Hoogervorst, 2019

Speech: IASB Chair o sustainability reporting can and cannot achieve

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Chair of the International Accounting Standards Board (IASB) Hans Hoogervorst delivered a speech at the Climate-Related Financial Reporting Conference in Cambridge, UK. Mr Hoogervorst describes how reporting that helps investors understand how companies are affected by sustainability issues offers a promising step forward, and the role that the Board intends to play in this area. At the same time, he cautions against exaggerated expectations for sustainability reporting as a catalyst for change in the absence of policy and political intervention.

Introduction

First, I want to thank Professor Alan Jagolinzer of the Cambridge Judge Business School for organising this event. Alan has been an Academic Practice Fellow at the IASB, so we know him well. Alan is living proof that accountants are not necessarily boring people, because he started out as a pilot in the United States Air Force. As far as I know, he was never shot down and captured, so I guess that even makes him a bit of a hero! Surely, we need all the heroes we can get to tackle climate change.

I am delighted to talk about climate-related reporting tonight. The mission of the IASB is to develop accounting standards that bring transparency, accountability and efficiency to financial markets around the world. IFRS Standards are designed to meet the financial information needs of investors and other market participants to support their economic decisions. This focus on financially relevant information for investors is embedded in our DNA and is front-of-mind when we develop our Standards.

Around the world 144 jurisdictions have adopted IFRS Standards. Despite the recent trend against globalisation, the number of adopting countries has continued to rise. What's more, most jurisdictions resist the temptation of making local adaptations to our Standards. This makes IFRS probably the most widely adopted economic standard in the world.

Before I give you my views on climate-related reporting, I have a bit of a confession to make. Some of you might know I spent a long time in politics in the past. As a liberal, free-market oriented politician, I started out being sceptical about climate change. It did not sit well with me that so many people in the environmental movement at that time had a strong anti-market and anti-globalisation agenda. It made the climate-change issue suspicious by association.

Over the years, I gradually changed my mind. I do not just believe in markets, but also in science and I could simply no longer ignore the growing numbers of Nobel prize winners warning against climate change. Moreover, while I still believe that free market policies generally deliver the best results, I also acknowledge that public policy is needed to counteract market failures.

Climate change—a market failure

Climate change is a massive example of such market failure. Just look at aviation. It is one of the fastest growing sources of green-house gas emissions and the most climate-intensive form of transport. Yet the price of international airline tickets in no way reflects the negative externalities of flying. Substantial taxes would be necessary to adequately price in its negative environmental impact, but instead, aviation is not subject to fuel tax or VAT. It is heavily subsidised compared to other sectors of the economy. As a result, a gas-guzzling flight from London to Amsterdam can be cheaper than the eco-friendly hybrid taxi to the airport! The economics of the aviation industry is a market failure, compounded by a public policy failure.

In an ideal world, there would be no need for sustainability reporting. Negative externalities, such as pollution, would be adequately taxed so that the price of a product would reflect the cost it imposes on the environment. A realistic carbon tax would cause the financial statements of smokestack industries to reflect the true costs of their products. Should these costs make an economic activity unfeasible, the financial statements would show the impairment of its related assets. Financial reporting and sustainability reporting would be one and the same.

As my aviation example demonstrates, we are clearly far removed from this ideal world. This is the reason why many people see climate-change reporting, or more broadly sustainability reporting, as an important catalyst for change.

Sustainability reporting methodology

According to the Financial Times, there are at least 230 corporate sustainability standards initiatives across more than 80 sectors[i]. In this plethora of sustainability initiatives, two main orientations can be distinguished.

The first strand of sustainability reporting is embedded in Corporate Social Responsibility (CSR) reporting. It seeks to promote behavioural change by requiring companies to demonstrate how they contribute to a better world by engaging in environmentally sustainable activities. This strand of sustainability reporting is oriented towards the public good and views society at large as the audience of reporting.

Although this strand in sustainability reporting is perfectly legitimate, its scope is different from the scope of IFRS Standards. Our Standards do not seek to portray the contribution of a company to the public good, but to provide information that helps investors in their efforts to predict future cash flow of the company itself. So, CSR-like sustainability reporting does not meet the objectives of financial reporting, although there may be some overlap in practice.

However, there is another, increasingly influential, strand in sustainability reporting that is more focused on the impact of sustainability issues on the company itself, rather than on the public good. It seeks to provide investors with information on how sustainability issues might impact the company's future financial performance. The work of bodies such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) is an example of such orientation towards investors and value creation. The scope of this disclosure framework comes very close to that of the IASB.

This brings me to the question how sustainability reporting relates to financial reporting and what role the IASB could play.

The role of the IASB

First, let me make clear that I do not think the IASB is equipped to enter the field of sustainability reporting directly. Setting sustainability reporting standards requires expertise that we simply do not have. Moreover, there are already more than enough standard-setters active in this field.

Having said that, sustainability issues can already have an impact that needs to be reflected in financial reporting as it currently is. The Australian Accounting Standards Board recently published a very interesting paper that discusses when climate-related disclosures are material, and therefore should be included within the IFRS financial statements[ii].

The paper mentions that in particular industries, the carrying value of assets—such as property, plant and equipment and assets recognised in relation to mineral resources—could be overstated if the impact of climate-related risks is not properly taken into account. Where climate-related risks could have a significant impact on a company's operations, information about how this has been factored into impairment calculations would be relevant to the users of the financial statements. In conclusion, as the effects of climate change become more prominent, they will become more and more visible in the financial statements.

However, many sustainability issues may only emerge in the long run. In such cases they will tend to escape the financial statements, which are essentially backward-looking. But even in such cases we believe the IASB has a role to play, namely through our efforts to improve what we like to call 'broader financial reporting'. Let me try to explain what I mean by this.

Broader financial reporting

While classical financial reporting will remain the cornerstone of our work, the IASB has always recognised its limitations. For example, the financial statements provide little information about a company's business model or the economic environment it is operating in. They also do not contain information about all the intangible resources and relationships that drive business success. This information is excluded from the financial statements for good reasons. Trying to capture the value of intangibles is a hugely subjective exercise and would pose enormous recognition and measurement challenges.

The financial statements also contain limited forward-looking information, including information on emerging sustainability issues. This makes it very difficult for investors to see whether a company is prioritising short-term financial targets at the expense of longer-term value creation that is not immediately recognised in the financial statements. That can lead to capital being diverted from companies pursuing long-term strategies in favour of those prioritising short-term earnings.

Responding to this need, in 2010 we published what we call our Management Commentary Practice Statement—basically a non-mandatory guide for how to write the front of an annual report. It should help management provide a broader context for the financial statements, which is why I like to refer to broader financial information.

Since 2010, a lot has happened in this space. As the technology giants have taken off, there is much more interest in the impact of intangibles. The International Integrated Reporting Council launched its <IR> Framework. We have also seen various jurisdictional initiatives, such as the European Union's Non-Financial Reporting Directive. And of course, many advances have been made in the environmental, sustainability and governance (ESG) reporting space, none of which was anticipated by our own Practice Statement. However, we continue to hear concerns from investors over the quality and focus of information that they are receiving.

For these reasons, we have started working on a major overhaul of this Practice Statement. The updated Practice Statement will remain primarily focused on the broader financial information needs of investors. We want companies to report on what is strategically important to them, including how remuneration policies align with their long-term objectives. There will be more focus on intangibles. And of course, companies will have to tell how sustainability issues, including climate changes, may impact their business if that impact is material. The work of bodies such as the TCFD may well help them meet the requirements of a Management Commentary here.

Sustainability reporting thoughts

In the final part of my speech I would like to make some general observations on sustainability reporting.

First, there are simply too many standards and initiatives in the space of sustainability reporting. This leads to a lot of confusion among users and companies themselves. To give one example, Tesla is ranked highest in terms of the sustainability index of MSCI, while FTSE ranks it as the worst carmaker globally on ESG issues. Yet another agency puts it somewhere *in the middle*[iii]. People may be forgiven for not making heads or tails of it. Moreover, with so many standards, the potential for disclosure overload is enormous. Consolidation is clearly needed. A useful first step are the efforts of the Corporate Reporting Dialogue, chaired by my former colleague Ian Mackintosh, to align the frameworks of various standards in this area.

Second, we should not have exaggerated expectations about sustainability reporting as an agent for change. Let us not forget that full transparency did little to curb excess in corporate remuneration. Equally, we should not expect sustainability reporting to be very effective in inducing companies to prioritise planet over profit. Greenwashing is rampant. When news of the VW emissions scandal broke, VW was leading the Dow Jones sustainability index's automotive sector, and its Audi subsidiary was running TV commercials featuring Kermit the Frog singing "it isn't easy being green". Coming back to aviation, we do not need sustainability reporting to know that flying is very bad for the environment. Yet we all love our trips abroad and the number of flights continues to grow year by year.

In the end, financial incentives remain crucial in combatting climate change. For this reason, I strongly believe that the most promising strand of sustainability reporting comprises those standards that focus on the investor and on the impact of sustainability issues on the future returns of the company. This is the type of sustainability reporting which will fit well with our Management Commentary Practice Statement, rather than the reporting that focuses primarily on a company's contribution to the public good. While some investors may be swayed to invest in companies that show good corporate responsibility scores, ultimately the impact of sustainability issues on future financial returns will have a much bigger impact on investment decisions.

In this respect, a lot of work still needs to be done. Just recently, the Economist ran a sobering story called *The truth about big oil and climate change*. It showed that even though the annual reports of the big energy companies tell a positive green story, investment in fossil fuels continues to grow strongly and dwarfs the investment going into renewables[iv]. The oil companies see the demand for energy surging and have no immediate reason to fear drastic carbon pricing measures in many parts of the world. For investors these companies remain attractive, with four of the 20 biggest dividend payers being oil majors.

This goes to show that sustainability reporting requirements cannot get politicians off the hook in terms of the need for credible climate-change policies. It is good that the G20 is promoting climate-related disclosure; it would be a thousand times better if they could agree on the introduction of a kerosene tax.

Close

There are reasons for hope. Since my early days as a climate-change sceptic, the issue of climate change has decidedly moved into mainstream politics. You may have noticed that even climate-change sceptics do not really deny climate change any more. There is simply too much evidence: they accept that climate change is real. Instead, they now deny that it is man-made. At least they know they have to adjust their pseudo-science in order to remain faintly credible.

Climate change has moved to the forefront of people's concerns and this will hopefully create more room for adequate public policies in the future. The more these policies start to bite, the more relevant sustainability reporting will become. I thank you for your attention and wish you a good continuation of the conference.

[i] Financial Times (2019) *Defective data is a big problem for sustainable investing*
[ii] AASB (2018) *Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB Practice Statement*
[iii] Wall Street Journal (17 September, 2018)
[iv] Economist (2019) *The truth about big oil and climate change*