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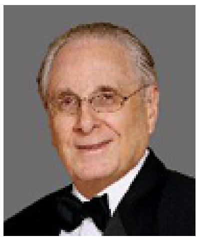
ACCOUNTING PRINCIPLES

The Securities Laws and the Sustainability Accounting Standards Board



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Introduction.

Uncertainties about future costs of doing business caused by the proliferation of federal business regulations (which now run thousands of pages), the radiations of Obamacare, continuing low labor participation rates, under-employment and difficulties in projecting future borrowing costs contribute to the precarious state of our economy. Unpredictability and volatility combine to repress business growth. In the current unstable business environment, a threat emerges as the Sustainability Accounting Standards Board (SASB) demands that American businesses be subjected to a new, regulatory reporting regime that requires disclosures in 10-Ks about Sustainability or Environmental, Social and Governance (ESG) data.

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Launched in 2012, the SASB is promoted by individuals and entities that believe ESG information is unreported information that is material to investing decisions. The SASB, structured to mimic the operation of the Financial Accounting Standards Board (FASB), asserts that reporting of ESG data should be required by the Securities and Exchange Commission in 10-Ks because present reporting focuses solely on financial information to the exclusion of non-financial sustainability information. ESG information purportedly affects a corporation's long-term value creation through the way a company uses resources and impacts the environment and society.

The SASB is issuing industry-specific standards for 10-K disclosures of material sustainability issues. SASB specifies that reasonable investors are the primary targets of its proposed industry-wide standards for reporting of ESG performance as a necessary complement to current financial reporting in 10-Ks based on financial statements that are fairly presented in accordance with generally accepted accounting principles. SASB deems ESG information equal in importance to financial information. The SASB and its proxies are attempting to create the illusion of a tsunami of adoring acolytes to overwhelm anyone who questions their new 10-K proposals.

Under the guise of sustainability, the SASB would change current reporting requirements. 10-Ks would contain not only material information presently required by the SEC, but also non-financial ESG information not presently required. No longer would revenue and net income be the primary considerations. The new sustainability reporting would include disclosure about natural (environmental), human and social ''capitals'' that SASB says would measure a company's ability to produce sustained, long-term value creation and overall value to society, which SASB asserts is material to investment decisions. By equating financial capital on which traditional reporting is based with social capital, an amorphous and ill-defined term, the SASB attempts an end run around current SEC reporting requirements.

Ironically, SASB's complex proposals were made at the same time that the SEC issued a report providing a framework for comprehensive disclosure reform and the development of specific recommendations aimed at streamlining reporting requirements.[1]

History of the IIRC. Launched in 2010 before the SASB existed, the International Integrated Reporting Council (IIRC, originally called the ''Committee'') is a London-based organization designed to create a globally acceptable framework for providing integrated reporting, a manifestation of the European Sustainability (ESG) movement. IIRC Integrated Reports attempt to link in a single report the disclosure of a company's strategies, governance and financial performance with information about social and environmental matters pertinent to operations. Those integrated reports purport to disclose how a business intends to increase its value over time.

In April 2013, the IIRC issued a Consultation Draft (CD) of its proposed framework for developing standards. The CD was finalized in December 2013 with the issuance of the International <IR> Framework (IR). The CD and the IR require disclosure about entity value creation not limited to traditional financial capital and financial reporting but also including non-financial information about a business's forms of capital (manufactured, intellectual, human, social, natural) that reflect interests of stakeholders of the reporting entity who are not shareholders (employees, customers, suppliers, business partners, communities, non-governmental organizations, environmental groups, legislators, regulators, policy-makers). IIRC integrated reports claim to disclose how key non-shareholder stakeholders are treated by reporting entities and how operations of reporting entities affect those self-designated stakeholders and the external environment. The CD and the IR define material disclosure as information which ''could'' substantively affect assessments of primary intended report users about value creation.[2] While providers of capital are expected to be the primary users of the IIRC's integrated reports, the broader category of stakeholders is expected to benefit from those reports because, according to the IIRC, the interests of providers of financial capital who take a long-term view of value creation are expected to align over time with the interests of other stakeholders.[3]

Supporters of the IIRC have stated that Western capitalism must be questioned following the banking crisis in 2007 and should be ''rebooted'' because of a present over-emphasis on short-term financial information. This philosophy has already borne fruit in the European Union where, starting in 2015, stock exchange listed companies will no longer be required to report quarterly results. Instead semi-annual reporting will be required.[4] A reduction in timely information provided to investors will theoretically improve upon the capital allocation process critical to capitalism. This thinking is alien to U.S. investors.[5] Semi-annual reporting in the U.S. would violate the axiom that the market wants all current information.

The ''less is more'' reporting approach demonstrates a divide between the philosophies in the EU and the U.S. about what constitutes necessary, useful information for investors. The EU's position is paternalistic. It tells investors that they do not know what is good for them and that they should not have information that leads to bad investing behavior. The U.S. believes the opposite, the more timely that disclosure of useful information, the more rational the investment decision. Excluding material information from the market does not improve market efficiency. In the upside down world of the EU, home of the IIRC and the sustainability movement, the EU's Commissioner for Internal Market and Services announced that the new directive is an advance in efforts to make European companies more ''responsible and transparent.''[6] Moreover, quarterly information, while useful to some investors, is not necessary for investors' protection.[7] According to EU logic, depriving investors of timely information improves transparency. Logically then transparency would improve even more if the EU reduced required reporting to an annual basis!

History of the SASB. After commencing operations in 2012, in 2013 the SASB, which operates in the U.S. as a separate entity but echoes the IIRC, issued a Conceptual Framework Exposure Draft (CFD) of proposed standards.[8] The CFD asserted that reasonable investors need not only material information that is presently required in 10-Ks, but also material non-financial ESG information not presently reported in 10-Ks. SASB said that its goal was to ''broaden'' the definition of materi-

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[1] Sec. & Exch. Comm'n, Report on Review of Disclosure Requirements in Regulation S-K (December, 2013), *available at* http://www.sec.gov/news/studies/2013/reg-sk-disclosure-requirements-review.pdf

[2] Int'l Integrated Reporting Council, The International <IR> Framework 33 (2013) ; Int'l Integrated Reporting Council, Consultation Draft of the International <IR> Framework 36 (2013) [*hereinafter* CD]

[3] IR, *supra* note 2, at 4; CD, *supra* note 2, at 8.

[4] Anne-Kathrin Meves, *EU Abandons Quarterly Reporting for Listed Companies*, CFO Insight, June 3, 2013, *available at* http://www.cfo-insight.com/reporting-forecasting/forecasting/eu-abandons-quarterly-reporting-for-listed-companies/.

[5] *Id.*

[6] *Id.*

[7] Press Release, European Commission, Proposal for Directive on transparency requirements for listed companies and proposals on country by country reporting—frequently asked questions (Oct. 25, 2011), *available at* http://europa.eu/rapid/press-release_MEMO-11-734_en.htm.

[8] Sustainability Accounting Standards Bd., SASB Conceptual Framework Exposure Draft (2013), *available at* http://www.sasb.org/wp-content/uploads/2013/06/SASB-Conceptual-Framework-Exposure-Draft.pdf [*hereinafter* CFD].

   ISSN 0037-0665

ality presently used in 10-Ks and to recognize that businesses should present material social and environmental costs to investors and society.[9] The CFD stated that material information about all ''capitals'' (both financial and non-financial) pertinent to discussing value creation should be included in management discussion and analysis of 10-Ks.[10] SASB specified that it intended to develop and issue industry-wide standards to report ESG performance.[11] The SASB said it would develop those standards primarily for the benefit of providers of capital, but would determine materiality by considering input from different types of stakeholders.[12]

The SASB's CFD. The CFD expressly stated that SASB would develop its standards for sustainability issues in a manner that was complementary to that which appeared in the IIRC's then extant CD.[13] SASB dutifully explained that the two frameworks were ''fully aligned'' on many core concepts of integrated reporting, including materiality and accounting for capitals.[14] In the CFD, the SASB defined materiality by applying the U.S. Supreme Court's standard that an omitted fact is material if its disclosure probably ''would'' have been viewed by a reasonable investor as significantly altering the total mix of information previously made available.[15] However, the CFD simultaneously relied on an FASB Concepts Statement that asserts information is material if omitting or misstating it ''could'' influence decisions that users make relying on financial information of a specific reporting entity.[16] The CFD emphasized that the SASB's application of materiality was ''fully aligned'' with the IIRC's definition, which also applied a ''could'' influence standard. Thus the CFD presented inherently inconsistent definitions of materiality, interchanging and confusing ''would'' with ''could.''

The SASB CF and Materiality. SASB's final Conceptual Framework (CF), issued in October 2013, stated that SASB's concern was to ''account for'' forms of capital in addition to financial capital and to report on corporate governance, collectively, ESG information.[17] ESG information will be reported side by side with traditional financial reporting primarily for the benefit of reasonable investors who rely upon information about long-term value creation.[18] In short, SASB believes that ESG information should be mandatorily included in 10-Ks because it is of equal importance to traditional financial information. To achieve this, SASB will develop industry-wide standards and will consider input from a broad range of participating stakeholders, including non-investors.[19] That input will be used, among other things, to assess materiality of information by industry.[20]

In the CF, SASB tried to clean up its definition of materiality by simply excising its prior CFD reference to attempting to ''broaden'' the definition of materiality and removing its CFD statement that the SASB's use of materiality was ''fully aligned'' with that of the IIRC. However, the CF perpetuated SASB's reliance on FASB's entity-specific definition that information is material if omitting it or misstating it ''could'' influence decisions that users make relying on financial reporting of a specific reporting entity.[21]

The SASB misinterprets the meaning of materiality. In its CF, initially the SASB asserts that it relies on the definition of materiality derived from the seminal 1976 U.S. Supreme Court case (*TSC v. Northway*) that an omitted fact is material if its disclosure *would* have been viewed by the reasonable investor as significantly altering the total mix of available information.[22] Incredibly, the SASB simultaneously relies upon a definition of materiality that directly *contradicts TSC v. Northway*. SASB states that its disclosure guidance and industry accounting standards ''are likely to be material to a company within that industry'' and that this approach is *consistent* with FASB's approach to an entity-specific materiality determination.[23] SASB's CF quotes approvingly from an FASB Concepts Statement which says, ''Information is material if omitting it or misstating it *could* influence decisions that users make on the basis of the financial information of a specific reporting entity.''[24] Clearly, SASB and FASB rely on a definition of materiality different from that of *TSC v. Northway*, in which the Supreme Court, 8-0, reversed the U.S. Court of Appeals for the Seventh Circuit *because* of the distinction between *would* and *could*. Either the SASB agrees with the Supreme Court's definition of *materiality* or with the FASB definition. Using contradictory definitions is intellectually muddled.

In determining materiality, SASB will evaluate evidence of interest to different types of stakeholders, including non-investors, purportedly on behalf of the reasonable investor.[25] The CD defines stakeholders broadly and is replete with statements that SASB considers the views of all stakeholders.[26] The SASB says it will collaborate with a broad range of industry stakeholders when setting standards.[27] Moreover, up to one-third of the standard setting industry working groups will not include investors or the corporations in which they invest.[28] SASB effectively equates input from investors and non-investors in determining materiality of industry-wide ESG issues and pretends that investors benefit. However, *only* investors put up risk capital. They are the only participants whose pocketbooks are affected by materiality judgments. Yet SASB expects investors to risk their money without having the absolute voice. SASB says that today's investor and the market are ignorant of information needed to make reasonable

[9] *Id.* at paras. 1.13, 1.15, 1.19.
[10] *Id.* at paras. 3.6-3.9, 3.21, 3.31, 3.32, 6.1.
[11] *Id.* at para. 3.17.
[12] *Id.* at paras. 3.58, 3.59, 4.3.
[13] *Id.* at paras. 7.1, 7.3.
[14] *Id.* at para. 7.5.
[15] *Id.* at para. A1.3
[16] *Id.* at para. 3.16; Fin. Accounting Standards Bd., Conceptual Framework: Statement of Financial Accounting Concepts No.8 (2010).
[17] Sustainability Accounting Standards Bd., Conceptual Framework (2013), *available at* http://www.sasb.org/wp-content/uploads/2013/10/SASB-Conceptual-Framework-Final-Formatted-10-22-13.pdf [*hereinafter* CF].
[18] *Id.* at 3.
[19] *Id.* at 9-12.
[20] *Id.* at 8-10, 13.
[21] *Id.* at 9.
[22] 426 U.S. 438, 449, June 14, 1976.
[23] CF, *supra* note 17, at 8-9.
[24] *Id.* at 9.
[25] *Id.* at 13-15.
[26] *Id.* at 8, 12, 14-15, 20, 22.
[27] *Id.* at 20.
[28] *Id.* at 22.

investment decisions. Implicitly, investors who risk capital are irrational.

The SASB desperately needs the SEC to accept its position on the materiality of ESG information and the methods for defining materiality. SASB's position creates a conflict between investors and non-investors, including activists whose input affects the SASB's evaluation of materiality and whose interests may be biased against judgments made by management. As a matter of law, management works for investors in a reporting company.

Disguised as social concern, the SASB attempts to circumvent a U.S. Supreme Court decision but does not explain why sustainability information is material to investors. Weak attempts at justification state that sustainability issues *can* create direct financial impact on companies and affect assets and liabilities.[29] Moreover, issues having long time horizons *could* present significant investor risk.[30] SASB's proposal identifies sustainability topics at an industry level which *may* be material to a company.[31] Such speculation about future financial impact does not satisfy the ''*would consider important*'' definition of materiality of the securities laws. SASB acknowledges that negative environmental and social considerations do not currently affect the financial returns of companies.[32] SASB does admit that ''companies are already required by law to disclose material sustainability information.''[33] SASB does not explain why additional disclosure makes sense. If the SASB is *not* attempting to ''broaden'' the definition of materiality, just what is SASB seeking to achieve? Stripped of rhetoric, SASB proposes that the SEC change the definition of materiality established by the U.S. Supreme Court to serve the SASB's social agenda.

MD&A. SASB wants the SEC to include ESG information in the MD&A sections of 10-Ks.[34] MD&A is the SEC's required commentary by management about *financial statements*. ESG information does not satisfy that criterion. Indeed, SASB specifically describes sustainability reporting as ''non-financial.''[35] Tactically, placing ESG information in MD&A would equate the importance of sustainability data with financial information.

Reporting companies are presently required to consider and report in MD&A known trends or uncertainties that have had or are reasonably expected to have material effects on revenues or income from continuing operations. Similarly, if management is aware of events that will cause a future material change in the relationship between revenues and costs, the change in that relationship must be disclosed. Management is also expected to describe known material events or uncertainties that will cause historical information not to be necessarily indicative of future operating results or future financial condition. Moreover, when evaluating whether that information should be disclosed, management must consider both: (a) whether there is a reasonable likelihood that a known trend, demand, commitment, event or uncertainty will occur; and (b) whether there is a reasonable likelihood that the occurrence will have a material effect on results of operations or financial condition.[36]

In February 2010, the SEC promulgated extensive guidance for reporting companies about circumstances that require disclosure related to climate change.[37] The Commission observed that depending on facts and circumstances, climate change disclosures may be required by several existing SEC regulations about business description, legal proceedings, risk factors and/or MD&A. Release 9106 discusses and provides examples of disclosure requirements that may be triggered by: (1) the impact of existing and pending legislation and regulations; (2) international accords; (3) indirect consequences of regulations on business trends; and (4) physical impacts of climate change. The Commission emphasizes that disclosures are required for the matters described above if they are material as defined in *TSC v. Northway*. The interpretive Release does not purport to expand on or change that definition. Notwithstanding the importance of Release 9106 including the examples provided, the SASB's CF, written more than three years after the Release was issued, makes no reference to Release 9106 and does not suggest that the Release was even considered by the drafters of the CF. Because SASB asserts that the information it proposes be added to 10-Ks should appear in MD&A, SASB's failure to consider and discuss Release 9106 is inexplicable.

If, after considering Release 9106, SASB believes that the Release does not adequately require the disclosure of material information about climate change, SASB has not articulated its reasoning. If SASB believes that Release 9106 *already* requires those disclosures necessary to understanding material information about climate change, then SASB's CF is irrelevant.

For Whose Benefits Are the Securities Laws Written? SASB seeks more than the reporting of ESG information for investors. SASB declares that sustainability issues such as climate change, water and political contribution *should be* considered by investors, the public *and* government agencies.[38] When developing standards including materiality, supposedly for investors, SASB admits that ''broader benefits to society will be considered, including improved market stability and more sustainable development.''[39] The SASB insinuates its own social agenda to expropriate from investors their *exclusive* right in the U.S. to define materiality.

Historically, the SEC has promulgated 10-Ks for use by investors. Yet the SASB's proposals for disclosures in 10-Ks mean that investors and non-investors are participating stakeholders. If SASB were to succeed, would management have to disclose in 10-Ks whether it agreed with disparate interests of stakeholders? Requiring disclosures in 10-Ks about how management has taken those interests into account would invite disgruntled non-investor stakeholders to state that their interests were disregarded. That would create significant

[29] *Id.* at 15, 16.
[30] *Id.* at 13.
[31] *Id.* at 19-20.
[32] *Id.* at 16.
[33] *Id.* at 11.
[34] *Id.* at 23.
[35] *Id.* at 3.

[36] 17 C.F.R. § 229.303 (Item 303) (2013).
[37] SEC Securities Act Release No. 33-9106 and Securities Exchange Act Release No. 34-61469, Commission Guidance Regarding Disclosure Related to Climate Change, Feb. 2, 2010 (Release 9106).
[38] CF, *supra* note 17, at 19, 14, 15.
[39] *Id.* at 11.

   ISSN 0037-0665

securities laws exposure based on assertions by parties that have *no* interest in the investing process but do have a *vested* interest in redefining materiality. The increased cost of doing business would include new costs of potential litigation, information collection and verification of that information. The SASB dismisses the enormous financial burden imposed on companies, especially smaller companies, by its proposed new regulations. What an invitation to sue existing corporations for providing inadequate and misleading information! In the words of Fagin in the musical film version of *Oliver*, ''You've got to pick a pocket or two.''

The well-funded SASB is hiring staff and developing industry standards for sustainability reporting. It has completed provisional standards for health industry reporting. Most recently the SASB issued provisional standards for seven industries in the financial sector. In 2013, the IIRC entered into an agreement with the International Accounting Standards Board (IASB) to assist the IIRC in furthering its ESG proposals.[40] In January 2014, the SASB and the IIRC agreed to cooperate, collaborate, and align their efforts to develop and promote sustainability reporting.[41] The SASB, IIRC and IASB troika recognize that convincing the SEC to require sustainability reporting is critical to the furtherance of their cause. Voluntary disclosure proposals will fail because companies will avoid the additional costs of reporting and potential litigation. Only a regulatory hammer wielded by the SEC can guarantee success to the trio.

The SEC enforces our securities laws for the benefit and protection of reasonable investors, not for non-investor ''stakeholders.'' As stated in case law, ''The securities laws are written [for] an 'Economic Man' . . . whose sole motivation is . . . to employ his capital so that its produce may be of greatest value . . . He intends only his own security, only his own gain.''[42] SASB knows that directly seeking support for its goals by introducing legislation in Congress would fail. SASB and its allies believe that American business is inherently untrustworthy and must bear greater regulation for an undefined common good. SASB must convince the SEC that it has the power and obligation to mandate the inclusion of ESG reporting in 10-Ks. Can the SASB persuade the SEC to transform free market capitalism into a social compact? As the sustainability reporting project advances rapidly, its broad changes threaten U.S. free enterprise under the pretense of furthering good causes. This stealth initiative commands investor and management vigilance.

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[40] Press Release, IFRS, IASB and IIRC Formalise Cooperation on Work to Develop Integrated Corporate Reporting Framework (Feb. 7, 20130, *available at* http://www.ifrs.org/Alerts/PressRelease/Pages/IASB-and-IIRC-sign-MoU.aspx

[41] Press Release, Sustainability Accounting Standards Bd., SASB and IIRC Announce Memorandum of Understanding (Jan. 15, 2014), *available at* http://www.sasb.org/category/news-archive/

[42] *Chock Full O'Nuts Corp.v. Finkelstein*, 584 F. Supp. 212, 219 (1982).