Charting the Path to Standards for Nonfinancial Information

Here is our response to the question raised in our Green Paper “Should FASB and IASB be responsible for setting standards for nonfinancial information?” There are many exciting things happening on this topic and so we decided to write a very short “White Paper” presenting our point of view. We see this as a “living document” that will be updated and added to as important events occur and progress is made in establishing standards for nonfinancial information.

Richard Barker and Bob Eccles, September 2019

Corporate accountability matters. It is the reason why - ever since the stock market crash of 1929 and the ensuing Great Depression - public corporations have filed financial statements. According to the Financial Accounting Foundation (FAF) “Many market participants felt that poor accounting and reporting procedures helped cause the downturn.”

This accountability is traditionally understood in terms of reporting financial performance, for the benefit of investors. Yet a silent corporate reporting revolution is underway. We live in a world of planetary boundaries and growing social inequality, and so investors’ information needs are changing. An economically sustainable business model is no longer one concerned with financial performance alone.

Regulation has not kept pace. We have comprehensive financial reporting standards, set by the Financial Accounting Standards Board (FASB) in the United States, and the International Accounting Standards Board (IASB) globally. We have nothing comparable for “nonfinancial” information, relating to environmental, social, and governance (ESG) issues. There is no single set of agreed standards, no regulatory body to set one, no process for audit and, as a result, limited comparability and low quality of ESG data in practice. There is growing demand by investors for such standards, in order to help them make better resource allocation decisions, but, as yet, there is no supply. As with the origins of financial accounting standards, a crisis is brewing and must be avoided.

In our Green Paper “Should FASB and IASB set standards for nonfinancial information?” we analyzed the pros and cons of having these existing standard setters take on ESG data. This would be a regulatory solution to the extant information deficit. We also explored a potential market solution to the problem. We noted the continuing proliferation of ESG data vendors and NGOs working to create standards for nonfinancial information. In that study, we analyzed the problem without proposing a solution. In writing this article, we are setting out a path towards that solution.

Our basic argument is a simple one, based on adopting a sequential strategy of market and regulatory actions, leading to standards for nonfinancial information. Market forces can
generate and test possible approaches to nonfinancial accounting, incubating approaches that have the potential to be accepted as standards. There are, however, barriers to market forces themselves creating standards, and it was a regulatory solution, not a market solution, that led to standards for financial accounting information. Moreover, it is FASB and IASB that have expertise in standard setting and, critically, institutional legitimacy and support in the domain of corporate reporting. Yet these bodies also have their weaknesses, such as a lack of expertise in nonfinancial issues, a reluctance to take on the task, and remits that may limit their ability to do so even if they were so inclined. It seems clear that both market forces and regulatory bodies are needed to achieve the solution that we are seeking.

As a first step, we believe that much progress can be made through market forces and investor support. The second step is regulation that enacts market solutions, while also ensuring comparability and quality of data. The investor community should call upon the regulatory community to mandate standards, in order to ensure a level playing field amongst all reporting companies, so reducing the obvious risk of selective reporting of both good and bad performance. We are using the term “mandate” to denote a continuum from soft encouragement to legislation. This standardization process will no doubt be partial and provisional, just as it is for financial reporting. There is no ultimately right answer. What is needed are standards that are good enough. They will be so if they are sufficiently credible to the companies who report according to them, and to the investors who use the information based on them. More prosaically, we must not let the perfect be the enemy of the good in creating standards for nonfinancial information.

The market forces we are looking to operate in the community of NGOs, including those who fund them, reinforced by actions of users of ESG information, particularly investors and credit rating agencies. Some existing initiatives that we believe are very promising, and could lead to at least a prototype market solution, are the following: the Impact Management Project (IMP), the One Planet Sovereign Wealth Fund Framework, State Street Global Advisor’s “R™-Factor,” and the Corporate Reporting Dialogue (CRD), a consortium that includes FASB and IASB, along with comparable organizations in the realm of nonfinancial reporting: CDP (formerly Carbon Disclosure Project); Climate Disclosure Standards Board (CDSB); Global Reporting Initiative (GRI); International Integrated Reporting Council’s (IIRC); International Organization for Standardization (ISO); and Sustainability Accounting Standards Board (SASB). There is already conceptual overlap between these initiatives, but it will require collaborative efforts between them (which have already started), and pressure from their funders and from investors, to effectively harmonize their collective endeavors.

The regulatory forces we are looking to include quasi-regulatory initiatives, that are potentially laying the groundwork for a regulatory endorsement of market efforts. The most prominent example is the Task Force on Climate-related Financial Disclosures (TCFD), which is concerned with voluntary disclosures only, yet was created by the Financial Stability Board (FSB) and has the implied backing of its members. From a legislative perspective, the most prominent example is the EU Accounting Directive for Nonfinancial Information, which is currently under review. There is nothing like this even being contemplated in the United States, although the
Investor Advisory Committee (IAC) of the Securities and Exchange Commission (SEC) has voted to recommend that the SEC explore disclosures on human capital management (HCM).

In our ongoing work, we will take stock of these market and regulatory initiatives, pointing out the progress they’ve made and the challenges they are facing. We will provide our own views of what we would like to see happen. Things are moving quickly since the need for standards is an urgent one.