Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR)
High-level Policy Dialogue on Sustainability Reporting

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Statement

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Beyond pure numbers

Sustainability risks and financial reporting

Sammy Onyango, 21 July 2016

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Introduction

Corporate reporting is evolving at a rapid pace. Examples of new accounting standards are:

UK/SA	IASB/FASB
• New strategic report and revised form of director remuneration report; ii) SA – Corporate Governance Code (King III) requires preparation of an integrated report	• Started convergence project in early 2000 after the Enron saga. • To date IASB has issued: • (i) 21 IFRS • (ii) 28 IAS • (iii) 16 IFRIC

These developments have one thing in common: Reporting **beyond pure numbers** and seeking to communicate the organization **long term value creation**. Reporting must also reflect the **overall risk** management of the organization.

Conceptual framework

For IFRS and US GAAP there has been a joint improvement project by IASB and FASB.

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This is being undertaken in phases and set out the concept underlying the preparation and presentation of financial statements.

The first phase was completed in 2010. The two chapters issued were as below:

- **Chapter 1**: Objectives of General purpose financial reporting
- **Chapter 3**: Qualitative characteristics of useful financial information

Conceptual framework (Contd)

Objectives of General purpose financial reporting

The objective of financial reporting is identified as being to "provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Information is considered to be "useful" if it helps the primary users of general purpose financial reports to assess the prospects of future net cash inflows to an entity; such an assessment enables the primary users to estimate the return that they can expect from transacting with the entity.

To assess an entity's prospects for future net cash inflows, the primary users need information regarding (1) the resources of the entity and claims against the entity and (2) how efficiently and effectively the entity's management has discharged its responsibilities.

Conceptual framework (Contd)
Objectives of General purpose financial reporting

Information about an entity’s cash flows during a period is also considered to be useful in the assessment of the entity’s ability to generate future net cash inflows; it helps users to understand an entity’s operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

Finally information regarding changes in the entity’s resources and claims against it for reasons other than financial performance (e.g. the issue of additional ownership shares) is needed to provide users of general purpose financial reports with a complete understanding of why the entity’s economic resources and claims against it have changed and the implications of those changes for its future financial performance.

Conceptual framework (Contd)

Qualitative characteristics of useful financial information

Chapter 3 of the conceptual framework considers the qualitative characteristics of decision – useful financial information, and constraints on the information that can be provided by financial reporting, so as to identify the types of information that are likely to be most useful to the primary users of general purpose financial reports.

The usefulness of financial information is considered to be enhanced if it is comparable, verifiable, timely and understandable. ‘Comparability’, ‘verifiability’, ‘timeliness’ and ‘understandability’ are therefore described as enhancing qualitative characteristics. The Conceptual Framework notes that such enhancement should be maximized to the extent possible. However, these qualitative characteristics cannot make information useful if the information is irrelevant or not faithfully represented.

Big Question: Can one afford to ignore environmental matters when assessing future net cash flow of an organization or assessing its risk management?

Reporting principles on selection of core Sustainable Development Goals (SDGs) Indicators

UNCTAD’s Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has been working on the integration of environmental, social and governance information in the corporate reporting with a view to selecting core reporting indicators on the Sustainable Development Goals (SDGs).

Based on research conducted by UNCTAD of existing sustainability reporting frameworks, as well as on comments made by the consultative group members, the following key criteria were suggested of core Sustainable Development Goals (SDGs) indicators:

- Consistency with SDGs monitoring framework
- Cover economic, environmental, social and institutional areas
- Universality
- Capability of consistent measurement
- Based on existing reporting initiatives, requirements and companies practices

Environmental Impact on Accounting
The A4S CFO Leadership network

In December 2013, the A4S Chief Financial Officer Leadership Network was launched by HRH The Prince of Wales. The Network brings together a group of leading CFOs from large European businesses seeking to embed the management of environmental and social issues into business processes and strategy. The network has worked on a number of projects during 2014 including looking at natural and social capital accounting.

Environmental Impact on Accounting (Contd)

Some of the key trends impacting business over the coming years are:

Rapid population growth and urbanisation.

I. Population is predicted to grow from 7B in 2011 to between 8.3B and 10.9B in 2050 (“World Population Policies 2013” Department of Economic and Social Affairs, UN (2013)). Coupled with growth of the global middle class by almost 3 billion by 2050. This will result in large scale increases in resource consumption.

II. At the same time there is an increase in the percentage of people living in urban areas from 54% today to 66% in 2050 –an extra 2.5B people putting a strain on resources and available land for urbanization (“World Urbanization Prospects – 2014 Revision” Department of Economic and Social Affairs, UN (2014)).

III. Between 2000 and 2050 the proportion of the worlds population over 60 will double from 11% to 22% (World Health Organization Research on ageing), significant consequences for pensions and healthcare costs.

The share of urban population is expected to grow from 54% today to 66% in 2050

Environmental Impact on Accounting (Contd)

Some of the key trends impacting business over the coming years are:

Increasing resource constraints

I. Global population growing by 80m every year. By 2030 it is estimated that the world will need 30% more water, 50% more energy and 50% more food. (Speech by Professor Sir John Beddington, then chief adviser to HM Government, at SDUK 09.). Our ability to meet these needs is constrained by a stressed natural environment. The world consumes 50% more than the planet's natural resources can renew every year. This overconsumption continues to gather pace and presents a significant challenge to how businesses need to operate.

II. Businesses are constantly responding to change but in order to do this successfully and protect their long term financial performance, businesses need to adapt to supply changes of natural resources and invest in their supplies of social skills.

By **2030** we will need

30% more water

50% more energy

50% more food

Conceptual framework (Contd)

Some of the key trends impacting business over the coming years are:

Climate change

The intergovernmental Panel on Climate Change predicts that we are on a path to a 3.7°C to 4.8°C warmer climate by 2100. Many scientists agree we need to keep below 2C to avoid dangerous climate change. In 2013, extreme weather events were behind $37bn of the world’s $45bn disaster related insured losses.

We are on a path to a **3.7°C to 4.8°C** warmer climate by 2100

Value of sustainability to shareholders

Strong correlation between sustainability practices and performance

Sustainable business is one that delivers financial returns in the short and long term in a way that generates positive value for society and operates within environmental constraints.

To create value for investors in both short and long term, managers need to create confidence in their business model, strategy, resource needs and main risk factors so that they are willing to provide the capital needed for it to achieve its aims.

Value of sustainability to shareholders

Strong correlation between sustainability practices and performance

A recent research published by the University of Oxford Smith School and Arabesque Asset Management found that:

- 80% of studies show that stock price is positively correlated with good sustainability practices.
- 90% of relevant studies suggest that sound sustainability standards lower cost of capital.
- 88% of research suggests a correlation between strong environmental, social and governance (ESG) practices and better operational performance.

Those investors who do take sustainability issues seriously tend to be those that invest for the long term. Integrating sustainability into business may therefore increase the long term orientation of your shareholder base.

Investors say that companies are not communicating sustainability issues

Value of sustainability to shareholders (Contd)

Strong correlation between sustainability practices and performance

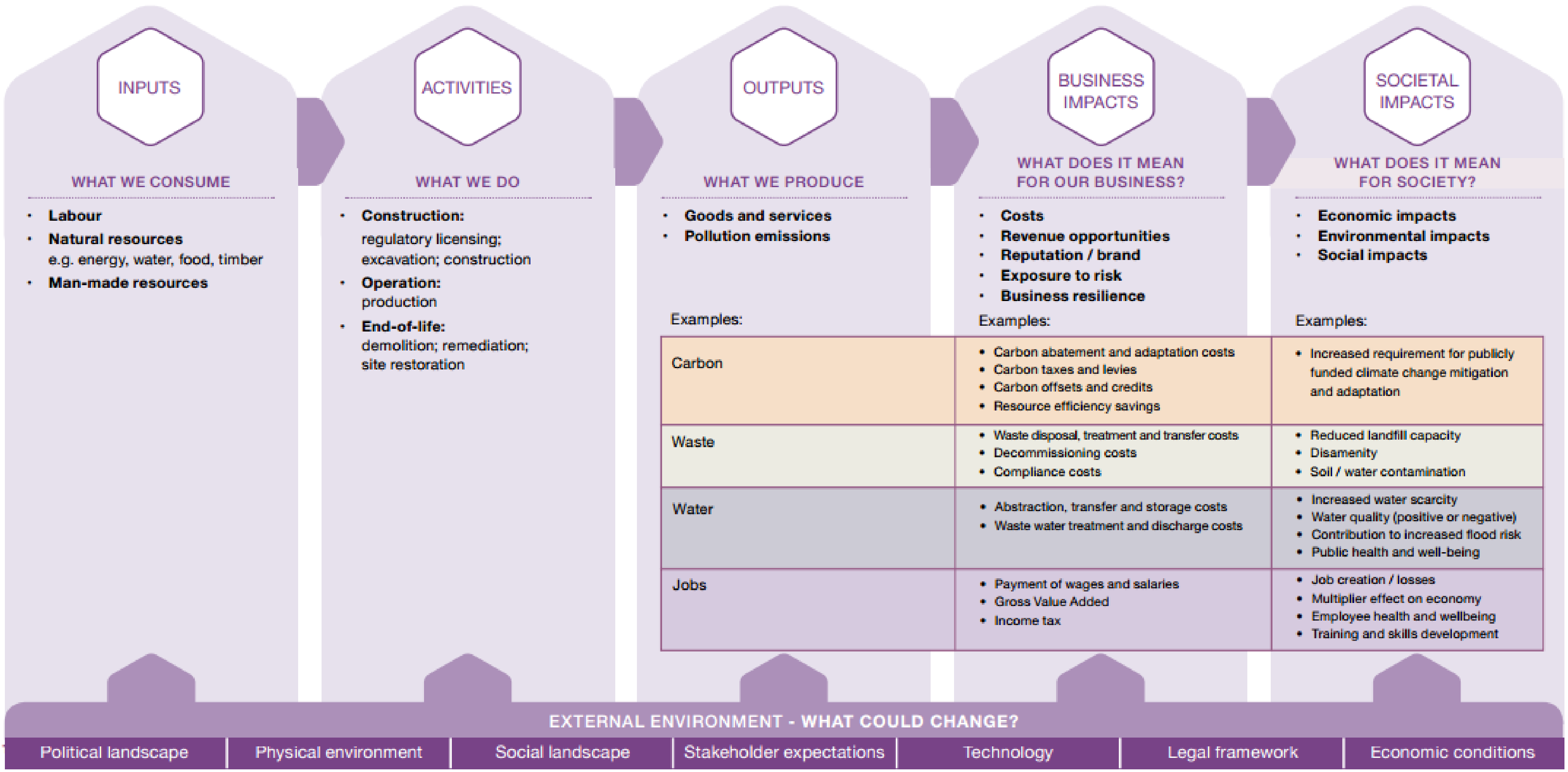
88% of investors **saw sustainability as a route to competitive advantage**, but companies were not communicating this effectively. According to a recent Accenture/UN Global Compact survey of over 100 investors and 1000 corporate CEOs

57% of corporate CEO’s said they were **able to set out their strategy for seizing opportunities presented by sustainability**; when asked the same question of the companies in which they invest, just **8%** of investors believed this to be the case.

38% of CEOs believed they were **able to accurately quantify the business value** of their sustainability initiatives - but just **7%** of investors agreed.

Financial metrics and business viability

Assessing financial and societal impacts



Source: A practical guide to embedding sustainability into capital investment appraisal, A4S Chief Financial Officer Leadership Network

Importance of accounting for natural and social capital for business

01 **Strengthened decision making** that can result in long term sustainable value creation e.g. improved foresight into future regulatory or price risks from resource scarcity.

02 **Enhanced risk management** leading to increased business resilience and reduced future costs e.g. improved ability to increase security or supply of water, agricultural products or skilled labor.

03 **Identification of new business opportunities** e.g. more sustainable products or services

04 **Improved reputation and strengthened 'license to operate'** e.g. easier planning consents.

Case for standards

- A lack of comparable, standardized performance information across companies is a major barrier to investors integrating sustainability issues into their analysis. The Global reporting initiative is the most widely used reporting standard that companies can reference.
- The new Kenyan Companies act which was just came into force, now requires listed companies to incorporate Sustainability reporting in their Annual reports, but what standards will they apply?

Reporting principles on selection of core Sustainable Development Goals (SDGs) Indicators (Contd)

Furthermore, ISAR recommends that reporting on the core SDG indicators should be based on the following reporting principles:

- General consistency with the IFRS conceptual framework
- Materiality
- Comparability
- Reliability and assurance
- Clarity of the reporting boundaries
- Incremental approach

Reporting principles on selection of core Sustainable Development Goals (SDGs) Indicators (Contd)

Core SDG reporting indicators should take into account the requirements of SDGs monitoring framework in order to be useful purveyors of information to statistical offices, including such as:

- Universal, integrated and interrelated nature and cover the three dimensions of sustainable development
- Voluntary and country-led
- Longer-term orientation
- Open, inclusive, participatory and transparent for all people
- People-centered, gender-sensitive, respect human rights and have a particular focus on the poorest, most vulnerable and those furthest behind.

Conclusion

ISAR’s recommendations are acceptable but I do not agree that reporting standards should be voluntary and country-led. Every organization, regardless of its size/sector affects the environment.

Each should assess the effects of its inputs and outputs on the environment and also assess how it contributed to overall sustainability of our eco system. But as long as there are no standards to apply, reporting will be varied.

The level of dependence of economic activities on natural capital is huge, but seldom reflected in market prices, with the ‘services’ frequently provided for free and the cost of depletion not priced in financial terms. The risk of internalization of these costs to business for example through tax or regulation is likely to increase as resources become scarcer.

My proposal is that IASB together with FASB(US) be mandated to have Accounting for Sustainability in their joint projects and come up with a set of standards soon. Being part of IFRS/US GAAP, compliance becomes mandatory.

Questions & comments

Appendix
Citations

1. CAPEX: A practical guide to embedding sustainability into capital investment appraisal by A4S Chief Financial Officer Leadership Network
2. Enhancing Investor Engagement: A practical guide for investor relations teams to engage on the drivers of sustainable value
3. The Kenya Companies Act. No. 17 of 2015
4. Integrated Reporting: The International Framework by the The International Integrated Reporting Council (IIRC)
5. The United Nations Millenium Development Goals. http://www.un.org/millenniumgoals/