The Past, Present and Future of Sustainability Reporting

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I'd like to start today by quoting the acclaimed Canadian communication theorist and philosopher, Marshall McLuhan, perhaps best known for his aphorism that "The medium is the message". For today's purposes, though, it is something else McLuhan once said that I'd like us to consider, which went something like this: "The last thing a fish is liable to realize is the water it's swimming in", or words to that effect. What I want to focus on today in particular are the sustainability waters we've all been swimming in for at least the past twenty years, and the deficiencies therein that are all but invisible to most of us, including myself until, say, 5 or 6 years ago.

Indeed, it was then that I began to settle quite clearly on the idea that the development of sustainability reporting standards (and practices) in the past 25 years or so years has been premature and therefore highly problematic, mainly because of the failure of the standards-makers involved to develop, or at least first come to terms with, measurement standards, not to mention core principles for what sustainability as a construct actually means.

Now here I want to be clear that my whole critique rests upon an interpretation of sustainability measurement and reporting that is deeply grounded in a performance theory of accounting. Or in other words, that the whole purpose of sustainability reporting is to disclose the sustainability performance of organizations, just as the purpose of financial reporting is to disclose financial performance. Put differently, I subscribe to a *sustainability theory of performance*, according to which reports designated as "sustainability reports" should actually disclose the sustainability performance of the organizations that publish them. Contrast this with, say, a risk theory, or impact valuation theory, according to which the purpose of reporting is to disclose risks to shareholder value, environmental costs, social benefits, or other things that speak to the purely pecuniary interests of shareholders. ESG reporting, too, falls into these other forms of reporting which have nothing to do with sustainability.

Now here you can perhaps already begin to see the contours of the critique I want to make of today's leading sustainability standards in particular (i.e., of GRI, ESRS, and IFRS), which is that meaningful standards for such things (i.e., for reporting) are impossible to obtain unless we, first, have established corresponding standards for measurement, not to mention a clear and compelling understanding of what sustainability itself means, and what the performance implications are that go with it. It is precisely the fact that neither of these steps were adequately taken as precursors to the development of today's leading reporting standards that explains why there are so many of them, and why they do not in any way make actual or authentic disclosures of sustainability performance possible. Let's look at them individually.

Starting with GRI in the 2002 time-frame (which is when G2 was released), the question we can ask ourselves to help test my theory is this: <u>"What were the preexisting generally accepted principles for sustainability measurement upon which the proposed GRI reporting standards were based at the time?"</u> The answer, I believe, is <u>"Nowhere to be found, that's where!"</u> In other words, there were no preexisting standards for measurement – at least not that were properly vetted or recognized as such. And the same can be said, I believe, for both the European ESRS standard and the more globally applicable IFRS standard. And that is why all three are so different from one another, despite the fact that they each claim to be addressing the same thing: sustainability reporting. But since neither of them sprang forth from a clear understanding of what sustainability actually is and how to measure it, their qualifications and pedigrees as putative reporting standards are unconvincing at best.

Indeed, this is not the way to develop reporting standards, if only because of what can happen when we do. What can happen, in particular, is that prematurely developed standards can too often make it possible to report ostensibly positive or favorable performance, even in cases where the effects of an organization's operations either (a) diminish or fail to maintain vital resources in the world at required levels, (b) inflict harm to stakeholder well-being, or (c) both.

In other words, such ill-considered reporting standards can send us false positives, while encouraging behaviors that actually make things worse in the world, not better.

Even more insidious is the damaging role such standards can play in helping to defraud the very constituents whose narrow interests they too often set out to serve – shareholders – not that I condone the hi-jacking of sustainability reporting for such narrow purposes! Nevertheless, instead of disclosing the ethical and empirical sustainability of an organization's social, economic and environmental impacts as inputs to investment decisions, they (the standards and the reports they beget) essentially make it possible to hide the truth from their primary audience, thanks mainly to the fact that such reports are context-free (i.e., in the formal sense of the context-based sustainability method). Still, these are the waters we are swimming in.

Now imagine for a moment what things would be like in the capital markets if the same thing were happening relative to financial reporting: investors wouldn't stand for it, nor should they. This was arguably the case in the United States before Congress passed the Securities Act of 1933, which among other things, required publicly traded companies for the first time to fully disclose their income statements and balance sheets to prospective and current investors – none of which, mind you, as reporting standards, would have been possible if corresponding measurement standards – if only de facto ones – with metrics like assets, liabilities, equity, profits, losses, etc. did not first exist!

Indeed, the conceptual, measurement and empirical foundations of financial measurement were so clear and well established by 1933, that standards for reporting naturally followed. In fact, the Securities Act of 1933 actually mentions income statements and balance sheets by name since they were already in widespread use. Today, of course, we commonly refer to the principles behind such measurement and reporting norms as "Generally Accepted Accounting Principles", or GAAP. What, then, can we say are the Generally Accepted Accounting Principles for non-financial – or better yet, sustainability or integrated measurement – today? In other words, what are or were the generally accepted measurement principles upon which today's sustainability reporting standards were based, and when did we all agree to them? Certainly they exist, but rather than refer to them as generally accepted principles, it would better to think of them, I believe, as generally neglected principles – yet another hallmark of the waters we're swimming in.

Now as I say, even before we get to core principles for measurement, we must first have conceptual principles for what the thing is we are trying to measure, which in the case of integrated reporting under the theory of performance I subscribe to, is *sustainability*, the construct. And like all such constructs, sustainability includes a corresponding theory of performance that must be attended to (i.e., that performance is a function of the effects organizations have on the sufficiency of vital capitals and must be measured in those terms)!

For financial measurement and reporting, by contrast, the concept or construct of interest is *shareholder value*, not sustainability, with the corresponding performance norm being to maximize it. That's the conceptual foundation of it all: shareholder value gives rise to a standard of maximizing profits. Measurement standards for financial performance then logically follow, thereby defining things financial accountants now routinely measure (e.g., assets, liabilities, equity, debt, revenue, expenses, profits, losses, etc.). Credits and debits, too, logically follow, as do recommended accounting practices such as double-entry bookkeeping. But these things take time. Indeed, it should not be lost on any of us that the time between Luca Pacioli's writings on double-entry bookkeeping in the 15^{th} century and the Securities Act of 1933 in the U.S. was well over 400 years. Thus, we can't just dream up reporting standards in the laboratory without regard to their ancestral antecedents and expect them to turn out OK. Specifying reporting standards before their corresponding measurement principles have first been defined is like asking for trouble, since reporting logically follows measurement.

In the normal sequence of events, then, we first have concepts or constructs, like shareholder value, sustainability, and others, which in turn, give rise to corresponding theories of performance and the measurement principles that come with them. Those are the measurement standards I refer to. Then and only then as a fourth and final step can we take up the question of principles and standards for reporting.

So that's the pattern: concept, performance, measurement, and reporting – in that order! Sadly, though, that is not how things have unfolded in the case of today's leading sustainability reporting standards, which too often have either completely skipped or glossed over the first three steps. In the waters we've been swimming in, it is demonstrably the case that we have been doing things exactly backwards!

Indeed, none of the leading reporting standards we have before us today have been developed in this way. And boy does it show! Here's the principle I use to assess the authenticity or credibility of a reporting standard in these terms: If it is possible under a particular doctrine, or standard, to ostensibly perform well, while simultaneously putting the sufficiency of vital resources or the well-being of those who depend on them at risk, then the doctrine or standard itself fails on its face and should be rightly rejected. By this standard, none of today's leading sustainability reporting standards pass muster. Why not? Because none of them mandate disclosures of the effects organizations may be having on the sufficiency of vital capitals as determined through the use of preexisting measurement standards.

It was in light of this conclusion a few years ago that I took it upon myself to begin to document what I felt should be regarded as generally-accepted principles for integrated sustainability accounting, with a heavy emphasis on the conceptual and measurement parts, precisely because of their conspicuous absence from most of what passes for mainstream practice today. I refer to the principles I've compiled as the Generally-Accepted Integrated Accounting (or GAIA) Principles, of which there are currently twelve. They include principles for things like vital capitals, thresholds, allocations, carrying capacity, materiality, and sustainability itself. And importantly, most of them are not new and have been around for decades if not centuries, albeit unrecognized as such by contemporary standards makers. And this, as I say, is why today's leading standards for reporting do not, in fact, make authentic sustainability disclosures possible. How could they? The conceptual, epistemological, and empirical foundations upon which they must be based are all missing in action!

What, then, does all of this suggest for what the future may hold for sustainability reporting? Well for starters, it is important to recognize that two of the three leading international standards I have been talking about – ESRS in Europe and the global IFRS standard (ISSB) – are for all intents and purposes brand new. They're just getting started! Their regrettable influence on corporate sustainability reporting, like GRI, has only just begun and will intensity over time, probably for at least the next 20 to 30 years. This will do nothing but further delay the need to get serious about sustainability concepts and measurement principles. Far from making authentic sustainability reporting possible, these new standards serve only to vandalize it!

GRI, for its part, is a bit of a different case – no less unhelpful, but for different reasons. Notwithstanding the laudable intentions of its creators some 25 years ago, its administrators ever since have persistently failed to enforce its most redeeming feature – the *Sustainability Context* principle, which when faithfully applied can make authentic sustainability reporting (and measurement) possible. Instead, its overseers have chosen to tolerate the utter absence of such context in GRI reports for more than 20 years now, while also repeatedly refusing to provide guidance for how to do it. Because of this, <u>it would be no exaggeration to say that no GRI report ever produced has actually disclosed the sustainability performance of an organization</u>!

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Looking backwards and forwards, then, all of what I describe here can be attributed to the corruptive influence of the shareholder primacy doctrine, the defenders of which have tended to dominate standards development efforts, especially at IFRS. And some of them, as I say, are just now getting started and have a long way to go before they run their course. It therefore seems, I'm afraid, that things are going to have to get a lot worse before they get better. I wish I had better news.

I thank you for your attention today. Thank you so much!