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.

TO BE CLEAR, THERE IS NOTHING WRONG WITH VALUE CREATION FOR SHAREHOLDERS EXCEPT WHEN IT MASQUERADES AS SUSTAINABILITY ACCOUNTING.

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
Additional Principles Added Following Publication:

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
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<tbody>
<tr>
<td>1. ACCOUNTING ENTITY</td>
<td>The concept of a business or accounting entity whose books record its performance, as distinct from its owners or shareholders.</td>
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<td>2. ACCOUNTING PERIOD</td>
<td>A defined period of time for which performance is measured.</td>
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<td>3. STAKEHOLDERS</td>
<td>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.</td>
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<tr>
<td>4. DUTIES &amp; OBLIGATIONS</td>
<td>Responsibilities to have, not have, or otherwise manage one’s impacts on vital capitals in ways that can affect stakeholder well-being.</td>
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<td>5. VITAL CAPITALS</td>
<td>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).</td>
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<td>6. CARRYING CAPACITY</td>
<td>The level of demand for its goods or services that a stock and/or flow of capital can support without degrading.</td>
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<td>7. THRESHOLDS</td>
<td>Upper and lower limits in the carrying capacities of capitals that must be maintained in order to ensure human well-being.</td>
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<td>8. ALLOCATIONS</td>
<td>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.</td>
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<td>9. MATERIALITY</td>
<td>The degree to which actual or possible impacts on vital capitals correspond to any duties or obligations owed to stakeholders.</td>
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<td>10. SUSTAINABILITY</td>
<td>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).</td>
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**Note:** The Generally Accepted (Non-Financial) Accounting Principles (GAAP-NF) discussed below have since evolved to become the Generally Accepted Integrated Accounting (GAIA) Principles: [https://bit.ly/32lwZ75](https://bit.ly/32lwZ75)
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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 sus-
nertion, even. Why should nonfinan-
cial reporting be any different?

THE NEGLECTED PRINCIPLES
The table on page 51 summarizes 10 fair-
ly well-established, although not entirely
official, principles of what is referred to
here as GAAP-NF, which include three
sustainability-related variants of prin-
ciples found in both GAAP and IFRS:
accounting entity, accounting period,
and materiality. These principles apply
to measuring and reporting the sustain-
ability performance of organizations, and
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 re-
port against related norms, standards,
or thresholds. Having a performance
accounting system that, in addition to fi-
nancial 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 account-
ing has arrived.

One could even argue that having ac-
cess to the kind of integrated accounting
system described here would confer to
a business a degree of protection or im-
munity from the effects of its own unsus-
tainable impacts on the world, if only by
making them and the behaviors that cause
them more visible and less likely. We can-
not 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 founda-
tional principles, and replace them with
value creationism, as if the mere mea-
surement and reporting of the incidental
social and environmental impacts of orga-
nizations somehow equate to sustainabil-
ity 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 sus-
tainability accounting again has a chance
to 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.