SHOULD ACCOUNTING FOR SUSTAINABILITY BE MANDATORY?

By Frank Badua, Ph.D., Frank Cavaliere, J.D., and Ricardo Colon, CPA, J.D., LL.M.

CURRICULUM: Accounting and Auditing, Management

LEVEL: Basic

DESIGNED FOR: CPAs in public practice and industry

OBJECTIVES: To address the history and current status of environmental, social and governance (ESG) policies, and the arguments for and against requiring ESG reporting.

KEY TOPICS: History and description of ESG, current rules for sustainability accounting, FASB guidance related to ESG reporting, petition to the SEC in favor of mandatory sustainability accounting, arguments against related initiatives, and environmental sustainability performance and reporting

PREREQUISITES: None

ADVANCED PREPARATION: None

When AICPA held its spring meeting in Washington, D.C. during May of 2019, members of the AICPA Council met with Congressional leaders to discuss important items from the organization's "advocacy agenda."[1] Those items only included seemingly "bread and butter" issues, specifically, taxpayer services, disaster assistance, digital taxes and the fiscal state of the nation. Nowhere in the discussion was a seemingly red-hot issue: the idea that companies should practice and report on their "environmental, social and governance" (ESG) policies.

An outgrowth of the decades-old corporate social responsibility (CSR) movement, ESG is taking the investing world by storm, with trillions of dollars already committed to funds dedicated to this so-called "impact investing." If ESG advocates have their way, accountants will shortly be required to find ways to report and verify the ESG activities of their corporate clients.

A petition was recently filed with the Securities and Exchange Commission (SEC), supported by heavyweights in the ESG movement, to require companies to do just that, but it is highly unlikely it will move forward at this time.[2]

This article will briefly address the history and current status of ESG, and the arguments for and against requiring ESG reporting.

A Brief History of ESG

ESG is generally viewed as an offshoot of the CSR concept that gained popularity following the social turmoil that occurred in the U.S. during the 1960s, characterized by events such as the Watts Riot, Vietnam anti-war protests and the tumultuous 1968 Democratic Presidential Convention in Chicago. It was hoped that companies could, by acting "responsibly," cool the temper of those times, that they could help to fix what was broken in our society.

That effort was idiosyncratic, left to individual companies to work out on their own and the results were, predictably, disappointing. Some would call the whole effort a fool's errand; swimming against a seismic demographic shift - the coming of age of the Baby Boom Generation.

To some, their hoped-for ultimate "top-down" authority is the United Nations. The United Nations in 2000 officially launched its Global Compact stating 10 principles grounded in four subject areas central to CSR, namely, human rights, labor, the environment and anti-corruption. Figure 1 contains a list of those principles. These principles depend upon voluntary CEO commitments of support. In essence, the principles were a more organized, top-down, yet voluntary, approach to CSR.

The desire to harness the power of corporations shifted into a higher gear with the start of the ESG movement, an organized, investment-centric, top-down approach to doing the right thing. The United Nations again took a leading position. In 2005, then-U.N. Secretary-General Kofi Annan brought together a global group of institutional investors and experts to develop Principles for Responsible Investment (the PRI). They developed Six Principles of Responsible Investing, which, like the Global Compact, are voluntary and aspirational.

The Six Principles of Responsible Investing, contained in Figure 2, are aimed at the investing community as opposed to management. If CSR was premised on "do the right thing," ESG can be looked at as following the adage "money talks." Like CSR, ESG is fluid – it is concerned with various "issues," which change with new circumstances. One version of these issues comes from the PRI website and is contained in Figure 3.

As implied by its name, ESG accounting is concerned with measuring firm performance in three very different endeavors, namely: environmental sustainability, social equity and corporate governance. Thus, the metrics used to document and report a company's performance in these three areas will differ significantly from one another and from traditional accounting measures that focus on financial performance.

The next few paragraphs will provide short descriptions of some of the measures and accounts used, the various reports comprised of these measures, and ways by which ESG accounting or its components may be audited.

Currently, those countries that report environmental sustainability performance use one or more of three types of accounts: sustainable cost accounts, natural capital accounts and physical flow input-output accounts. Sustainable cost is the (hypothetical) cost of restoring the Earth to a pristine state before a firm's activities impact it. However, valuing external costs such as pollution are highly problematic, since damage to critical natural capital would, in theory, be valued at infinite cost because it is irreplaceable.

Figure 1: The United Nations Global Compact's 10 Principles

Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and
Principle 2: Make sure that they are not complicit in human rights abuses.

Labor

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4: The elimination of all forms of forced and compulsory labor;
Principle 5: The effective abolition of child labor; and
Principle 6: The elimination of discrimination in respect of employment and occupation.

Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;
Principle 8: undertake initiatives to promote greater environmental responsibility; and
Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

Natural capital inventory accounting concerns the recording of stocks of natural capital over time, with changes in stock levels used as an indicator of the quality of the natural environment. Measures of distinct categories of natural resources are predominantly non-financial.

Finally, input-output analysis accounts for the physical flow, that is introduction, use and disposal, of materials and energy inputs and product and waste outputs in physical units. It uses a balancing technique familiar to accountants and chemists, applying the principle what goes in must come out, to structure the development of environmental information.

With regards to social accounting, standardized measures, accounts and reports are harder to develop. This is because the social justice objectives towards which a company endeavors will vary, just as an individual's conception of what is socially equitable will differ from others. However, the objectives, and related

measures, will often center on issues including working conditions and equitable compensation, skills-sharing, educational opportunities, and overall personal and job satisfaction.

The Current Rules for Sustainability Accounting

The SEC has not adopted specific disclosure requirements applicable to "environmental, social and governance" issues. Today, ESG reporting relies on the concept of materiality. Issues about sustainability that are material to a company's financial condition or results of operations must be disclosed.

TODAY, ESG REPORTING RELIES ON THE CONCEPT OF MATERIALITY.

Similarly, ESG disclosures are required whenever they are necessary to prevent other financial statement disclosures from being materially incomplete or misleading and to inform investor's proxy decisions. Management is in the best position to determine which ESG issues are material to a company.

The current framework on sustainability accounting originates in Securities Act Release No. 5627, issued in 1975, where the SEC reached four conclusions:

1) In formulating disclosure policy, the SEC is not generally authorized to consider the promotion of social goals unrelated to the objectives of the federal securities laws, except to consider the promotion of environmental protection as authorized and required by the National Environmental Policy Act of 1969 (NEPA);

2) The primary focus of the securities laws is on the economic interest of investors and disclosure requirements should be based on the economic significance of information;

3) No showing had been made, at least back in 1975, that disclosure of information describing corporate social practices should be required of all registrants;

4) Disclosures of corporate behavior in socially significant areas may sometimes be necessary to prevent other statements from being materially incomplete or misleading.

The SEC has adopted two rules addressing disclosures related to environmental protection issues. Item 101(c)(1)(xii) of Regulation S-K, Description of the Business, requires companies to disclose, as part of the description of the business, "the material effects that compliance with federal, state and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the [company] and its subsidiaries. The [company] shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the [company] may deem material."

Additionally, Item 103 of Regulation S-K, Legal proceedings, requires companies to disclose

Figure 2: The PRI's Six Principles of Responsible Investing

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.

Figure 3: ESG Issues Per PRI

Environmental Issues

Climate Change; Water; Sustainable Land Use; Fracking; Methane; Plastics

Social Issues

Human Rights and Labor Standards; Employee Relations; Conflict Zones

Governance Issues

Tax Avoidance; Executive Pay; Corruption; Director Nominations; Cyber Security

"administrative or judicial proceeding[s] arising under any federal, state or local provisions that have been enacted or adopted regulating the discharge of materials into the environment or primary for the purpose of protecting the environment" if the proceeding is material to the business or financial condition of the registrant and certain thresholds are met.

Beyond environmental protection, Item 303 of Regulation S-K, Management's discussion and analysis of financial condition and results of operations, requires companies to provide information about material trends and events that may affect its financial condition, changes in financial condition and results of operations. Furthermore, Item 105 of Regulation S-K, Risk factors, requires disclosure of the most significant factors that make an investment in a company speculative or risky.

Other regulatory actions may affect ESG corporate disclosures. In 2010, the SEC issued an interpretive release to provide guidance to public companies regarding disclosure requirements with respect to climate change matters. According to the interpretive release, if material, companies should consider the following factors with respect to climate change disclosures:

- Significant development in federal and state legislation and regulation regarding climate change;
- Treaties or international accords related to climate change;
- Legal, technological, political and scientific developments regarding climate change;
- The physical impact of climate change, such as effects on the severity of weather, sea levels, the arability of farmland, and water availability and quality, among other factors.

Also, in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress mandated the SEC to adopt various disclosure requirements pertaining to ESG topics, such as conflict minerals provisions (Section 1502), resource extraction payments (Section 1504), mine safety and health (Section 1503), and employee and CEO compensation (Section 953(b)).

With respect to standards issued by the Financial Accounting Standards Board (FASB), the standard most pertinent to ESG reporting is Accounting Standards Codification (ASC) 450-20, Loss Contingencies. A contingency is defined as "[a]n existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."

The Codification provides that an estimated loss contingency shall be accrued by a charge to income if both of the following conditions are met: (1) information available before the financial statements are issued or are available to be indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements; and (2) the amount of loss can be reasonably estimated.

Disclosure shall be made of any loss contingency that is probable as to occurrence but not accrued because the amount of loss cannot be reasonably estimated. Also, companies are required to disclose loss contingencies for which there is a reasonable possibility, but it is not probable, that a loss may have been incurred.

Other FASB guidance related to ESG reporting relates to environmental liabilities and asset retirement obligations (AROs). ASC 410-30 provides a framework for determining whether a contingent liability should be recorded for environmental liabilities. ASC 401-20 discusses AROs, which consist of obligations associated with the retirement of a tangible long-lived asset.

Per ASC 410-20-25-4, companies are required to recognize the fair value of an ARO in the period in which it is incurred if a reasonable estimate of fair value can be made. If a reasonable estimate of fair value cannot be made, the liability should be recognized in the period in which a reasonable estimate of fair value can be determined.

Furthermore, ASC 410-20-25-5 requires companies to recognize an ARO by increasing the amount of the related long-lived asset by the same amount as the liability. As the asset is used in operations, depreciation is recognized on the carrying value of the asset, which includes the present value of closure and removal costs. Also, changes in AROs due to the passage of time are measured using the effective interest method and the amount of the increase of the liability is recorded as accretion expense. Examples of activities that require the recognition of AROs include:

- Dismantling offshore oil and gas facilities;
- Decommissioning of nuclear facilities;
- Closure, reclamation and removal costs of mining facilities; and
- Closure and post-closure costs of landfills and hazardous waste storage facilities.

Although the guidance discussed previously establishes a general framework for ESG reporting, the SEC has not adopted specific rules addressing this topic. Investors have expressed some concerns with the lack of specific ESG reporting requirements, particularly due to the difficulty in making comparisons across companies. The current landscape for ESG reporting has become more difficult to navigate as numerous companies have adopted sustainability disclosure frameworks developed by different organizations. These include the:

- Global Reporting Initiative (GRI);
- International Integrated Reporting Committee (IIRC);
- Task Force on Climate-Related Financial Disclosures (TCFD);
- Carbon Disclosure Project (CDP); and
- Sustainability Accounting Standards Board (SASB).

Thus far, SASB has been widely accepted as a reporting framework that is aligned with the requirements of the U.S. securities laws in terms of ESG disclosures. SASB consists of 77 industry-specific sets of sustainability accounting standards, which were officially codified in 2018. The standards focus on financially material information covering a range of industry-specific sustainability areas of interest to investors, such as water management for beverage companies, data security for technology firms, and supply chain management for consumer goods manufacturers and retailers.

While SASB standards are intended to be a useful guide for disclosure, the final decision as to what is financially material rests with the reporting company. Many companies, including General Motors, Merck, JetBlue, Kellogg's, Nike, Bloomberg, NRG, and Wells Fargo, have adopted SASB standards as the framework for reporting ESG information to investors.

The Petition to the SEC From ESG Heavyweights in Favor of Mandatory Sustainability Accounting

On October 1, 2018, a petition was filed with the SEC. Filed by two distinguished law professors, Cynthia A. Williams of Osgoode Hall Law School, the law school of York University in Toronto, Canada, and Jill E. Fisch of the University of Pennsylvania Law School. It was also signed by 16 additional law professors from the U.S. and Canada, all of whom were designated "securities law specialists."

Additional signatories include 50 individuals and organizations. They are some of the biggest heavyweights in the investing and ESG fields, such as the aforementioned PRI, Morningstar and the California Public Employee Retirement System (CalPERS), which is the nation's largest public pension fund. Even some elected officials signed the petition, including the New York State Comptroller and the Illinois State Treasurer.

As stated in the Conclusion to the 16-page petition, the goal of the petition is to cause the SEC "to promptly initiate rulemaking to develop mandatory rules for public companies to disclose high-quality, comparable, decision-useful environmental, social and governance information." The petition recounts a number of perceived positives from requiring mandatory sustainability information, including:

1) It promotes market efficiency by allowing investors to compare companies by their commitment to ESG.

2) It will put the U.S. on an equal footing with other countries that have already made ESG reporting mandatory, such as the United Kingdom and Sweden.

3) It facilitates capital formation by giving capital markets more useful, material information that will "increase confidence in capital markets."

4) It is material and "decision-useful."

5) Standardization will make it easier for companies to disclose this useful information.

6) Voluntary disclosure is insufficient to meet the expressed needs from some of the largest financial services companies, such as Black Rock and Bloomberg.

7) It provides a level playing field by standardizing ESG reporting, which now is subject to a variety of ESG reporting frameworks.

8) Given the number of similar petitions that have been filed with the SEC over the years from a variety of groups, it appears that the time is right to make the move to mandatory reporting of ESG.

Arguments Against Mandatory Sustainability Accounting

Many of the arguments against mandatory sustainability reporting are the same as, or similar to, the arguments that have long been raised against CSR. The main arguments historically raised against CSR include:

1) It is the job of managers to maximize profits;

2) The costs associated with CSR are borne by the stockholders, who may have no voice in the matter;

3) The board of directors and management are taking credit for spending the stockholders' money;

4) Business managers have no innate special abilities to solve society's problems and;

5) Social problems are best left to social workers and politicians.

Many of the same arguments can be raised against ESG initiatives by institutional money managers.

A major contention for both CSR and ESG is the concept of fiduciary duty. Like boards of directors and top managers, fund managers are fiduciaries who have a duty to put the interests of their beneficiaries above their own. The proponents of ESG argue that it is part of the fiduciary responsibility of money managers to take ESG into account; failure to follow its precepts, they argue, is actually a breach of fiduciary duty. Opponents worry that promoting social issues reduces returns to stockholders and plan beneficiaries and violates fiduciary duty.

THERE IS A REAL CONCERN OVER ESG "MISSION-CREEP" BECAUSE OF THE FLUID, EVER-EVOLVING NATURE OF ESG ISSUES.

President Donald Trump issued Executive Order 13868 on April 10, 2019, titled "Promoting Energy Infrastructure and Economic Growth." The Order implies that the president was concerned that some pension managers were taking actions antithetical to the interests of oil companies and plan beneficiaries.

In Section 5(b) of the Order, the Secretary of Labor was instructed to "complete a review of existing Department of Labor guidance on the fiduciary responsibilities for proxy voting to determine whether any such guidance should be rescinded, replaced or modified to ensure consistency with current law and policies that promote long-term growth and maximize return on ERISA plan assets."

Finally, there is a real concern over ESG "mission-creep" because of the fluid, ever-evolving nature of ESG issues. Some of the leading players in the ESG movement, such as Laurence Fink, the CEO of Black Rock, have expanded the ESG parameters to issues such as gun control, which has angered Second Amendment advocates in the U.S.

More recently, 200 CEOs signed a letter opposing the anti-abortion law passed by the State of Georgia, angering pro-life advocates. It is not a huge stretch to see some ESG proponents considering abortion rights as one of the "Human Rights" issues under ESG. In this time of deep divisions along political and cultural lines, espousing divisive ideas is likely to anger as many investors as it pleases.

ESG Performance and Reporting

It has been argued that voluntary disclosure of ESG performance or corporate performance in any of its components makes good business sense and there is evidence that stocks of corporations that report ESG performance trade at a premium compared with those of non-reporters. And yet, it has also been pointed out that in jurisdictions wherein ESG reporting is not legislatively mandated, such reporting is the exception rather than the rule, notwithstanding lip-service provided by companies and business associations.

Puzzlingly, the stock premium found among ESG reporting corporations is hard to explain and to characterize as providing meaningful and value-adding information to an investor. Is it the reported performance in ESG that leads investors to see value in the firm, derived from its sustainability and equity endeavors, or is it just market hype or do-gooder sentiment, drawing irrationally exuberant attention, and investment dollars, to these corporations? For firms that provide triple-bottom-line reports, which aspect of ESG is regarded as comprising high-information content reporting?

In the current social and political environment, adopting a uniform set of ESG standards may prove to be difficult, due to the risk of over-inclusion or under-inclusion of topics and metrics, and ultimately management is in a better position to determine which ESG issues are material to a particular reporting company.

From an accounting perspective, ESG reporting should continue to be driven by materiality. For now, the most prudent and fairest approach might be to wait and see.

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CPE ARTICLE: SHOULD ACCOUNTING FOR SUSTAINABILITY BE MANDATORY?

By Frank Badua, Ph.D., Frank Cavaliere, J.D., and Ricardo Colon, CPA, J.D., LL.M.

Today's CPA offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TXCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

1. ESG reporting refers to the idea that companies should report on their _________ policies.
A. Environmental, shareholder and government
B. Environmental, social and governance
C. Equity, shareholder and government
D. Environmental, social media and governmental

2. Which of the following is not one of the four subject areas of the Global Compact adopted by the United Nations in 2000?
A. Labor
B. Intellectual Property
C. Environment
D. Human Rights

3. There are ____ Principles for Responsible Investment.
A. Two
B. Four
C. Six
D. Nine

4. The Securities and Exchange Commission (SEC) has not adopted specific requirements applicable to ESG issues.
A. True
B. False

5. Currently, ESG reporting relies primarily on the concept of ____________.
A. Cost-Benefit
B. Return on Investment
C. Risk
D. Materiality

6. Regulation S-K requires disclosure of the most significant factors that make investment in a company speculative or risky.
A. True
B. False

7. In the absence of mandatory ESG standards, U.S. companies have adopted sustainability disclosure frameworks developed by different organizations, including:
A. Global Reporting Initiative (GRI)
B. International Integrated Reporting Committee (IIRC)
C. Sustainability Accounting Standards Board (SASB)
D. All of the above.

8. In 2018, ESG heavyweights filed a petition with the Securities and Exchange Commission (SEC) to request the issuance of mandatory ESG rules for public companies.
A. True
B. False

9. Which of the following arguments is used against mandatory sustainability reporting?
A. Allows investors to compare companies by their commitment to ESG
B. Places the U.S. in equal footing with other countries that already require ESG reporting
C. The job of managers is to maximize profits
D. Uniformity will make it easier for companies to disclose ESG information

10. The concept of ______________ requires fund managers to place the interests of their beneficiaries above their own interests when making investment decisions.
A. ESG
B. Fiduciary duty
C. Materiality
D. Corporate Social Responsibility

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