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Here Is How To Set Global Standards For Nonfinancial Information

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Leadership Strategy

The opportunity has come to establish independent, rigorous global standards for nonfinancial information for companies' environmental, social, and governance (ESG) performance as well as their external impact. We cannot lose this opportunity lest it never come again. As I wrote in this column in May 2016 "we won't have the capital markets we need today to create a sustainable society for future generations" without nonfinancial information that is of the same rigor and relevance as financial information—and subject to the same degree of auditability.

From my vantage point, the best case scenario for a path forward is for three powerful bodies to act in concert. Each one has made real progress towards establishing a standard.

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The Impact Management Project (IMP), led by Chief Executive Clara Barby, should join forces with the World Economic Forum International Business Council (IBC), led by Bank of America Chairman and CEO Brian Moynihan and, in consultation with the European Union, provide the mechanism for delivery of a complete system of standards. This process will leverage the work the IMP has done to reconcile the sets of existing standards, the strong commitment from the corporate community through the IBC, and optimize the positive aspects of the enforcement powers of government of the European Union. I will expand on this below.

The IMP facilitates a "structured network" of 13 members working to leverage and harmonize their expertise in nonfinancial reporting and impact measurement for the benefit of companies, investors, and public entities in order to ensure long-term value creation for shareholders while supporting the Sustainable Development Goals. Especially important for corporate disclosure standard setting in the public markets are Global Reporting Initiative (GRI), led by Chief Executive Tim Mohin, and the Sustainability Accounting Standards Board (SASB), led by CEO Janine Guillot.

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The IBC has gained the support of a substantial global group of 140 CEOs (whose identity I hope will be made public soon) who have recommended 22 metrics for every company to report on in their report "Toward Common Metrics and Consistent Reporting of Sustainable Value Creation," many of which were drawn from SASB's and GRI's work.

The European Commission has taken the regulatory bit in its teeth and is currently reviewing the Non-Financial Reporting Directive in order to strengthen it by establishing standards that will be mandated for external reporting. The document is now out for comment.

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They could get the job done, or they could default to “business as usual” group behavior, preventing the creation of these critical standards. A worst case scenario is that each defaults to imagining itself to be “the answer:” The members of the IMP won’t reconcile their differences, predictably putting their organizational goals and egos ahead of society’s needs. The IBC marches blindly ahead thinking investors and companies will accept their standards because of their power and high profile, even though they lack the legitimacy achieved by due process (which are present in both the IMP and the European Union’s tool kits). The EU decides that simply because it can mandate standards it should also create them.

The result would be sharply increased fragmentation. The NGOs in the IMP aren’t going away and each will continue to do their own thing. It is unlikely the 22 metrics in the IBC report will receive broad adoption since no real due process, adoptive body or implementation protocol exists, and the standards they cite are not unified. The EU’s standards will become a compliance exercise that won’t benefit companies or investors.

But there is a different, more optimistic path, if these organizations act in concert.

Before expanding on the optimistic view, however, I’d like to step back and present some personal history which informs it. A key aspect of the current need for nonfinancial standards is that we are more than ready to respond to it. These standards exist and have been in the making for a long time, with contributions from this writer and many colleagues. This moment does not need a reinvention; it needs a final forging of a unique, rigorous set which is suitable for today's world.

Nearly 30 years ago I published "The Performance Measurement Manifesto" (*Harvard Business Review*, January-February 1991). In it I called for every company to redesign how it measures business performance "from treating financial figures as the foundation for performance measurement to treating them as one among a broader set of measures." Although I was largely focused on internal management reporting, I did address the issue of external reporting in terms of whether companies would resist doing so out of the perception it would put them at a competitive disadvantage. I suggested that "ultimately the SEC could untie this Gordian knot by recommending (and eventually requiring) public companies to provide nonfinancial information in their reports."

Four years later, and two years before GRI was founded by my friends Bob Massie and Allen White, I published, with Sarah Mavrinac, "Improving the Corporate Disclosure Process" (*Sloan Management Review*, Summer 1995). It was based on a survey we did of companies, sell-side analysts, and portfolio managers. In it we asked for their views on the importance of a list of nonfinancial metrics, how effectively companies were reporting on them (not very), and the quality of internal systems for producing them (not good). All groups felt that nonfinancial metrics were important, especially for an adequate view of the long term. We also found that all felt that more reporting of nonfinancial information increased credibility, share value, the number of patient investors, analyst following, and access to capital.

Six years later (2001) I, with others, published *The ValueReporting Revolution: Moving Beyond the Earnings Game*. Among my co-authors was Bob Herz who went on to be a two-term Chairman of the Financial Accounting Standards Board and is now on the board of the SASB. In Chapter 13, "Standard Setters," we discussed the need for standards and cited the contribution of GRI. We called for a market-based approach to industry-specific standards that could eventually be supported by regulation.

In 2002 I published *Building Public Trust: The Future of Corporate Reporting*, with Sam DiPiazza, who was then the Global CEO of PwC. In it we argued for a three-tier reporting model. The bottom tier was Global GAAP (calling for the convergence of U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards), the second tier was global industry-specific standards, and the top tier was guidelines for company-specific information.

Although "sustainability" was briefly mentioned in both books, it was not central and financial reporting was considered to be quite separate from sustainability reporting, which was growing rapidly. The increasing recognition of the link between "sustainability" and financial performance led a few companies, like Natura and Novozymes, to issue the first "integrated reports" in 2002, followed by Novo Nordisk in 2004. This led to my first book, with Mike Krzus, on integrated reporting in 2010: *One Report: Integrated Reporting for a Sustainable Strategy*. We discussed the role of GRI, noted the fundamental need for standards for nonfinancial information, said that it should not be divorced from financial reporting, and called for regulators to mandate integrated reporting standards.

By the time Mike and I published *The Integrated Reporting Movement: Meaning, Momentum, Motives, and Materiality* in 2015, much had happened. The International Integrated Reporting Council (IIRC), of which I was a founding member, had been established in August 2010. SASB was founded by Jean Rogers in July 2011 and I became its first Chairman.

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Today, mandated standards for nonfinancial information have gone from unimaginable or unacceptable to a hot topic. There is a broad consensus among investors (as suggested by BlackRock CEO Larry Fink's 2020 letter calling for companies to report according to SASB and the Task Force on Climate-related Financial Disclosures and IMP members IFC and PRI), companies (as represented by the IBC and the much larger number of companies represented by IMP members B Lab, GRI, SASB, and UN Global Compact), and regulators (the EU and IMP member OECD). I have written how corporate sustainability and sustainable investing have gone mainstream so the game has changed. Companies want standards for the nonfinancial information they are already reporting and investors want them for the nonfinancial information they are already using.

The European Union's regulatory undertaking is providing forward movement. In a February 19, 2020 speech at the IFRS Foundation Conference, EC Executive Vice President Valdis Dombrovskis stated that "the Commission will ask the European Financial Reporting Advisory Group - or EFRAG - to start preparatory work on non-financial reporting standards as quickly as possible." A solid intellectual foundation for this is the May 2019 report "Ensuring the relevance and reliability of non-financial corporate information: an ambition and a competitive advantage for a sustainable Europe" by Patrick de Cambourg, President of the Autorité des Normes Comptables and a board member of EFRAG.

It appears that EFRAG is keen to develop globally applicable standards, a laudable goal. I would urge EFRAG to consider the work done by the IBC whose "report proposes a common, core set of metrics and recommended disclosures that IBC members could use to align their mainstream reporting and, in so doing, reduce fragmentation and encourage faster progress towards a systemic solution, perhaps to include a generally accepted international accounting standard."

Both groups need to recognize the critical importance of the IMP which "is a forum for building global consensus on how to measure and manage impact" that has "brought together the perspectives of investment, grant-making, business, non-profits, social science, evaluation, wealth management, policy, standards bodies and accounting (among others)." This group has done more than any other to leverage the excellent work of the diverse members of its structured network with the aim of coming to a global set of standards. It has articulated the role of different types of standards, including how standards of practice and standards for benchmarking both depend upon, but should not be confused with, standards for measuring and disclosing nonfinancial performance.

In particular, it is essential that GRI and SASB, who have created the largest voluntary standards for nonfinancial performance information, come to a shared vision and act as a system. The IMP can focus its technical support on enabling this, as well as work with other standards to relate their work to this system.

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I know and respect both of these organizations. They have spent too much time arguing over turf. Their relationship is a highly complementary one. GRI is about impact: “GRI helps businesses and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance and social well-being.” It defines materiality as an externality. Sooner or later these issues become material to investors from the perspective of long-term value creation which is the focus of SASB. As I’ve recently written, materiality is a dynamic concept and is the analytical bridge between these two organizations.

GRI and SASB have many years of deep experience in developing standards for nonfinancial information through a rigorous due process involving all key stakeholders. Why wouldn’t the EC want to benefit from this? The IBC’s role is important because it is the first time the corporate community has acknowledged the need for standards—a far cry from where it was 30 years ago.

If the EC recognizes its role is more important as a “standards requirer” than a “standard setter” by leveraging the work of the IMP members and IBC, it will be able to effectively set truly global standards for nonfinancial information. No other jurisdiction is close to following their leadership. U.S. regulators have lagged so far. Through the EU, de facto standards can be set that U.S. companies can follow.

Assuming a set of global standards for nonfinancial information are developed, the remaining technical question is the document in which they are reported so we can have true integrated reporting. The answer is simple. U.S.-listed companies can report this information in the required Management Discussion and Analysis. Companies using IFRS can report this in the voluntary Management Commentary. This should be made mandatory and is something the EC can do.

Shot of a group of businesspeople high fiving while sitting in a meeting GETTY

For the first time in 30 years there is a real possibility to develop a set of high-quality global standards for nonfinancial information. This could get done by the end of 2020 or 2021 at the latest. Should it happen, all these groups and many others who collaborate in this effort can take credit. If it does not, they all need to shoulder the blame. I'm hopeful, but cautious. Putting the public interest before self-interest is one of the most challenging things for humans to do. But this is the time, if any, when enlightened self-interest must rule the day.

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