Sustainability Accounting Standards as the New GAAP

BY TRICIA DUNLAP

Imagine the CEO of a U.S. corporation refusing to disclose any information about his company's financial performance. Instead, he tells investors he won't "wet-nurse" them, and they will have to "wade in and get stuck" because that's the way men are "educated."

As outlandish as that sounds, in 1899 that's essentially what Henry Havemeyer, president of the American Sugar Refining Company, said to a congressional committee by way of justifying his refusal to disclose any financial information to American Sugar's 11,000 investors. One hundred years ago, Havemeyer's perspective was perfectly acceptable. Almost no corporations issued financial reports, and when they did the data were usually fantasy.

Much as Havemeyer dismissed financial reporting in his day, you might dismiss the idea of including non-financial business risks and opportunities in your reporting. But just as financial reporting in 2014 looks nothing like it did a hundred years ago, recent shifts in nonfinancial ("sustainability") reporting have changed the corporate landscape. The introduction of new quantitative metrics keyed to the Supreme Court's definition of "materiality" proposes to change how corporations are valued, and as a result alter their marketplace value and access to capital.

In 2012, the Sustainability Accounting Standards Board (SASB) began a process to set sustainability reporting metrics that were unlike earlier iterations. The SASB metrics track five kinds of non-financial capital – human, environmental, social, business model and innovation, and leadership and governance. SASB standards are evidence-based, auditable, industry-specific, potentially material, and designed to allow investors to compare one company's performance with that of its competitors.

Investors may now access better data, and CEOs and CFOs may sleep better, knowing that Sarbanes-Oxley certification is backed by a more thorough and objective materiality analysis. And corporate leaders who face criticism for reporting sustainability issues may now defend their decision by pointing to SASB standards.

HOW WE GOT HERE

It took the 1929 stock market crash, fueled in part by misleading financial reports that inflated corporate value, to alter the face of the laissez-faire capitalism of Havemeyer and his peers. In 1934, Congress created the Securities and

Exchange Commission and mandated reporting for publicly traded companies.

Neither Congress nor the SEC, however, established accounting standards. As a result, for the next 40 years, in court and in the halls of Congress, some corporations fought efforts by the Investment Bankers Association, the New York Stock Exchange and the American Institute of Accountants to standardize financial reporting practices. Even 30 years after the creation of the SEC, without accounting standards in place, U.S. capital markets did not have reliable information on corporate financial performance.

In 1973, the Financial Accounting Foundation formed the Financial Accounting Standards Board (FASB) – one of the "most important organizations you've never heard of," according to FASB Vice President Robert Stewart. Recognizing that investors benefit from "the expertise and resources that the private sector could offer to the process of setting accounting standards," the SEC blessed FASB's standards as "generally accepted." Thus, since 1973 publicly traded U.S. corporations have reported financial performance using FASB's "Generally Accepted Accounting Principles," or GAAP, and our understanding of corporate performance has been significantly altered.

Almost immediately, however, a small chorus of voices began arguing that financial metrics alone do not accurately reflect corporate value. Over the last four decades, that chorus has only grown louder.

In 1989, the Coalition for Environmentally Responsible Economies (CERES) published its "Valdez Principles," advocating for environmental disclosures. The Global Reporting Initiative (GRI) grew out of that effort, and today it is the most widely-adopted framework for voluntary corporate sustainability analysis and disclosure. The GRI framework, however is neither industry-specific nor tied to the legal definition of materiality. GRI standards consider a broad stakeholder community and are not pointed to the "reasonable investor" so familiar to U.S. securities lawyers. In addition, its standards do not take into account that different industries face distinct risks and opportunities related to their unique practices. Thus, while GRI disclosures may be appropriate on a voluntary annual report, they are not useful in the materiality analysis necessary for preparation of SEC filings.

Since GRI's emergence in the late 1990's, examples of non-financial reporting have proliferated and it's become a cluttered landscape. Aside from GRI, you've likely heard of the Carbon Disclosure Project (CDP), which represents 767 mostly institutional investors holding over $100 trillion in market assets. Because its roots are in the environmental movement, when you hear "sustainability" you quite likely think "green" or perhaps even "left-wing environmental activists."

Today, however, sustainability measures are applied to a broad spectrum of corporate operations and issues that feed into corporate value, including supply chain vulnerabilities, brand and reputation value, human rights, intellectual property, cybersecurity, and management of regulatory environments. None of these are financial issues in a direct sense, yet performance on any of them can affect corporate value. Investors want to know what companies are doing to manage these risks and opportunities, and that's why demands for sustainability disclosures have grown louder.

Some may dismiss sustainability reporting as a mere PR gimmick, or feel they are bombarded with sustainability questionnaires and become impatient with their sometimes subjective nature. This view is not necessarily wrong, as the quality of voluntary reports varies widely. Like the information in pre-GAAP financial reporting, some of the data is not always useful, and

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much like during the early decades of financial reporting, the first 30 years of sustainability reporting has generated confusion as well as enlightenment.

THIS GENERATION'S GAAP?

The emergence of the Sustainability Accounting Standards Board in 2012 changed the status quo, because for the first time it laid out evidence-based, objective, potentially material, and industry-specific standards to guide an analysis.

Though FASB and SASB are not affiliated, the SASB process is modeled on that of the FASB and its success. Both organizations are private, non-profit corporations. They also share a mission of educating investors and ensuring that capital markets are informed by material information, produced according to rigorous disclosure standards, and designed to allow markets to accurately price corporate value. SASB intends to guide reporting of sustainability issues on SEC filings, so the market can factor sustainability into corporate value.

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Thus we may be on the cusp of another "GAAP-moment." Forty years ago, when FASB launched GAAP, 83 percent of corporate assets were tangible and easily valued. Today, 80 percent of assets are intangible, and value can be difficult to assess. On that fact basis, plus additional concerns over dwindling or degraded natural resources, climate risks, growing interest in social responsibility and demands for greater transparency, it appears that the market is adopting a different understanding of corporate value.

SASB sets standards by researching each industry's unique issues; soliciting input from individual industry working groups, investors, and other stakeholders; drafting provisional standards supported by quantitative metrics; and soliciting public comment. SASB also provides access to its materiality standards and industry briefs, which set forth the evidence supporting the standards.

It has finished this process for eleven economic sectors. Within each sector are distinct industries with standards tailored to that industry's unique needs. (For example, the Financials sector distinguishes commercial banks from insurance companies).

MORE THOROUGH MATERIALITY ANALYSIS

SASB's goal is to provide a more thorough analysis of material information, so that disclosure to investors enables more informed decision-making. It's too soon to know if the goal has been met, although a recent study by SASB found that 38 percent of companies already include information on SASB disclosure topics in their SEC filings.

Like FASB, SASB will fine tune its standards as additional evidence comes to light. If your industry's standards are already in place, you need to understand them, and independently determine the degree to which each is material to your company's performance. As with financial issues, the decision regarding whether or which non-financial information is material lies with each company's leaders and their legal counsel.

You may already be measuring the issues that SASB identifies as material for your sector, but the SASB process may turn up material risks or opportunities that are not yet on your company's radar. Or SASB's quantitative metrics may provide a new method of tracking issues already of concern. A company needs to know if these data gaps exist and determine whether they matter, because they may impact its ability to see and respond to challenges or opportunities.

Just as it currently does with its GAAP-driven analysis of financial issues, a company can privately review and evaluate the degree to which SASB standards apply to its operations. Understanding the shifting landscape will prepare the company to report material information, or to be ready with credible explanations for why it is not reporting if investors ask. For those who represent investor interests, SASB standards may enhance their ability to accurately evaluate and communicate corporate value.

At some point, one of your competitors may use SASB metrics in its materiality analysis, and disclose its sustainability performance on its SEC filings. That may have already happened. Or perhaps your company will lead. Regardless, it's clearly time to understand this changing landscape. ■

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