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Generally Neglected Accounting Principles

By Mark W. McElroy

Executive managers and board members could be forgiven for thinking that now that the International Financial Reporting Standards (IFRS) Foundation has entered the sustainability reporting space, the turbulence surrounding so-called environmental, social, and governance (ESG) disclosures will die down. After all, who could possibly be better than the foundation, the leading international administrator of financial accounting, to step in and quell the cacophony of competing frameworks for nonfinancial accounting?

Indeed, what has been missing the most in nonfinancial reporting for the past 20 years is precisely the kind of rigor and consistency that the IFRS standards possess. Along with the generally accepted accounting principles (GAAP) in the United States, the IFRS standards provide clear guidance for the preparation of financial statements around the world.

But everything the foundation intends to do—and ESG itself—falls well short of true sustainability accounting, thanks mainly to the disregard of core principles of the field. What will the core principles be in the foundation's vision of sustainability accounting? Which of the competing schools of thought does it subscribe to, and is it the right one? Is it really time to pop the cork on all of this, or does the foundation's arrival in the sustainability arena amount to a setback of some kind? Business leaders should brace themselves accordingly.

SUSTAINABILITY SCHOOLS OF THOUGHT

Far from being a unified field, in the sustainability world there are at least two competing schools of thought. Depending on which ultimately prevails, the makeup of sustainability accounting could go in two very different directions in the coming years.

The first of the two is the sustainability accounting school, a doctrine that concerns itself with stakeholders of all walks and not just shareholders. This is the school most often associated with the Global Reporting Initiative. The challenge it sets out to address is how best to assess an organization's inside-out impacts on vital resources of all kinds and the well-being of those who depend on them. In that regard, sustainability accounting is stakeholder-centric.

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The second is the value creation school, most often associated with the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB), which recently announced their merger to become the Value Reporting Foundation. The primary interest of the value creation school is how best to assess an organization's ability to create value and then measure and report it—shareholder value, that is.

Embedded within the value creation school are two other underlying doctrines: risk management and impact accounting. Both of these sub-schools, which are associated with, for example, the Task Force on Climate-related Financial Disclosures and the Impact-Weighted Accounting Initiative at Harvard University, respectively, have long-term shareholder value

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creation at their heart. And contrary to the sustainability accounting school, the chief concern of the value creation school is the outside-in impacts of the world on an organization itself, and the effects they might have on its ability to create shareholder value.

It is the value creation school and its subsidiary doctrines where most of what passes for ESG issues lives. That makes ESG unabashedly shareholder-centric, though its frameworks occasionally include consideration of the impacts organizations have on non-shareholder stakeholders. Even then, it is only the effects such impacts might have on shareholder value that make them important or material in the value-creationist view.

WHAT WILL THE IFRS FOUNDATION DO?

Based on what the IFRS Foundation has already disclosed about its intentions, it seems clear that the Sustainability Standards Board (SSB) it plans to create will be a creature of the value creation school. As explained in statements the foundation put out on March 8 and 22, the SSB's primary concern will be "investor focus for enterprise value," especially involving climate-related reporting at the outset.

This raises the general question of principles for accounting, and which ones the foundation intends to abide by in its conception of sustainability reporting. Assuming that value creation will be the SSB's doctrine, shareholder primacy will almost certainly animate everything it does. If so, the foundation will have fallen into the same trap that SASB did when it launched in 2011 and that the IIRC did when it followed two years later: shareholder primacy is the antithesis of sustainability accounting.

To be clear, there is nothing wrong with value creation for shareholders except when it masquerades as sustainability accounting. To say that a firm has

UNOFFICIAL GENERALLY ACCEPTED NONFINANCIAL ACCOUNTING PRINCIPLES

1. ACCOUNTING ENTITY	The concept of a business or accounting entity whose books record its performance, as distinct from its owners or shareholders.
2. ACCOUNTING PERIOD	A defined period of time for which performance is measured.
3. STAKEHOLDERS	Individuals or groups to whom duties and obligations are owed to manage one's impacts on vital capitals in ways that can affect their well-being.
4. DUTIES & OBLIGATIONS	Responsibilities to have, not have, or otherwise manage one's impacts on vital capitals in ways that can affect stakeholder well-being.
5. VITAL CAPITALS	Stocks and flows of resources that people rely on for their well-being (i.e., human, social, constructed, economic, intellectual, and natural capitals that yield valuable goods and services).
6. CARRYING CAPACITY	The level of demand for its goods or services that a stock and/or flow of capital can support without degrading.
7. THRESHOLDS	Upper and lower limits in the carrying capacities of capitals that must be maintained in order to ensure human well-being.
8. ALLOCATIONS	Entity-specific fair, just, and proportionate shares of duties or obligations to maintain thresholds in vital capitals at levels required to ensure stakeholder well-being.
9. MATERIALITY	The degree to which actual or possible impacts on vital capitals correspond to any duties or obligations owed to stakeholders.
10. SUSTAINABILITY	The degree to which human impacts on vital capitals have the effect of maintaining them at levels required to ensure stakeholder well-being (i.e., in accordance with normative thresholds and allocations of responsibilities to preserve and/or produce them, as the case may be).

Additional Principles Added Following Publication:

11. Sustitutability	The extent to which the diminishment or loss of one type of capital can or cannot be compensated for by the excess availability or production of another (e.g., the view that capitals of different kinds are generally not interchangeable with one another and must therefore be separately maintained at required levels).
12. Commensurability	The degree to which measures of impacts on disparate capitals are expressed in terms of a common conceptual framework and on a common scale, such as sustainability performance, so that measurements can be combined in like terms.

Source: Mark W. McElroy

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created value for its shareholders, and to describe how, is to tell us nothing about its sustainability performance. For all we know, value creation may have come at the expense of impacts on other resources of great importance to the well-being of other stakeholders.

Thus, if the IFRS Foundation moves ahead with its value creation agenda, it will amount to yet another chapter in a long line of gratuitous misappropriations of the sustainability concept, vocabulary, and halo effect, all in the narrow service of shareholder primacy. Authentic sustainability accounting will have been lost in the translation once again.

Most conspicuously missing from the IFRS Foundation's plans are core principles in sustainability accounting. Think of these as the functional equivalent of GAAP for nonfinancial, not financial, sustainability measurement and reporting, or GAAP-NF. Like GAAP, the principles in GAAP-NF have been evolving for centuries and have only crystalized in the past 25 years as sustainability issues have come to the fore.

Nowhere in what the IFRS Foundation proposes to do, however—in the name of sustainability accounting, no less—are these principles represented. It is as if principles for authentic sustainability accounting do not apply while value creation dominates the game. If the tables were turned and it was financial reporting we were discussing, what the foundation is planning to do would be scandalous—negligent, even. Why should nonfinancial reporting be any different?

THE NEGLECTED PRINCIPLES

The table on page 51 summarizes 10 fairly well-established, although not entirely official, principles of what is referred to here as GAAP-NF, which include three sustainability-related variants of principles found in both GAAP and IFRS: accounting entity, accounting period, and materiality. These principles apply to measuring and reporting the sustainability performance of organizations, and largely involve assessments of impacts on multiple vital capitals relative to their effects on stakeholder well-being.

As financial accounting makes it possible to assess the economic performance of organizations, accounting systems grounded in the principles listed can make it possible to assess sustainability performance, as well. The questions they allow managers and corporate directors to properly ask and answer are: Are our social, economic, and environmental impacts fair, just, and proportionate? And, are we sustainable? These are not to be confused with: Are we creating financial value for our shareholders, and if so, how?

Perhaps the most emblematic principles of GAAP-NF are thresholds and allocations. Together they address upper and lower limits for what an organization's impacts on vital capitals must be in order to be sustainable, or fair, just, and proportionate. To one degree or another, they call for organizations to live within their means and ensure the means to live, all in accordance with duties and obligations owed to stakeholders.

But to do so effectively, organizations must first be able to measure and report against related norms, standards, or thresholds. Having a performance accounting system that, in addition to financial accounting, makes this possible has arguably become indispensable in the resource-constrained, climate-impaired, and stakeholder-charged 21st-century economy. The time for real, and not just metaphorical, triple bottom-line accounting has arrived.

One could even argue that having access to the kind of integrated accounting system described here would confer to a business a degree of protection or immunity from the effects of its own unsustainable impacts on the world, if only by making them and the behaviors that cause them more visible and less likely. We cannot manage what we cannot see. Why would any executive or board member want anything less from a "Sustainability Standards Board"?

Still, many accounting and disclosure frameworks seem content to hijack the sustainability agenda, neglect its foundational principles, and replace them with value creationism, as if the mere measurement and reporting of the incidental social and environmental impacts of organizations somehow equate to sustainability accounting.

What is more unfortunate is that the IFRS Foundation has now joined this group. If the plans it made take hold, it could be decades before authentic sustainability accounting again has a chance to see the light of day, thereby depriving executives and directors of precisely the kind of information they need to manage and govern responsibly, especially in a post-pandemic world. D

TO SAY THAT A FIRM HAS CREATED VALUE FOR ITS SHAREHOLDERS, AND TO DESCRIBE HOW, IS TO TELL US NOTHING ABOUT ITS SUSTAINABILITY PERFORMANCE. FOR ALL WE KNOW, VALUE CREATION MAY HAVE COME AT THE EXPENSE OF IMPACTS ON OTHER RESOURCES OF GREAT IMPORTANCE.