The Future of Accounting Is Now

Financial Performance Is Linked to Sustainable Growth

By Jeffrey Hales, PhD

July 2018 Issue, Featured |
July 2018

A growing body of research indicates that the language people speak could shape the way they think. Might the same be true when it comes to accounting—the "language of business"? For all its strengths, traditional financial accounting is focused almost entirely on measuring the past performance and present condition of an organization; like a language with no future tense, the emphasis is on the here and now.

Yet global capital markets are increasingly concerned that an overemphasis on "short-termism" is limiting economic prosperity. According to the McKinsey Global Institute, strategic planning over near-term time horizons "is rising … it harms corporate performance, and … it has cost millions of jobs and trillions in GDP growth" ("Measuring the Economic Impact of Short-Termism," February 2017, https://mck.co/2K4kyHL). Similarly, surveys of corporate officers suggest that many would rather meet quarterly earnings estimates than take on an investment benefiting their company over the long term (John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal*,November/December 2006, http://bit.ly/2yB9UCU).

In response to these concerns, markets have increasingly begun to focus on pathways to long-term, sustainable growth and have recognized that certain environmental, social, and governance (ESG) issues are closely linked to financial outcomes. Although they are not inherently financial in nature, ESG factors can reflect business issues that have measurable impacts on a company's balance sheet, its income statement, or its risk profile, and thus its cost of capital.

Recent history provides no shortage of examples. When the Deepwater Horizon oil spill put BP in the news, its share price dropped by more than half in less than two months—a loss to shareholders of approximately $70 billion. When Chipotle was hit with a series of E. coli and norovirus incidents, its stock price—which had soared in the preceding year—lost about one-third of its value (roughly $7 billion) in just two-and-a-half months. After Wells Fargo's account fraud scandal, its stock price dropped during a year when its industry rivals gained between 33% and 46% on hopes of tax cuts and regulatory reform.

When incidents related to the environment, customer safety, and employee governance have such dramatic impacts on market prices, it becomes clear that sustainability issues are business issues and that their near-term market impacts reflect anticipated long-term effects on cash flows and associated risks. The goal, then, is to help investors accurately price these risks *ex ante*rather than simply wait for a significant price correction of the type that introduces volatility into individual portfolios and instability into the market at large.

Growing Investor Demand

Although certain sustainability issues have long been considered by socially minded investors, in recent years, mainstream investors have become vocal proponents of integrating ESG factors into corporate management and reporting, particularly when those factors are financially material. Whether they are active owners seeking outperformance through best-in-class securities or passive managers looking to address ESG risks while keeping portfolio returns in line with broader market benchmarks, investors are increasingly interested in useful data and information about how the companies they own are performing on these issues.

These investors want sustainability performance data that are clearly linked to financial performance and are thus useful for making investment decisions. Imagine having ESG metrics that are focused on financially material factors, quantitative whenever possible, comparable and consistent among industry peers, and suitable for independent, third-party assurance. Imagine if markets had access to key performance indicators—such as an oil company's track record on health, safety, and emergency management or a restaurant chain's history of food safety incidents—to better understand how, and to what extent, a company's past financial performance is likely to indicate its future performance.

This is precisely what the Sustainability Accounting Standards Board (SASB) is working to help companies deliver to the global capital markets: financially material, decision-useful information on business-critical sustainability factors that can be reported in a cost-effective way by companies that issue securities. Over the last six years, SASB has engaged in evidence-based research, market outreach, and public input, with expert-led oversight, as it attempts to build a future tense for the language of business.

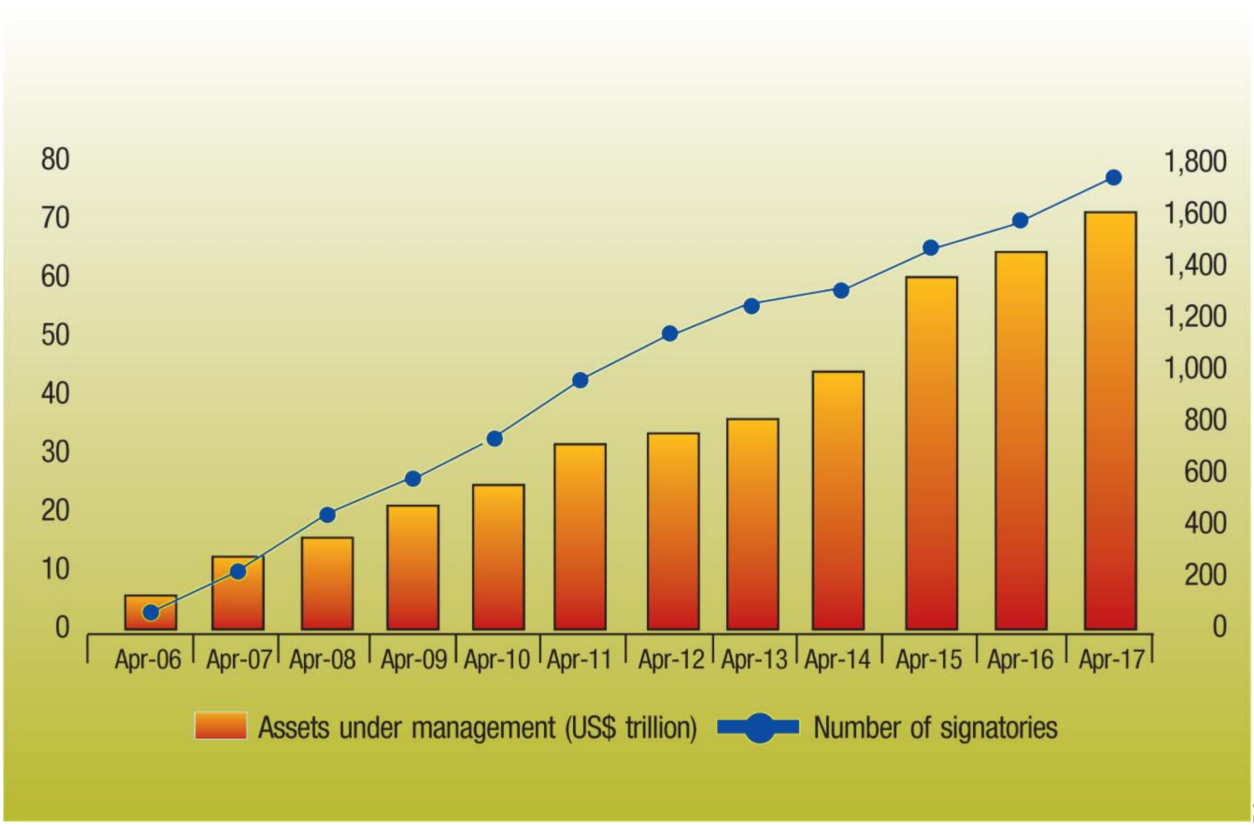
The SASB standards are a market-driven response to demand for information that is increasingly prioritized by mainstream investors. In January, the CEO of BlackRock—the world's largest asset manager—told S&P 500 chief executives, "Environmental, social, and governance factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects." BlackRock backed up that assertion by incorporating the SASB's standards into its proxy voting guidelines (Larry Fink, "A Sense of Purpose," annual letter to CEOs, BlackRock, January 2018, http://bit.ly/2KafUqP;BlackRock, "Proxy Voting Guidelines for U.S. Securities," February 2018, http://bit.ly/2lu97dy). In 2017, Vanguard, the world's second largest asset manager, issued an open letter calling on public companies to "embrace the disclosure of sustainability risks that bear on a company's long-term value creation prospects," and recommended using a framework like the SASB standards to do so (F. William McNabb III, "An Open Letter to Directors of Public Companies Worldwide," Vanguard, Aug. 31, 2017, https://vgi.vg/2McJaue).

These asset managers' actions are notable, but are neither anomalous nor unfounded, as illustrated by a growing number of like-minded analysts and asset owners. For example, Bank of America Merrill Lynch recently released research stating that "ESG is the best signal we have found for future risk" (Savrita Subramanian et al., "ESG Part II: A Deeper Dive," *Equity Strategy Focus Point*, June 15, 2017, http://bit.ly/2K2m2Cf). In 2017, 25 asset owners, managing $2.8 trillion, petitioned the SEC for improved human capital reporting, articulating a set of principles that overlap considerably with SASB's approach (Meredith Miller, letter to SEC, Human Capital Management Coalition, July 6, 2017, http://bit.ly/2IiedCq).

These examples are admittedly anecdotal, but in this author's opinion, they represent a deep and broad trend, perhaps best illustrated by the growth of the signatories to the United Nations' Principles for Responsible Investment (PRI), which has more than doubled in terms of assets under management since SASB started its standards-setting work (see *Exhibit*). Indeed, 26% of global assets are now invested using sustainable strategies, representing an increase of 25% in just the past two years (Global Sustainable Investment Alliance, *Global Sustainable Investment Review*, 2016, http://bit.ly/2MRLRCu).

Exhibit

Growth of PRI Signatories and Their Assets under Management



Source: United Nations Principles for Responsible Investment

To harness and focus this escalating interest in financially material ESG information, SASB recently formed an Investor Advisory Group (IAG), comprising 32 leading asset owners and managers with more than $26 trillion in assets. Members of the IAG, which include such organizations as BlackRock, the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and

State Street Global Advisors, are committed to improving the quality and comparability of sustainability disclosure. In pursuit of this goal, they work with SASB to ensure the development of sustainability accounting standards that facilitate disclosures fit for the purposes of portfolio management, fundamental analysis, and corporate engagement.

Early Implementation

While reporting to investors is important, companies are increasingly realizing that they have their own reasons for addressing sustainability factors. The growing recognition that sustainability performance and financial performance are linked has inspired companies to pursue "shared value" projects that address societal challenges while also enhancing an organization's bottom line. Thus, more than 1,300 companies, representing $25 trillion in market capitalization, have voluntarily adopted targets for reducing greenhouse gas (GHG) emissions (America's Pledge, Phase 1 Report: States, Cities, and Businesses in the United States Are Stepping Up on Climate Action, Bloomberg Philanthropies, November 2017, http://bit.ly/2Ir5LRn), and automakers have begun phasing out conventional engines and embracing electric vehicles, which posted 63% year-over-year sales growth in the third quarter of 2017 (Anna Hirtenstein, "Global Electric Car Sales Jump 63 Percent," *Bloomberg*, Nov. 20, 2017, https://bloom.bg/2Km62dm). In addition, food companies are pouring resources into the organic market, where growth is outpacing the overall food market by 1,400% ("Robust Organic Sector Stays on Upward Climb, Posts New Records in U.S. Sales," Organic Trade Association press release, May 24, 2017, http://bit.ly/2KhhUdt).

> *Companies are not pursuing these initiatives as a means of corporate philanthropy; rather, they view them as sound business opportunities.*

In this author's opinion, these companies are not pursuing these initiatives as a means of corporate philanthropy; rather, they view them as sound business opportunities. These companies are honing their strategic focus, enhancing their risk management, and increasing their operational efficiency. They are disrupting markets with innovative inputs, processes, and products, attracting top talent and strengthening their brands. In many cases, they are also achieving a sustainable competitive advantage.

A growing number of companies have also begun to issue increasingly robust reports on their sustainability performance, in many cases using SASB standards. Recognizing the value in a focused set of performance metrics for managing financially material ESG factors, companies have begun to incorporate SASB standards into their core communications to investors.

For example, companies in a variety of industries have embraced the SASB standards for use in their annual filings with the SEC, perhaps most prominently in the real estate industry, where Kilroy Realty, Host Hotels & Resorts, and Digital Realty Trust are leading the way. An analysis of filings for fiscal year 2016 revealed 805 instances of companies disclosing information on SASB metrics across all sectors, including 15 companies—most of them 20-F filers, such as Diageo and Deutsche Bank—that provided disclosure on at least half of the metrics included in the provisional SASB standard for their industry.

Other companies have opted to use the SASB standards in stand-alone reports, such as that produced by JetBlue. In 2018, the airline company issued its second annual SASB report, which also incorporates the complementary recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures. Meanwhile, companies from footwear giant Nike, to medical equipment company Medtronic, to automaker Peugeot have incorporated the SASB standards into their sustainability reports.

This adoption is particularly striking given that SASB decided to release its initial standards in a provisional status, allowing for an extended period of market outreach and consultation to ensure that the codified standards would reflect both investor interest and the concerns of corporate issuers. For example, in addition to the hundreds of corporate professionals who participated in the provisional standards–setting process, SASB has also engaged in deep consultation with 141 companies (representing $7.5 trillion in market capitalization) and 19 industry associations (representing hundreds of companies) to inform ongoing codification efforts. The result is a cost-effective approach to ESG reporting, with an average of just five topics and 13 metrics per industry, helping companies and investors avoid disclosure overload.

Looking Ahead

The above trends illustrate how investors are demanding material ESG performance data, and how companies are working to supply it in a way that adds value. This summer, SASB will codify its sustainability accounting standards, incorporating important market-driven updates and officially ratifying them for use by corporations and investors. Although the codification marks the culmination of six years of work, it is also a starting point for the next stage of SASB's efforts. The board is committed to engaging in a regular cycle of maintenance to ensure that standards remain relevant and responsive to the most important sustainability factors, which by their nature can evolve over time. This ongoing due process will involve internal research, external outreach, technical agenda-setting, public comment, and transparent oversight (Sustainability Accounting Standards Board, "Codification Process and Documents," May 14, 2018, http://bit.ly/2tBXViG). Codification also creates new opportunities for learning from the market and for measuring success.

After codification, SASB will begin to review corporate and investor implementation with the twin goals of further evaluating the standards for decision-usefulness and cost-effectiveness. Corporate implementation in particular will involve many issues relevant to the accounting profession, thus introducing a new era of business for accountants with a solid grasp of sustainability issues.

For example, as companies begin to incorporate more ESG factors into their enterprise risk management processes, they will likely look to accountants for help bridging the gap between accounting and risk management. Because many SASB metrics serve as key risk indicators, accounting professionals can help companies not only monitor their risks and opportunities, but also adjust their strategies and improve their operating and financial performance.

Accountants will also play a key role in designing, implementing, and maintaining an integrated system of internal control over companies' financial and sustainability-related objectives. To provide decision makers with full confidence in reported sustainability data, companies will need to turn to accountants as experts in measurement and reporting. For example, accountants can lend their experience and expertise in developing and maintaining entity- and transaction-level controls, manual and automated controls, and preventive and detective controls to emerging and evolving sustainability-related activities.

Indeed, as ESG data becomes more fully integrated into performance management, resource planning, and financial reporting systems, CPAs who are also Certified Information Technology Professionals (CITP) are likely to be called on for their technical expertise in areas such as analytics, security and privacy, risk, and assurance. Meanwhile, as demand for reliable external information grows, opportunities will abound for CPAs who are well versed in ESG-related assurance considerations, such as those outlined last year in key guidance from the AICPA [*Attestation Engagements on Sustainability Information (Including Greenhouse Gas Emissions Information)*, July 27, 2017].

To advance the field of sustainability accounting and to ensure that the appropriate knowledge structure is in place to help issuers with implementation, SASB will need to build key partnerships with the broader accounting profession, including with accounting firms, consultancies and advisory firms, professional organizations, and standards setters. To that end, SASB has begun recruiting key individuals who can lend their technical and industry expertise to its Advisory Groups and Committees. SASB will also need to strengthen its relationships with educators, helping sustainability become further embedded in the curricula of colleges and universities—not as a philanthropic marketing exercise, but as a financially critical area of a company's strategic focus.

> *As companies begin to incorporate more ESG factors into their enterprise risk management processes, they will likely look to accountants for help bridging the gap between accounting and risk management.*

Although investor demand is important, it is not nearly enough on its own to ensure the appropriate integration of business and sustainability. To create value for an organization and its shareholders, ESG factors will need to be strategically aligned, directly linked to financial outcomes, measured with systematic rigor, meaningfully communicated, and actively managed within C-suites and boardrooms. This cannot and should not be done without accountants.

Corporations have long looked to the accounting profession for its expertise in strategy, measurement, reporting, and analysis. These same skills make accountants uniquely positioned to help companies implement SASB standards—to communicate useful information not only to investors, but also to internal decision makers, helping them drive long-term value creation. As more companies continue down this path, opportunities will arise for accountants in all types of roles to add their own value.

By bringing their skills to bear on sustainability, accountants can shape the future of the accounting profession and the broader capital markets. Developing a future tense for the language of business can allow the story of more focused companies, better-informed investors, and more stable and resilient 21st-century markets to be told.

Jeffrey Hales, PhD is the Catherine W. and Edwin A. Wahlen Jr. Professor of Accounting at Georgia Institute of Technology's Scheller College of Business, Atlanta, Ga., and the chair of the Sustainability Accounting Standards Board.