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Policy Workshops from the ECGI Network

2020 WORKSHOP REPORT

SUSTAINABILITY REPORTING

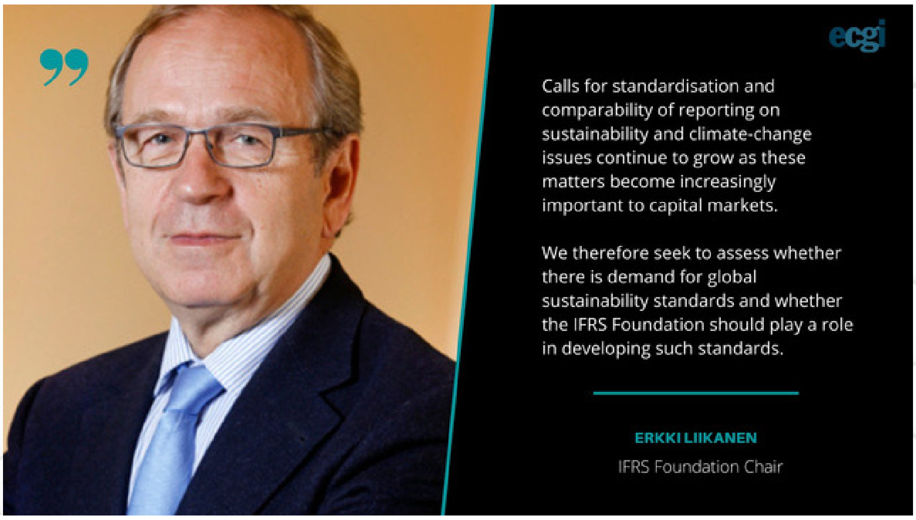
4 DECEMBER 2020

by Romeo Kaptijn | Impact Economy Foundation

Introduction

The online policy workshop on 'Sustainability Reporting' hosted by the European Corporate Governance Institute (ECGI) and the Impact Economy Foundation (IEF) was held on 4 December 2020, in reaction to IFRS' consultation paper. The IFRS Trustees published the consultation to explore the desirability of global sustainability standards and what the potential role of the IFRS Foundation could be. The workshop was organised by **Lucrezia Reichlin**, Professor of Economics at the London Business School, ECGI Chair and IFRS Trustee, together with **Dirk Schoenmaker**, Professor of Banking and Finance at the Rotterdam School of Management. The term 'sustainability reporting' is used throughout instead of 'non-financial reporting'.

Erkki Liikanen, Chair of the Trustees of the IFRS Foundation, opened the workshop by stating that the establishment of the new Sustainability Standards Board (SSB) would be an important pathway forward. However, to be successful, support is needed from public authorities, global regulators, and market stakeholders. Additionally, the board will have to work together with regional and other authorities to achieve global consistency and reduce complexity. He further mentioned that the process should happen gradually, and the first focus should be on the most relevant information starting from climate.






Academic Keynote Briefing: An Economic Analysis of Sustainability Reporting

Christian Leuz, Professor of International Economics, Finance and Accounting at the University of Chicago's Booth School of Business and ECGI Fellow, provided a keynote briefing containing lessons from literature which set the stage for the discussion. Three key topics were raised: Should we make reporting mandatory? Should there be a global set of standards? (and, if so, which one?); And what is the goal of sustainability reporting? Regarding the last question, he presented **two goals: giving the investors what they want** and **driving change with sustainability reporting.** At first glance, the IFRS intrinsic motivation seems related to the second goal, but the consultation paper hints at the first goal. He observed that focusing on investors' needs **ignores externalities unless their preferences go beyond shareholder value.**

Prof. Leuz stressed that it is important to ask why investors want sustainability reporting standards. Is it because firms do not comply with existing materiality requirements or is it because the information is not standardized and harmonized (or both)? If we aim to harmonise practices, we need to **be realistic about what standards can achieve and build a proper infrastructure.** Another important question is whether investors indeed push companies to internalise their external effects. They would only have incentives to do so if their preferences go beyond shareholder value. He noted that transparency solutions, like reporting initiatives, are often perceived to be less intrusive and pursued because they are politically more difficult to oppose. But they are far from innocuous. Important issues to consider for transparency solutions include '**democratic legitimacy**' – who gets to decide on what changes in behaviour the reporting intends to induce – and the unintended '**real effects**' that are difficult to foresee. Prof. Leuz argued that **a reporting regime focused on financial materiality would limit these two issues**, but at the same time would likely have less impact when it comes to major environmental concerns, which highlights an important tradeoff.

Adrian de Groot Ruiz, Executive Director of the Impact Institute and Board Member of the Impact Economy Foundation, gave a presentation on what corporate reporting looks like in practice and reflected on the potential impact of IFRS. In line with Prof. Leuz's comments, he acknowledged that sustainability disclosures are necessary but **insufficient to internalise externalities**. Dr. De Groot Ruiz further stated that due to externalities, the social responsibility of the firm is now to optimise stakeholder value, however this is difficult to measure. Reasons for this are that sustainability reporting is **output or input focused instead of addressing what is material to stakeholders,** the incomparability of metrics, and the subjectiveness to bias and inconsistencies with low correlations. **All-encompassing information** for decision making would include: **all material impacts, quantification, valuation, attribution, and differentiation per impact, capital, stakeholder and welfare dimension**. He then shared that in practice four different impact-weighted accounts need to be measured, being: investor value creation, stakeholder value creation, external cost, and Sustainable Development Goals. To illustrate, he presented different real-life examples of companies' impact statements. Dr. De Groot Ruiz concluded his presentation by raising some important questions which suggested taking on a holistic, long-term perspective to **avoid continuous revision** of frameworks and principles. Furthermore, he asked how the IFRS can create a dynamic and inclusive standardisation process and **whether the focus of the SSB could lie on impacts instead of dependencies.**

Panel 1: The Global Perspective

The first panel discussion included the views of **Sandy Boss**, Global Head of Investment Stewardship for BlackRock and a member of BlackRock's Global Executive Committee, and **Bob Eccles**, Visiting Professor of Management Practice, Saïd Business School, University of Oxford, Founding Chairman of the Sustainability Accounting Standards Board (SASB) and one of the founders of the International Integrated Reporting Council (IIRC), on global sustainability standards. Ms. Boss indicated that the events of 2020 deepened BlackRock's conviction that **sustainability risk - in particular climate risk - is an investment risk**. Ms. Boss shared that from an investment perspective, sustainability disclosures enable BlackRock to express its conviction that risk-adjusted returns can be superior when sustainability risks are taken into consideration. BlackRock is encouraged by the direction of travel amongst private standard setters towards a comprehensive global reporting system, and while it continues to endorse the TCFD and SASB frameworks, BlackRock believes the IFRS Foundation has the right standard-setting and regulatory expertise to establish a global reporting standard. Prof. Eccles emphasised that standards remain a social construct, and so are imperfect. It is important to recognise the system-level effects and that income inequality remains an overlooked risk. Lastly, he mentioned that sustainability reporting is not only about infrastructure, but that the big trend on engagement and stewardship must continue. Once we have the tools, it is a matter of what we do with them.

When asked how new standards would change the stewardship and engagement work of Ms. Boss and her team, she highlighted that the ability to have comparable information would be invaluable for BlackRock's global stewardship activities. Ms. Boss pointed to the lack of quality and lack of comparable data as one of the biggest current challenges to assess impact over time. To better understand the effectiveness of the team's engagement and voting tools, **time-series analytics are desirable** to compare populations of companies across metrics that BlackRock – and third-party research – have proven are linked to better performance.

Prof. Leuz raised a critical question related to the migration of sustainability activities. He sketched a scenario whereby **the pressure put on public companies leads to evasion by private companies** and asked how to counter that. In response, Ms. Boss stated that it is important that investors not only engage with companies with an excellent disclosure record, but rather expand engagement efforts across geographies and disclosure levels. Second, she emphasised the relevance of integrating sustainability standards into the private sector's debt underwriting processes, e.g. banks' lending practices. **Alain Deckers**, Head of Unit, Corporate reporting, audit and credit rating agencies, DG FISMA, European Commission, similarly stressed that **sustainability reporting will be more important for SMEs as banks, clients and private equity investors will be asking about sustainability performance**. Prof. Eccles added that the adoption of sustainability standards by public companies will probably have trickle-down effects.

The panel discussion ended with short statements on the position of supply chains, index makers and how these issues should be governed. Regarding supply chains, Prof. Eccles observed the reporting boundary

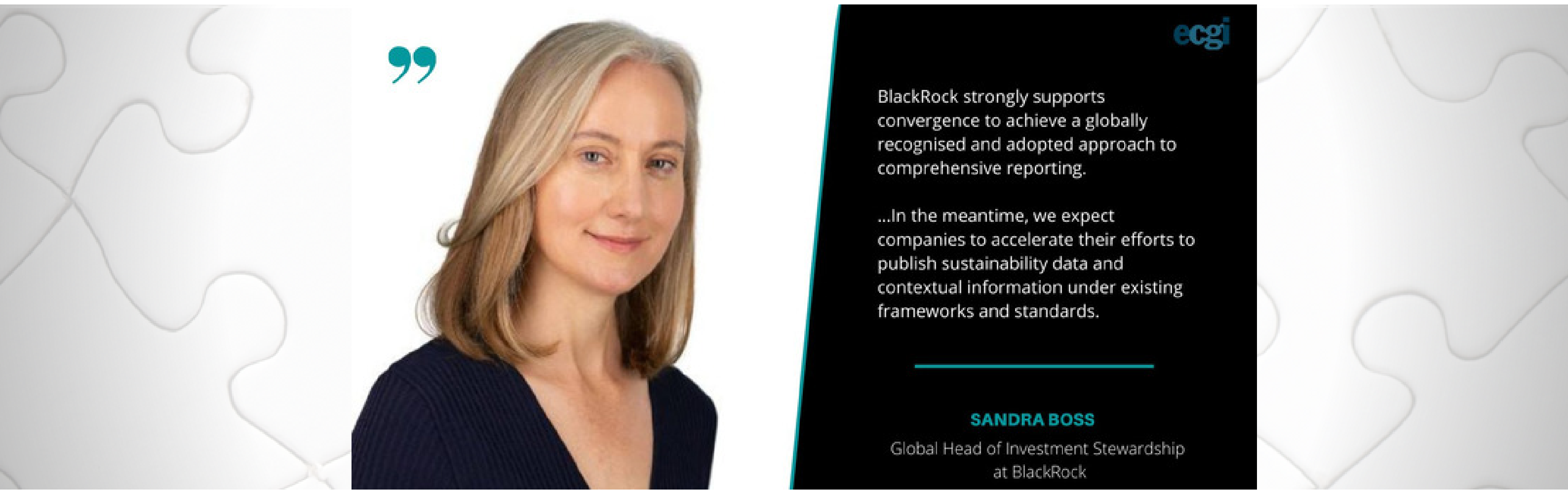
ever remains an issue. Regarding index providers, Ms. Boss recognized the migration from purely exclusionary indices towards more sophisticated, ESG-integrated indices. Index providers are increasingly aware of the role they play in the sustainability space. Closing remarks of the two panelists were similar. The private sector should make the most out of current standards while the convergence is taking place. Learning, piloting, and rolling out initiatives in combination with embracing the imperfectness of standards is, for now, the best way to move forward.

Panel 2: The EU Perspective

The next panel discussed the position of sustainability reporting in Europe and the potential role of the EU. **Alain Deckers**, Head of Unit, Corporate Reporting, Audit and Credit Rating Agencies and Vice Chair of the European Corporate Reporting Lab at the European Commission, began by commenting that the problem, as communicated by investors and civil society organisations, is that received information on sustainability is often inadequate, incomparable, irrelevant and unreliable at times. As a result, he has observed fragmentation in sustainability reporting where there is now a soup of standards, principles, and frameworks. At the same time, **the non-financial reporting directive and possible future standards are believed to be the foundations for the successful implementation of several parts of the EU's sustainable finance policy.** The use of global standards will provide assurance, facilitate enforcement, facilitate convergence, and **facilitate the transition to digital reporting**.

The EU realises the global character of investments and does not want to reinvent the wheel but rather build on current practices. Still, Europe has already adopted a legal framework that can have a guiding function. Moreover, the IFRS Foundation can contribute to international governance, something desired by investors. Mr. Deckers sees the provision of connectivity between financial and non-financial information, robust governance, and an established reputation as strong assets of the Foundation. A key condition for success is that **the IFRS must federate existing initiatives, and not become an extra voice that further fragments**.

Rients Abma, Executive Director of Eumedion, highlighted that institutional investors' beneficiaries and clients are pushing for the integration of sustainability factors in their investment, engagement, and voting decisions. In order to keep their license to operate, organisations need to 'walk the talk'. Furthermore, he stated that more consistent and reliable information on sustainability will lead to higher quality input for the internal decision making by company boards. In Eumedion's view, the IFRS should play a leading role in the standard-setting process as it already has a strong due process for standard-setting, a proven governance structure, and is considered independent and authoritative. However, it is crucial to have global support from international stakeholders like the EU. A starting task of the SSB should be exploring **what key performance indicators have universal relevance** for all (or nearly all) organisations.






Pierre-Emmanuel Beluche, Head of Sustainable Finance at the French Treasury, began by stating that sustainability reporting is often considered technical and confusing, while he believes it is **essentially a political matter.** He explained that it directly involves shareholders, savers, citizens and other stakeholders, and they all want to achieve climate objectives, know how they can contribute, and know how money is spent. Thus, sustainability reporting is not only about numbers and ticking boxes, but it **carries a vision of a society we want as people.**

Mr. Beluche identified multiple strengths of the European Union. The EU has a critical economic size, a unique ability to harmonise standards through legal instruments, regulations and directives, with established foundations and credentials in the sustainability reporting area, and it has already established a dedicated task force within the European Financial Reporting Advisory Group.

The Q&A session opened with a question about the potential for cooperation between the SSB and the Global Reporting Initiative (GRI), to which Mr. Deckers responded that it is a bit premature to make comments on this though he believes GRI will continue to play a role because of their history. Prof. Reichlin further clarified that the IFRS does not see their initiative as competing since it is demand-driven. As mentioned earlier, democratic legitimacy is considered very important. She explained that global standards setters need to be careful with double materiality as they will need support from various stakeholders. For that reason, the IFRS Foundation board consists of members with different backgrounds.

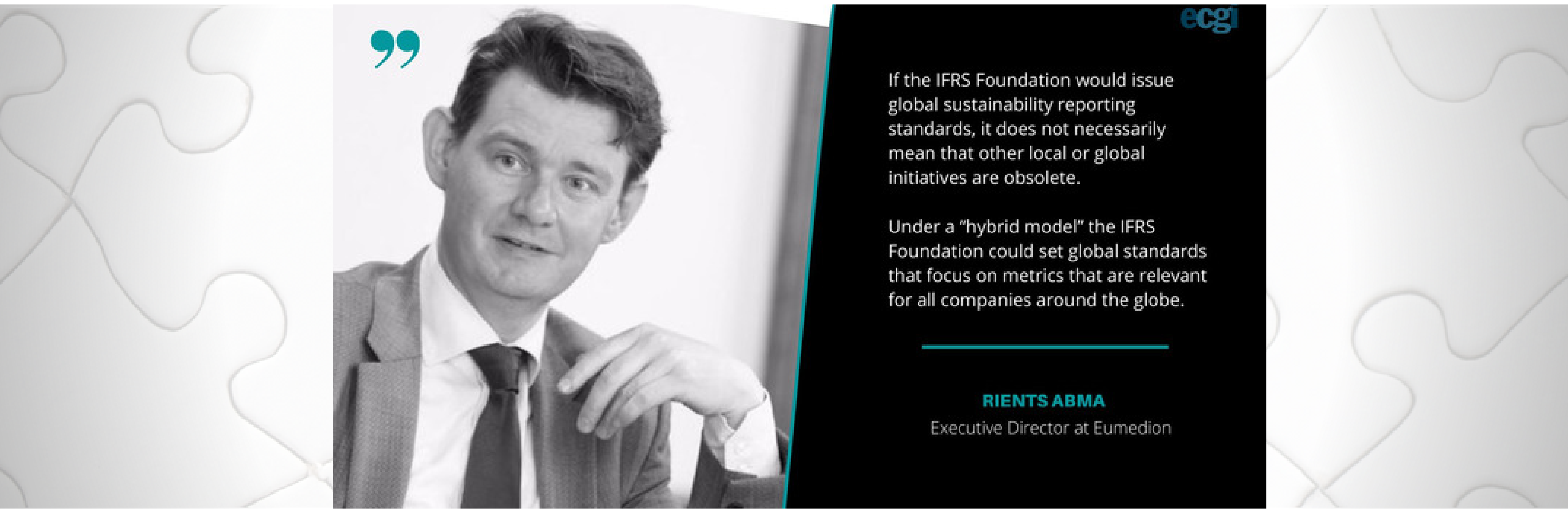
When asked about the movement for a minimum global standard, Mr. Beluche commented that there always exists a **trade-off between harmonisation of norms and individual ambitions**. Mr. Deckers added that there is not always a 'minimum' harmonisation. If, for instance, IFRS is adopted in Europe, there is no deviation possible. He also mentioned that **double materiality is clearly embedded in the current EU framework**. Concerning double materiality, Mr. Abma concluded that there is an artificial split from an investor's point of view. Alongside financial performance, investors want to know the wider impact on society and the environment. Therefore, the IFRS should **reformulate the target audience** of the reporting standards.

Panel 3: Securities Regulators

The third panel reflected on the theme of enforcement. Panel member **Steven Maijoor**, Chair of the European Securities and Market Authority (ESMA), first commented that the allocation of capital is also driven by non-financial information. Therefore, there can be risks that this information is misleading – for instance in the case of greenwashing – and investors need to be protected from misrepresentation. The vagueness of current standards leads to bigger risks and, therefore, common international standards are desired. He reiterated the international character of investments and climate agreements and the stress testing of financial systems as reasons for international standards.

In line with other speakers, Dr. Maijoor emphasised that standards should not be built from scratch. Furthermore, he hinted that the stakeholder base should be broader. At present, the IFRS has limited interaction with NGOs and civil society. From an enforcement perspective, standards need to be principle-based, not too detailed, but they need to be **sufficiently granular to allow enforceability**.

Second panel member **Tajinder Singh**, Deputy Secretary-General of IOSCO, outlined that IOSCO has three main objectives: investor protection, fair, efficient, and transparent markets, and the reduction of systemic risks. The implementation of IFRS standards can be considered beneficial to all objectives. Speaking for IOSCO, Mr. Singh supports the initiative and hopes the IFRS can promote consistency and comparability and address fragmentation. Robust international sustainability reporting standards, that are **interconnected with financial reporting standards**, will support auditor assurance as well as enhance comprehensive sustainability disclosures. **International high-quality standards, underpinned by a sound governance structure and jurisdictional adoption mechanisms**, can form the foundation for mandatory corporate reporting that helps with enforcement. He then referred to an IOSCO report which stated that the voluntary, high-level nature of sustainability disclosures, the lack of binding obligations and issues like greenwashing and lack of comparability are being described as the biggest emerging challenges that need to be addressed. For IFRS to succeed, applying the existing governance structure, with public accountability, independence and rigorous due process are key criteria.



The Q&A session began with a question on how regulators ensure that fund managers and their security supervisors are competent and adequately trained. In response, Dr. Maijoor stated that they have provided advice to the Commission on how to integrate sustainability factors both for asset managers and investment firms. Also, investment advisors are given guidelines on how to take sustainability elements into account. Apart from this, Dr. Maijoor identifies the technical soundness of sustainability reporting as the biggest challenge. Getting reliable data on, for instance, carbon footprints remains a big internal control and accounting issue. **Financials should become more involved in sustainability accounting and carbon accounting amongst others.** Mr. Singh mentioned that there is a need for capacity building among regulators. Additionally, asset managers need to incorporate the voices coming from emerging markets.

Prof. Leuz asked Dr. Maijoor whether regulators should focus more on making sure stakeholders know what aspects can be financially material. He asked Mr. Singh what **the role of exchanges** can be, for instance by designing premium segments that align with the ambitions of global companies. Dr. Maijoor responded by saying the problem around enforcement is that there is not yet a common standard like there is for financial reporting. He later added that t**he right internal controls** to collect information are still lacking. Mr. Singh reacted that some exchanges are encouraging, however it is not sufficient.

Concluding Remarks

Prof. Schoenmaker concluded that regulators are willing to act, however they require clear, common standards. He further remarked that he had learned two new important words: **dynamic materiality** and **dynamic convergence**, both stemming from **transition dynamics**. The distinction between single and double materiality is more an analytical dividing line, but in practice it will be dynamic. Mr. Singh similarly stated that they are not so much isolated silos. Lastly, he stressed the importance of building on existing work conducted to date by the leading sustainability reporting initiatives and keeping a holistic approach. Thereby, Prof. Schoenmaker presented a visual in which it is shown that you need all the niches (GRI, SASB, IEF, etc.) to develop new ideas and he was delighted to hear that the IFRS and SSB are keen on building on these initiatives.

Videos of the workshop discussions are available on the ECGI website and also at:
https://www.youtube.com/watch?v=Es01_r8rUa8&list=PL0ysOguv9W0KOvRRkp8MYoudnFc3gFcJ1

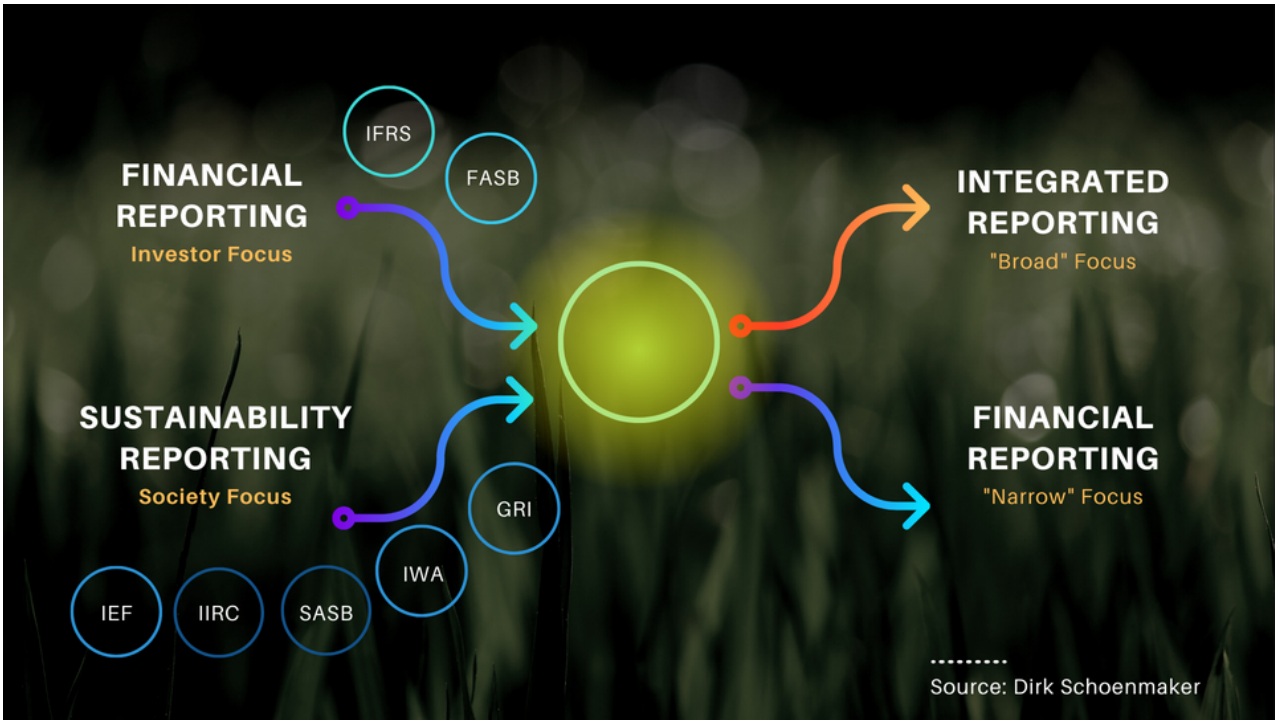


Figure 1: The Reporting Transition

ABOUT ECGI

www.ecgi.global

ECGI is global research network and international scientific non-profit association providing a forum for debate and dialogue between academics, legislators and practitioners, focusing on major corporate governance issues. Its 327 appointed research members publish their work on corporate governance in the ECGI Working Paper Series, a trusted source of global research used by practitioners and academics worldwide.

ABOUT THE IMPACT ECONOMY FOUNDATION

www.impacteconomyfoundation.org

The Impact Economy Foundation wants to accelerate the transition to an Impact by Economy by establishing a global community of impact professionals, incubating a standard for impact statements and developing concrete regulatory and policy proposals for the impact economy.

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