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Opinion

Things to Consider When Implementing Building Blocks Approach for Global Sustainability Reporting Standards

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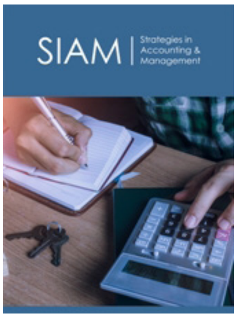

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Opinion

The Trustees of the IFRS Foundation has released three documents since September 2020 delving into the convergence in global sustainability reporting standards. SASB, GRI, TCFD, CDSB and CDP have agreed upon the collaboration to form the 'building blocks' approach for global non-financial reporting [1-3]. IFAC and IOSCO have also announced their support for this approach. As for the scope, the trustees announced a 'climate-first' approach that prioritizes Environmental issues among non-financial factors which compose of corporate sustainability. Inter alia, climate change and Greenhouse Gas (GHG) emissions will be the first focus. After that, it takes into consideration of wider environmental factors associated with financial risks. Then, the trustees plan to broaden its work overtime to focus on other criteria composing of non-financial reporting fields such as Social (S) and Corporate governance (G). Hear. We also see the 'building blocks' approach is great. Since many guidelines and measurement methodologies already exist when it comes to the Environment (E), they can provide substantial benchmark as a first step towards non-financial disclosures. However, there are things to note when adopting current principles by the trustees. We render three points to keep in mind before building the first block as per current approach. First, certain different properties exist on several points among E versus S, G in terms of their measurement methods, monetization potential, and the way how it is disclosed. With more than 20 years of global interest and joint effort represented by The Kyoto Protocol adopted in 1997 and Paris Alignment in 2015, methodologies for measurement and disclosure of E are substantially advanced. In most widely used international reporting tool, GHG emission including carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O) can be reported in units of tons emitted in a year. Then, reflecting it as monetized in the financial statements as illustrated in Figure 1 seems not so much problematic according to the fair value of emission since carbon markets have formed already. However, in terms of the S and G factors, the story can be different. GRI and SASB (refer to Figure 2) provide some guidelines regarding what to report as S and G metrics, but still, many more metrics need to be considered. Moreover, it is difficult to imagine at this point to monetize such values. Taking all things into consideration, a macroscopic blueprint is needed even in this 'building block' and 'climate first' approach, regarding whether non-financial information which is composed of E, S, and G that are whole different pillars in their nature regarding how all of these non-financial factors can be tied up under universal conceptual framework. Hence, the wholistic concept such as "conceptual framework of non-financial reporting" that can be compatible with S and G factors should be considered from the first step establishing standards for E factor in advance.

Figure 1: Climate-related risks, opportunities, and financial impact. (Source: TCFD [4]).

Labor Conditions in the Supply Chain	Percentage of (1) Tier 1 supplier facilities and (2) supplier facilities beyond Tier 1 that have been audited to a labor code of conduct, (3) percentage of total audits conducted by a third-party auditor	Quantitative	Percentage (%)	CG-AA-430b.1
	Priority non-conformance rate and associated corrective action rate for suppliers' labor code of conduct audits[3]	Quantitative	Rate	CG-AA-430b.2
	Description of the greatest (1) labor and (2) environmental, health, and safety risks in the supply chain	Discussion and Analysis	n/a	CG-AA-430b.3
Raw Materials Sourcing	Description of environmental and social risks associated with sourcing priority raw materials	Discussion and Analysis	n/a	CG-AA-440a.1
	Percentage of raw materials third-party certified to an environmental and/or social sustainability standard, by standard	Quantitative	Percentage (%) by weight	CG-AA-440a.2

Figure 2: An excerpt of sustainability disclosure topics and accounting metrics by industries (Source: SASB [5]).

Second, when disclosing non-financial information represented by ESG, tendency to disclose only positive information without mentioning any negative matters is clearly observed. In IIRC framework published in January 2021, it states "an integrated report should include all material matters, both positive and negative, in a balanced way and without material error" [4-6]. However, in reality, it is difficult to find a company that is reporting non-financial information which contains negative impact toward its firm value which can significantly mislead investors and other market participants' decision making. Volkswagen's diesel scandal in 2015 is a good example. In its 2014 Sustainability report that was released right before the scandal, Volkswagen only highlighted how much it contributes to renewable energy and made no mention of risk factors hinting its cheating on emission test. In regard to this, academic papers point out that current disclosure of corporate sustainability is not so much different from corporate IR (Investor Relations) or marketing tool [7,8], and concerns arises about the potential risk of green washing or window dressing [9-11]. Despite the GRI guideline and SASB standards that provide 77 industry-specific standards and sophisticated metrics, selective releases picking only positive content are occurring. Hence, paying close attention is essential to whether new standards for corporate sustainability reporting can be enacted in a way that can provide investors balanced information according to the materiality, regardless of whether it's positive or negative.

Lastly, harmonization with existing accounting standards should be considered even at this early stage embarking the 'building blocks' approach with E factor. Under the current circumstances, it is expected the sustainability report and the financial report to be published as separate ones. Nonetheless, combining these two into a single report that implies holistic information about the company that explains well on firm value would be necessary at ultimate level. Such discussions have been around for about a decade. According to recent research, 90% of S&P 500 market value is explained by intangible assets and there is only room for the rest 10% for tangible assets in 2020[1]. In line with

[1]Intangible asset market value study 2020 by Ocean Tomo, LLC

this, the FRC (Financial Reporting Council) published "business reporting of intangibles: realistic proposals" in 2019 noting that many intangibles cannot be recognized in financial statements given the IASB's Conceptual Framework's current definition of assets and recognition criteria so the compatibility with societal change is urgent [12]. As such, existing debates over financial standards related to intangible assets for intellectual capital or expenses for R&D, etc. are still not ended. At this point, the more radical ESG information is a preemptive question about how to be integrated in accordance with the current conceptual framework and standards for financial reporting.

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