existing market channels
8. customer relationships and demand
9. company reputation
10. dependencies on third parties
11. information security breaches
12. changing political conditions
13. laws and regulations
14. tax regulations
15. acquisitions and divestitures, and
16. outbreaks of disease.

All of these things and more can be construed as posing risks to a business, and are by no means exclusive of social or environmental concerns. Indeed, at least two of the risks identified by P&G (outbreaks of disease and disruptions in supply chains, which can be weather-related) are environmental in form, to which other external environmental issues could easily be added. The same is true for non-financial social risks, such as changing political conditions or laws and

regulations. Why must we have whole new outside-in reporting standards and frameworks to account for risks to the business when the existing one(s) will do? Is it because existing financial reporting frameworks prohibit mention of non-financial risks in their scope? We don't think so because they certainly don't.

This leaves us with the more urgent issue of inside-out considerations, or assessments, of the impacts of organizations on the world around them, and not the reverse. This is clearly the aspect of performance that is most in need of attention at this time. And it is also the one for which the absence of generally accepted non-financial accounting principles is most acutely felt, for without such principles we have no reliable way of measuring and reporting – much less assessing – the social and environmental impacts of organizations in meaningful terms.

What all of this suggests, then, is that, no, the priority highlighted in paragraph 50 of your consultation paper is misplaced. Existing reporting frameworks for financial reporting already address non-financial risks to the business, including climate. In addition, specific tools for assessing the outside-in risks of climate per se also exist (TCFD). We see no reason why any of that needs to be reinvented or duplicated, and instead see every reason why such tools and frameworks as they currently sit should simply be used just as they are.

Again, this leaves us with the comparatively under-developed and problematic area of non-financial inside-out impacts accounting, guidance for which (measurement and reporting) is still sorely needed. We say still sorely needed because despite the fact that multiple standards and frameworks already exist for reporting in this area, foundational accounting principles of the kind that should lie behind them do not. Here again, our view is that this is where the IFRS Foundation should be focusing its attention, including in the development of related guidance for making materiality determinations in the non-financial space. This is where the need for thought leadership in non-financial/sustainability reporting (and accounting) is greatest at this time!

Question 10

Should the sustainability information to be disclosed be auditable or subject to external assurance? If not, what different types of assurance would be acceptable for the information disclosed to be reliable and decision-useful?

Yes, but here again the need for underlying accounting principles is dire. For how can there be meaningful auditing or assurance if the sustainability measurement and reporting practices that come before them are themselves unaccountable to generally accepted accounting principles in the first instance? In all of the ways such principles come into play and support financial reporting and assurance, so, too, should they (i.e., of a non-financial type) guide and support sustainability auditing and assurance as well!

Question 11

Stakeholders are welcome to raise any other comment or relevant matters for our consideration.

We have two other bits of advice to offer the IFRS Foundation at this time:

1. **Do not confuse sustainability performance with risk management or value creation narratives!**

We think it important to understand that there are really three streams of thought in play in what is otherwise referred to broadly as non-financial or sustainability reporting. The first is risk-oriented, or what we referred to above as the outside-in orientation (i.e., what the non-financial risks posed to an organization are by the world around it); the second is the inside-out orientation, or what can best be thought of as sustainability performance per se (i.e., the one that focuses on whether an organization is sustainable in light of what its impacts on the world are); and the third is the value creation one (i.e., the one that addresses how an organization creates economic value for its shareholders, including indirectly by way of creating non-financial value for stakeholders of all kinds).

As the IFRS Foundation contemplates entry into the non-financial/sustainability reporting (and accounting) arena, it really needs to consider in a very deliberate way which of the streams of thought it is talking about stepping into. If it is the risk management stream, one has to ask what can be brought to the table that isn't already there, since we know of no limitations in current financial reporting models that would preclude consideration of non-financial risk factors, such as climate, etc. Indeed, as illustrated in the Procter & Gamble example given above, such non-financial risk considerations are already addressed in today's mainstream reporting systems.

If, on the other hand, it is the sustainability performance stream the IFRS Foundation has in mind (i.e., the inside-out one), there is much work to be done there, for sure, especially insofar as the development of generally accepted (non-financial) accounting principles is concerned as we have argued above. But even if this is the field the IFRS Foundation chooses to step into, it should be clearly understood that what we are talking about here should not be confused with the outside-in, risk-oriented stream, since the underlying principles for one versus the other will be fundamentally different. Indeed, it is not the absence of outside-in risk management principles we are suffering from; rather, it is the absence of principles for measuring and reporting the inside-out impacts of organizations that afflicts us. We must not conflate the two!

This leaves the value creation stream, which is perhaps best exemplified by the International Integrated Reporting Council's (IIRC) *<IR> Framework*, the stated purpose of which is to help organizations describe and disclose the ways in which they create value for the narrow benefit of their providers of financial capital (i.e., their shareholders and lenders). Here it should be clear that value creation is a fundamentally different topic from both risk-management and sustainability performance. To understand how an organization creates value is to understand its business model; and to understand its business model is to potentially understand nothing at all about what the risks to its existence are or whether its performance is sustainable (i.e., the other two streams).

Our view is that the IFRS Foundation should decline to get involved in the value creation *storytelling* business (i.e., the domain of the IIRC), and concentrate instead on the sustainability performance accounting (measurement and reporting) business. The risk management business, too, should be avoided (i.e., the domain of SASB and the broader world of ESG), as there is really nothing too terribly new there to take account of, that doesn't already fall within the scope of existing standards and frameworks, including those that already have the force of regulation behind them. All told, then, what we are recommending is that the IRFS Foundation leave the risk management and value creation storytelling domains to the IIRC and SASB, which are now neatly bound up in the merger they recently announced (i.e., the Value Reporting Foundation).

Sustainability performance accounting, by contrast (i.e., the inside-out orientation that remains), is still very poorly handled and is clearly foundering on the rocks most definitely because – as we have repeatedly said – of the failure thus far of any of the standards-makers in that space to put forward proposals for what the underlying (and generally accepted) non-financial accounting principles are or should be. Given the players involved to date, we think we can also safely say that:

- SASB cannot be counted on to provide such a set of principles because it is primarily a creature of risk management, not sustainability accounting as noted above (despite its use of the 'sustainability accounting' vocabulary in its name, which not only adds to the confusion but causes it);
- IIRC cannot be counted on to do so, either, thanks to its preoccupation with value creation, not sustainability accounting;
- And GRI, for its part, while arguably inside-out in its focus, has almost willfully ignored the essence of sustainability theory and practice over the years, including the importance of adhering to its own reporting principles. Its failure to provide guidance and examples for how to correctly apply its Sustainability Context principle has clearly led to the fact that no organization, not even those considered to be GRI-compliant, has ever, in fact, correctly applied that principle. And because of that, no GRI report has ever actually disclosed the sustainability performance of an organization – a shocking but demonstrably true statement.

Given a commitment to (a) create and codify a meaningful set of generally accepted non-financial accounting principles, and (b) also create a set of authentic inside-out sustainability reporting standards that are true to the discipline and which do not simply pander to the investment community, the IFRS Foundation could help fill a gaping hole in the field. Anything short of that at this time, however, will only make matters worse, as the need for it will only intensify and persist over time.

2. Do not set standards without also providing sufficient guidance for how to comply with them!

One of the profound ironies of the fact that a standard for sustainability reporting has been in existence for the past twenty years (i.e., the GRI *Guidelines* and *Standard*) is that perhaps no corporate sustainability report ever published in accordance with it has actually disclosed the sustainability performance of its authors. Why not? Because the *Guidelines* themselves failed to include sufficient instructions for how to abide by its most important principle: the *Sustainability Context* principle.

The Sustainability Context principle is arguably the most important element of sustainability reporting because it is the one that calls for assessments of performance to be made relative to sustainability norms, standards or thresholds. Short of taking steps to clearly identify such criteria and then measure performance against them, the most an organization can do is report impacts in purely incremental or relativistic terms – *more of this type of impact this year, less of that, etc*.

Authentic sustainability reports, by contrast, are ones that disclose the sustainability performance of organizations per se (i.e., whether or not an organization's impacts were sustainable as measured and reported against sustainability norms and standards for what their impacts would have to have been in order to *be* sustainable). To simply say that less

water, for example, was consumed this year than last only begs the question of whether the amount of water consumed in either year was empirically sustainable. The same goes for greenhouse gas emissions, solid wastes, biodiversity and a whole host of social and economic impacts as well.

The fact that few organizations committed to the use of GRI's *Guidelines* and *Standards* has ever actually incorporated Sustainability Context into their reports is demonstrably due to the fact that clear guidance for how to do so was never provided by GRI. This was a fatal mistake in the short history of sustainability reporting and should not be repeated by the IFRS Foundation. Otherwise, we can count on yet another twenty years of feckless reporting by which the sustainability performance of countless organizations will never be known.

Imagine, for example, what financial reporting would be like if it were the case that specific guidance for the preparation of balance sheets and profit and loss statements did not exist. Not only do these reporting norms or standards exist in the form of generally accepted accounting standards, they exist at the statutory level as well. Starting with the Securities Act of 1933 in the United States, publicly traded companies have been required to include such statements in their financial disclosures by law, with balance sheets and profit and loss statements being specifically mandated in the statutes. Sustainability reporting standards, by contrast, have been nowhere near as specific, thereby resulting in a twenty-year period of equivocal, vague and deficient reporting.

A similar lesson can be drawn from the history of financial reporting in the UK. In the Joint Stock Companies Act of 1844, issuers of stock for sale to the public were for the first time legally required to publish balance sheets for their companies as a form of security to their buyers. Guidance, however, for how to do so was left out of the Act. This undermined the legislators' intent until such time as it was corrected later on, since few disclosures made under the Act actually included the financial statements required. Listen to how a legislative committee in 1853 put it in their retrospective review of the matter in a report that year entitled, *Report of the Select Committee on Assurance Associations*:[1]

> "One of the chief securities contemplated by the Act of 1844 for the safety of the public is the duty imposed upon them [publicly traded companies] to return annual balance sheets representing the state of their affairs ... they are open to public inspection. But from the fact that the Act prescribed no form, and furnished the Registrar with no power to enforce a compliance with the spirit, or even the letter of the law, it appears that this provision has been very imperfectly complied with in many cases, and in others altogether neglected; so that it cannot be said that it has afforded, in the majority of cases, either the information or the security which was intended."

By the time of the subsequent Companies Act of 1862, the shortcomings of the 1844 Act had been resolved so as to provide more specific guidance for what the content and format of financial statements must be in order to properly convey the financial states of affairs of public companies. Thus, not only were reporting requirements

[1] As cited by author Bishop Carleton Hunt in his 1936 book, *The Development of the Business Corporation in England, 1800-1867* (p. 97).

specified by law, the form (i.e., structure and content) of such reports was also defined so that companies would know how to comply with it.

The lessons of history here are clear. It is not enough to simply call for disclosures in purely conceptual terms. Standards makers, too, must also provide explicit guidance for how such disclosures must be made. But how can they? Unless generally accepted principles for how best to *measure* performance in the first instance already exist, no such guidance will be possible. All the more reason, we argue, to double back and give priority to the development of what we call GAAP-NF (generally accepted accounting principles for non-financial performance), before yet another set of premature reporting standards is produced.