15th May 2015

UNEP inquiry on aligning the financial system with sustainable development
A contribution from CDSB

UNEP's January 2015 Inquiry Report acknowledges the "profound linkages between a healthy financial system and the pursuit of long term sustainability" and it calls for the separated agendas of financial reform and sustainable development to be brought together. CDSB's contribution to UNEP's Inquiry proposes that greater alignment between the financial system and sustainable development depends, in part, on resolving gaps and failures in corporate reporting regimes that mask the interdependence between financial system health and sustainable development and allow sources of systemic risk from sustainability challenges to be unobserved and unaddressed by financial systems.

Whilst a great deal has been achieved in the development of corporate reporting, continuing variability in the quality, quantity, type, location of and rationale for sustainability information reported by corporations leads to a lack of consistency and comparability. Limited, fragmented, un-enforced, un-assured, inconsistent information is difficult for readers to use in decision-making and the evidence of its use is inconclusive. Unless risks associated with sustainability are communicated and taken into account in the investment chain and by financial markets, those risks threaten to cause the "creeping changes in average conditions" that have been implicated in the sudden emergence of the global financial crisis.

CDSB proposes three strategies for maximising the effectiveness of information in forging alignment between the financial system and sustainable development. First, the identification of an institutional home for the consolidation, enhancement and further development of corporate reporting practice. Secondly, the development of technical reporting infrastructure, including resolution of technical issues that currently cause confusion for reporting organisations and impede the usefulness of reported information for decision-makers. Finally, CDSB proposes the development of assessment standards that enable reporting organisations and users of information to determine whether reported information achieves sustainable development objectives.

An institutional home and an international "complementary information reporting convention"

Many countries have introduced corporate reporting requirements that demand information from businesses about their environmental, social and economic performance as well as their financial results and governance practices. The demand for information that complements financial results (referred to here as "complementary information") recognises that the assessment of corporate performance and the continuance of whole systems (economic, environmental and social) depends on access to details about how corporate activity affects the resources and relationships on which business, the economy, the environment and society collectively depend for their continuance. Complementary information can include details of a company's environmental footprint (including GHG emissions, waste production, water abstraction etc.), its social performance, ethical standards, and so on.

Most reporting requirements that seek complementary information are designed to facilitate decisions that will lead to sustainable outcomes for society, the environment and the economy. Although they share this common objective, there are differences between countries and reporting regimes in relation to the motives for introducing reporting requirements as well as differences in the format and origin of the requirements and the channels through which information is reported in response to the requirements. This is because, as the urgency to address global mega-forces (such as poverty, food and energy security, resource scarcity, disparate prosperity) has intensified, many different actors have independently launched activity to elicit information from business and others about their contribution to and mitigation of those mega-forces. Requirements for companies to report on and take action to address sustainability challenges may therefore be found in governance provisions (equating sustainability with governance risks and accountability), or financial/securities laws (recognising the potential economic consequences of sustainability challenges) or environmental provisions. However, there is considerable duplication between requirements, supported by a patchwork of standards on reporting, measurement, strategy and management approaches to sustainability. Unpublished research by CDSB based on a sample of national and international developments on reporting suggests that there are almost 400 different provisions that directly or indirectly affect reporting of complementary information. A fuller analysis of the current state of the reporting landscape is expected to be available in a forthcoming report by the ACCA and CDSB - "Lost in the Right Direction: The Sustainability Reporting Landscape – A Primer". The duplication of requests for information and the multiple channels through which it is demanded results in considerable variation in the type of information reported by businesses as well as variation in the quality, quantity and placement of that information. The fragmentation, variation and lack of coherence impedes the use of information by investors and others in diverting resources to activity that supports sustainable outcomes.

The FSB[1] has called for high-quality, internationally comparable, converged accounting standards. CDSB proposes that in the same way that financial reporting approaches are becoming standardised as International Financial Reporting Standards (IFRS) through the work of the International Accounting Standards Board (IASB), a similar approach should apply to complementary information. In particular, the development of international reporting standards on "complementary information" could be enhanced through the identification of a suitable "institutional home" (equivalent to the IASB) for that work. An institutional home could facilitate the consolidation, enhancement and further development of the considerable advancements in corporate reporting that have been achieved through diverse channels and disciplines and enshrine the results in an international model complementary information reporting convention.

A model convention would reflect shared objectives between parties (including financial actors) seeking to support sustainable outcomes and enshrine agreed standard reporting requirements, measurement methodologies and terminology that reflect the highest common denominator of practice to create policy coherence. The model convention could encourage reciprocity between reporting regimes so that compliance with one regime might be regarded as satisfying obligations under another regime where the objectives of both are compatible. The model convention could co-exist alongside national approaches and rely on or adopt existing established corporate reporting regimes and practices where appropriate.

[1] http://www.financialstabilityboard.org/what-we-do/policy-development/additional-policy-areas/
[2] http://www.ecologyandsociety.org/vol12/iss1/art30/
[3] Terrafiniti, 2014. [Online] Available at: [http://www.terrafiniti.com/blog/entropic-overhead-measuring-the-circular-economy/]
[4] Terrafiniti, 2014. [Online] Available at: [http://www.terrafiniti.com/blog/entropic-valuation-energy-pricing-as-

In view of the wide range of complementary information that is demanded through different channels, an institutional home for the development of complementary standards would ideally offer access to policy makers and experts working across a range of subject matter. Supra-national bodies such as the OECD, UN agencies, IOSCO and others might offer appropriate organisational structures in which to negotiate an international model complementary information reporting convention covering subject matter outside the scope of IFRS and designed to elicit information that fits the requirements of financial systems and sustainable development objectives[2].

Technical reporting infrastructure for complementary information

Sustainability reporting has developed against the backdrop of the existing, well-established "mainstream reporting model" that generally results in the annual delivery by corporations of financial statements, management commentary and governance information. The mainstream reporting model is mature and is supported by established standards (such as IFRS) and codes (such as corporate governance codes) that provide reporting organizations with certainty about what and how they should report and result in a degree of consistency in reported information.

CDSB proposes that complementary information should be supported by similar infrastructure to provide reporting organizations with greater certainty about what and how they should report and to encourage greater consistency of reported information. Furthermore, in order to align the financial and sustainable development systems for their mutual benefit, the infrastructure for complementary information must reflect the needs of the financial reporting system and vice versa. In particular, if financial systems are to be redesigned for low-carbon and sustainable growth, the infrastructure for complementary information must recognize and, as far as possible, align with the existing mainstream reporting model, representing the primary source of information on which investors rely.

Currently, complementary information requests align with the existing mainstream reporting model to some extent. For example, addressing sustainability challenges is characterized by some reporting regimes as a matter of corporate governance; other regimes encourage estimation and disclosure of the financial consequences of sustainability risks. The existing mainstream reporting model has features that could be extended to complementary information and its reporting objectives. For example, CDSB's discussion paper on Carbon Asset Stranding Risks suggests that, although specifically applicable to financial instruments, the approach to sensitivity analysis in IFRS 7 could be extended to the analysis of value at risk from sustainability challenges.

It is therefore possible to see how information regarding sustainability could be embedded or integrated into the existing mainstream reporting model with some modifications. However, there are complex technical differences between complementary and mainstream reporting practices that need to be examined or resolved first and in order to forge greater alignment between financial systems and sustainable development. A thorough analysis is beyond the scope of this contribution, but technical research could explore:

- The scope of issues that are *material* for the purposes of financial systems and sustainable development. Whereas practices for identifying financial materiality are established and may be quantified to some extent, there is no standard approach for identifying material sustainability issues (and therefore the extent of

[2] http://www.ecologyandsociety.org/vol12/iss1/art30/

complementary information that needs to be reported). Some complain of complementary information being obscured by immaterial clutter that impedes decision-making. The issue is further complicated by uncertainty about:

- The stakeholder group or groups whose interests should be taken into account in determining the complementary information to be reported. By definition, sustainable development is crucial to, but wider in scope than, the financial system and it is not clear what type of information about sustainable development should be provided specifically to support healthy financial systems;
- The time frame over which management of the reporting organisation is expected to consider the subject matter concerned, because sustainable development risks manifest themselves over longer periods than business and financial horizons; and
- The purpose for which the financial system will use complementary information – for example to assess whether management has fulfilled its fiduciary duty through proper stewardship of the resources on which the company relies for its continuance or to deploy resources to activity that supports sustainable outcomes etc.

- Appropriate *measures and indicators* for expressing and communicating results about sustainable development. Complementary information is communicated through a variety of measures and indicators including measures of business outputs that are sources of environmental impact (such as greenhouse gas emissions and waste), measures that reflect social responsibility (such as community investment and training for staff), indicators of corporate performance against targets (such as the extent to which energy or water usage has been reduced) and so on. Financial measures that price externalities and value natural and social capital are also emerging. However, it is not clear whether, to what extent or how those measures are suitable for or capable of being integrated into financial models or used for decision-making about the deployment of capital to activities with sustainable development outcomes. Furthermore, it is not clear whether financial measures adequately convey sustainable performance or whether new measures of performance and risk such as Terrafiniti's proposed measures of "entropic overhead[3]" and "entropic valuation[4]" are more suitable for combined decision-making on financial and sustainable objectives.

- The *characterization* of activity, resources and relationships that support decisions on financial and sustainable objectives. Financial reporting standards have established the characterization of corporate resources, activities, results and relationships as representing capital or income or assets or liabilities etc. By contrast, there is as yet no agreed language for the characterization of movements in natural and social capital over time. In the absence of such characterization it is difficult to identify and enter into shared dialogue on whether reported complementary information should be interpreted as "good" performance (in the form of increased environmental and social profits or assets) or "bad" performance (losses and liabilities in relation to natural and social capital).

[3] Terrafiniti, 2014. [Online] Available at: [http://www.terrafiniti.com/blog/entropic-overhead-measuring-the-circular-economy/]

[4] Terrafiniti, 2014. [Online] Available at: [http://www.terrafiniti.com/blog/entropic-valuation-energy-pricing-as-if-thermodynamics-mattered/]

In summary, financial reporting has established what is material for financial reporting purposes and how results should be measured and characterized. A shared system of characterization is needed for complementary information.

Assessment standards

The "zero draft" of the Addis Ababa Accord identifies the business sector as being "a critical driver in achieving sustainable development" and acknowledges the responsibility of governments to develop regulatory systems to align business incentives with sustainable development. The zero draft refers to the need for initiatives that encourage socially and environmentally responsible business activity to be complemented with strong regulatory frameworks on ESG practices, including mandatory integrated reporting for large companies to be adopted sometime this century.

Assuming therefore that corporations will increasingly be called upon to contribute to (and report on their contribution to) wider sustainable development objectives, the purpose of corporate reports will in future extend beyond communication of the company's performance to its stakeholders to enabling policy makers to assess aggregate business impacts against agreed international sustainable development targets. Preparers and users of information are generally able to track a company's performance relative to its own results in previous reporting periods or relative to goals & targets set by management. As noted by Tweedie and Martinov-Bennie[5], the International Integrated Reporting Council's Integrated Reporting Framework focuses on what makes organizations sustainable rather than on what makes societies more sustainable.

The contribution that reporting makes to sustainability is evidenced by the outcomes that are reported or the availability of sufficient information in sustainability reports to enable readers to determine what outcomes have been achieved through the actions reported by corporations and whether those outcomes are in line with sustainable development objectives. Sustainability outcomes tend to affect whole systems, (for example environmental and social systems), that are themselves dynamic. Therefore, except in cases where local targets for specific action apply, goals and desired outcomes from them need to be defined in whole systems terms. Policies, statements, tools and activities that might help to evidence the contribution that corporate sustainability reporting makes to the achievement of sustainable development goals include:

- Defining the sustainability outcomes expected from corporations, for example, reductions in greenhouse gas emissions or implementation of governance practices in relation to natural resources;
- Negotiating the outcomes expected from particular sectors, for example, the absolute or relative amount of greenhouse gas emissions reduction;
- Defining the critical limits and thresholds that form the context for determining desired outcomes, for example, an increase in global mean surface temperature of no more than 2^0C;

[5] Dale Tweedie & Nonna Martinov-Bennie (2015) Entitlements and Time: Integrated Reporting's Double-edged Agenda, Social and Environmental Accountability Journal, 35:1, 49-61, DOI: 10.1080/0969160X.2015.1007466

- Agreeing metrics and indicators for assessing and tracking performance against agreed outcomes. They also should be flexible enough to accommodate evolving priorities among other considerations[6,7,8];
- Agreeing timescales over which outcomes are expected to be achieved; and
- A suite of agreed metrics and indicators to track progress against relevant targets and/or expectations.

Lois Guthrie
Founding Director, CDSB
Lois.Guthrie@cdsb.net
www.cdsb.net

[6] For example, ClimateWorks Australia is tracking progress in reducing GHG emissions in Australia, ClimateWorks Australia (2013) Tracking Progress Towards a Low Carbon Economy, available at http://www.climateworksaustralia.org/project/current/tracking-progress-towards-low-carbon-economy

[7] For example, the Human Development Index developed by the UN Development Programme, UNDP (2013) Human Development Index, available at http://hdr.undp.org/en/statistics/hdi/

[8] For example, the IISD BellagioSTAMP high-level principles used to guide the measurement and strategic assessment of progress towards sustainability, IISD (2009) BellagioSTAMP, available at http://www.iisd.org/measure/principles/progress/bellagiostamp