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ACCOUNTING PRINCIPLES

As the World Turns, So Must Its Markets

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A lot has changed in the past four decades. Here's why disclosure standards need to evolve.

It's been roughly 2,500 years since the Greek philosopher Heraclitus observed that our universe's only constant is change. By comparison, a scant 72 have passed since Austrian-American economist Joseph Schumpeter coined the phrase ''creative destruction'' to describe the process through which capitalism perpetually reinvents itself. The similarities between these insights are unmistakable and instructive. Like Heraclitus' river, our economy flows ever onward; driven by innovation and fueled by free-market forces, it revolutionizes itself from within.

In today's world, management of risks and opportunities not reflected in financial statements influences corporate success. In fact, mega-trends like population growth, climate change, and resource constraints can and do have a profound effect on business outcomes. For example, insurance companies must identify the vulnerability of their insured assets to rising sea levels, increasing drought, and more severe winters. Hardware companies must consider how to source minerals from unstable regions where mining can fuel conflict. Credit card companies must consider how to protect against data breaches. These are just a few examples of how these trends already affect business outcomes and consequently must affect financial reporting. This is a natural evolution and one already recognized by investors who are requesting information on such issues as how a company is prepared for the potential challenges and opportunities presented by resource constraints, climate change, population growth, and emerging markets.

The dynamic of a changing world and changing investor focus is perhaps most readily apparent in our financial markets, where the difference between the book values listed on balance sheets and the market values reflected in stock prices grows wider each year. In 1975, only 17 percent of the assets in the S&P 500 were intangible; in 2010, the number was 80 percent.[1] When market valuations are increasingly based on intellectual capital, market share, brand value, and other ''soft'' assets that create shareholder value in a knowledge-driven economy, traditional financial statements tell only a part of the story. This point has long been acknowledged by the Financial Accounting Standards Board (FASB).[2] Investors are looking beyond financial statements, to environmental, social, and governance (ESG) issues and other concerns that are particularly relevant to investors in an economy dominated by intangible assets.

It is in the context of this shifting economic landscape that we are compelled to respond to an Aug. 4, 2014, Securities Regulation & Law Report article entitled ''The Sustainability Accounting Standards Board, Insurance Companies and the SEC,'' which misapprehends SASB's goals and purpose and misconceives SASB's approach and methodology. To be clear, we share the authors' deeply held conviction that ''excluding material information from the market does not improve market efficiency.''[3] Nevertheless, we are equally convinced that the information that is ''material'' to

[1] Ocean Tomo, Components of S&P 500 Market Value (2010), *available at* http://www.oceantomo.com/productsandservices/investments/intangible-market-value.

[2] FASB Business Reporting Research Project, Improving Business Reporting: Insights into Enhancing Voluntary Disclosures (Jan. 29, 2001), *available at* http://www.fasb.org/brrp/brrp2.shtml.

[3] ''The Sustainability Accounting Standards Board, Insurance Companies and the SEC,'' by Samuel P. Gunther, Richard H. Murray and Sheila A.S. Gunther, Bloomberg BNA Se-

investors—much like the world around it—is rapidly changing (indeed, has changed). In today's world, investors need and are demanding both financial statements and other material information to make informed decisions.

The Legal Basis for Sustainability Disclosures. Regulation S-K, as prescribed under the Securities Exchange Act of 1934, lays out the reporting requirements for SEC filings by corporate issuers and already requires companies to disclose material information on the Form 10-K. Pursuant to Item 303, companies are required to disclose their financial condition and results of operations, and to provide management's view on known trends or uncertainties that are reasonably expected to have a material impact on liquidity, capital, sales, revenues, or income.

The materiality of a fact is defined by the U.S. Supreme Court:

> ''There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.''[4]

This definition of materiality has a singular and unwavering focus on the reasonable investor's decision to buy, sell, or hold a security.

A determination of materiality may be complex. In Staff Accounting Bulletin No. 99—Materiality, the SEC states that companies should not rely on financial thresholds or rules of thumb to make ultimate materiality determinations. For example, the Bulletin rejects the rule of thumb that a misstatement or omission of less than five percent is not material.[5] Instead, the Bulletin states that ''an assessment of materiality requires that one views the facts in the context of the 'surrounding circumstances,' as the accounting literature puts it, or the 'total mix' of information, in the words of the Supreme Court.'' In other words, one must ''consider both 'quantitative' and 'qualitative' factors in assessing an item's materiality.''[6] This interpretation is supported by auditors' professional standards, which state that ''materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.''[7]

Rising Investor Demand for Sustainability Disclosures. As investors increasingly recognize the financial impact of factors not reflected in financial statements, their demand for this information is growing. A recent global survey of institutional investors found that, during the past 12 months, assessment of performance on ESG issues ''had played a pivotal role in their investment decision-making process'' for 90 percent of the responding investors.[8] The report concluded that analysis of these issues ''can no longer be dismissed as a niche approach to investment.''[9]

While investor demand for information in addition to that contained in financial statements is rising, the availability and quality of this information needs improvement. Investors are engaging in fairly unproductive and costly means to get the information they need—89 percent of global institutional investors[10] responding to another recent survey say they will request sustainability information directly from the company, and 50 percent report they are ''very likely'' to sponsor or co-sponsor a shareholder proposal.[11] Significantly, two-thirds of these investors say that they would be more likely to consider this type of information when making investment decisions if common standards were used.[12] In order to use such information, investors need complete data sets and comparable data they can use to benchmark and compare companies. Enabling the production of such data and benchmarks is what SASB does.

A Market-Driven Response. The Sustainability Accounting Standards Board was created to fill the market need for standardized disclosure of sustainability information. SASB's mission is to develop and disseminate sustainability accounting standards that help publicly listed corporations disclose material factors in compliance with SEC requirements.

SASB standards follow the U.S. Supreme Court's definition of material information, defined as presenting ''a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ''total mix'' of information made available.''[13] They provide a model for reporting material sustainability factors in the MD&A section of the Form 10-K, which ''shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) matters that would have an impact on future operations and have not had an impact in the past, and (B) matters that have had an impact on reported operations and are not

curities Regulation & Law Report (Aug. 4, 2014) [hereinafter SASB, Insurance Companies and the SEC].

[4] *TSC Industries, Inc. v. Northway, Inc.* (426 U.S. 438, 449, June 14, 1976), *available at* http://caselaw.lp.findlaw.com/scripts/getcase.pl?navby=CASE&court=US&vol=426&page=438 [hereinafter TSC].

[5] Securities and Exchange Commission, 17 CFR Part 11, SEC Staff Accounting Bulletin No. 99 – Materiality (August 11, 1999), *available at* http://www.sec.gov/interps/account/sab99.htm.

[6] *Id.*

[7] American Institute of Certified Public Accountants, AICPA Professional Standards, AU § 312.10 (2013), *available at* http://www.aicpa.org/Publications/AuthoritativeStandards/Pages/AuthoritativeStandards.aspx.

[8] Survey respondents represented large financial institutions such as third-party investment managers, banks, pension funds, foundations, endowments, sovereign wealth funds, insurance companies, and family offices. Fifty-nine percent of respondents worked for institutions with more than $10 billion in assets under management.

[9] EY, Tomorrow's investment rules: Global survey of institutional investors on non-financial performance (2014), *available at* http://www.ey.com/Publication/vwLUAssets/EY-Institutional-Investor-Survey/$File/EY-Institutional-Investor-Survey.pdf.

[10] Survey respondents represented asset managers, pension funds, and other types of institutional investors with combined assets under management of more than $7.6 trillion.

[11] PwC, Sustainability goes mainstream: Insights into investor views (2014), *available at* http://www.pwc.com/en_US/us/pwc-investor-resource-institute/publications/assets/pwc-sustainability-goes-mainstream-investor-views.pdf.

[12] *Id.*

[13] TSC.

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expected to have an impact upon future operations.''[14] Companies can voluntarily use SASB standards to help them comply with Regulation S-K, to meet the SEC-required disclosure obligation found in the MD&A, and provide management's view of their company's future prospects. This is wholly consistent with SEC guidance on the purpose of the MD&A,[15] contrary to suggestions that ESG information does not belong in the MD&A[16] and that disclosures made according to SASB standards ''directly encroach on the domains of the FASB and the SEC.''[17]

As a private sector body, SASB does not and cannot require disclosures or mandate disclosure standards, nor does it purport to do so. Rather, SASB develops standards that assist companies in fulfilling *existing* regulatory requirements *as they deem necessary*. However, the final determination of materiality is the onus of the corporation—this is consistent with the Supreme Court's explanation that the determination of materiality is an ''inherently fact-specific finding.''[18] Moreover, SASB is in direct periodic communications with the SEC, the FASB, the PCAOB, and others concerned with the regulation of financial disclosures to ensure that its activities support the SEC's authority to prescribe and enforce disclosure standards.

SASB standards are rooted in evidence, informed by industry expertise, and shaped by consensus. The standards development process begins with a three-month research phase. Evidence of investor interest is assessed by searching tens of thousands of source documents—including Form 10-Ks, shareholder resolutions, and SEC comment letters—for key words related to 43 general sustainability issues. This ''heat map'' provides initial indication of investor interest in certain issues. Evidence of financial impact is gathered by examining, among other things, sell-side research, investor call transcripts, third-party case studies, and news articles for evidence of impact on revenue, costs, assets, liabilities, and cost of capital. After identifying a minimum set of issues for an industry, for which there is solid evidence of both investor interest *and* financial impact, SASB identifies and documents existing metrics and practices used to account for performance on each issue. SASB standards are then refined through feedback received via balanced industry working groups, a 90-day public comment period, and review by an external, independent standards council composed of experts in standards development, securities law, environmental law, metrics, and accounting.

Corporate issuers and investor users are driving the creation and adoption of SASB standards. To date, more than 1,890 experts representing $21 trillion assets under management and $9.5 trillion market capital have participated in SASB's standards development process.

SASB has issued standards for 27 industries in four sectors, which constitutes 40 percent of SASB's planned work. SASB will issue standards for 80+ industries in 10 sectors by 2016.[19]

A Natural Progression. SASB is not calling for a new regulatory regime. Rather, SASB's objective is to improve the completeness of material information made available to investors via existing regulatory requirements and in compliance with U.S. securities law. Today, investors do not have all the information they need to determine how companies are adapting to a changing reality and to compare companies in the same industry with each other. SASB standards enable a natural progression in the evolution of the information available to the capital markets.

Aulana Peters has served as Commissioner of the SEC, a member of the Steering Committee for FASB's Financial Reporting Project, a member of the AICPA's board of directors, and its Public Oversight Board. She was also a member of the POB's Blue Ribbon Panel on Audit Effectiveness. She was awarded the ASECA William O. Douglas Award as well as the AICPA Medal of Honor, the highest honor presented to a non-CPA. A retired partner of a prominent Los Angeles law firm, Ms. Peters currently serves on the board of directors for SASB.

Elisse B. Walter served as the 30th Chairman of the SEC during a five-year term as Commissioner. Previously she was Senior Executive Vice President, Regulatory Policy & Programs, for the Financial Industry Regulatory Authority. Ms. Walter has received, among other honors, the Presidential Rank Award (Distinguished), the ASECA William O. Douglas Award, the SEC Chairman's Award for Excellence, the SEC's Distinguished Service Award, and the Federal Bar Association's Philip Loomis and Manuel F. Cohen Younger Lawyer Awards. She currently serves on the board of directors for SASB.

[14] 17 CFR § 229.303, Regulation S-K, Item 303(a) Management's discussion and analysis of financial condition and results of operations, *available at* http://www.gpo.gov/fdsys/pkg/CFR-2011-title17-vol2/pdf/CFR-2011-title17-vol2-sec229-303.pdf.

[15] *See*, for example, Interpretation: Commission Guidance Regarding Disclosure Related to Climate Change, Securities and Exchange Commission, 17 CFR Parts 211, 231 and 241 (February 2, 2010), Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities and Exchange Commission, 17 CFR Parts 211, 231 and 241 [Release Nos. 33-8350; 34-48960; FR-72] (December 29, 2003), and SEC Docket (1973-2004), 43 SEC-DOCKET 1330-129, Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities and Exchange Commission, (May 18, 1989).

[16] ''The Securities Laws and the Sustainability Accounting Standards Board'' by Samuel P. Gunther, Richard H. Murray and Sheila A.S. Gunther, Bloomberg BNA Daily Environment Report (March 19, 2014).

[17] SASB, Insurance Companies and the SEC.

[18] *Matrixx Initiatives, Inc. v. Sircusano*, 131 S.Ct. 1309 (2011), *available at* http://www.supremecourt.gov/opinions/10pdf/09-1156.pdf.

[19] Sustainability Accounting Standards Board website, *available at* http://www.sasb.org