Durham University Business School

Professor Carol Adams[1] BA MSc PhD CA FAICD
Professor of Accounting
Durham University Business School

Andreas Barckow
Chair, International Accounting Standards Board

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Comment letter on the Exposure Draft on the Management Commentary Practice Statement

I appreciate the opportunity to provide feedback on the Exposure Draft. I have been following developments and evidence provided to the IASB in Board papers in connection with this revision over several years. Over that time the management commentary (narrative reporting) that organisations provide has improved in quantity and quality due to regulation, Stock Exchange requirements, increasing take up of the GRI Standards and the influence International <IR> Framework[2]. Importantly, **companies are communicating their approach to value creation for the organisation *and their stakeholders* to a broad range of stakeholders** – not just investors and creditors[3].

The Exposure Draft contains some good examples and guidance. The issues I raise below address the fit of the conceptual approach with examples you provide and current reporting practice. There is a substantial body of research that strongly indicates that prioritising enterprise value, cash flows and investors will not lead to the disclosures you seek, will not change corporate behaviour and will be detrimental to reporting organisations and their investors. The prioritisation of financial materiality in considering sustainable development risks and opportunities and the impact of the organisation on sustainable development has contributed to human and labour rights abuses, environmental degradation – and the situation outlined in the recent report of the Intergovernmental Panel on Climate Change[4].

My comments relate mainly to consultation questions 3, 7, 8, 9 and 11.

[1] My background relevant to this submission is here.
[2] See https://www.carrotsandsticks.net/, A4S (2021) and KPMG, (2020)
[3] Adams, Potter, Singh and York (2016); Arora, Lodhia and Stone (2021)
[4] See https://www.ipcc.ch/ (IPCC, 2021)

Durham University Business School
Mill Hill Lane Durham DH1 3LB United Kingdom

T: +44 (0)191 334 5200
durham.ac.uk/business

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Audience

Reporting organisations intend their narrative reporting (management commentary) for a wider audience than investors and creditors. A Management Commentary Practice Statement should enable these intentions - not diverge from them in ways that will limit take up and confound the stated aim of the IFRS Foundation Trustees to harmonise reporting. It would then also assist public, private and third sector organisations that do not apply IFRS Standards and are not funded by institutional investors.

Definition of value

Para 3.11 states: *"In this [draft] Practice Statement, 'ability to create value' refers to an entity's ability to create or preserve value for itself and hence for its investors and creditors. Some people refer to the value an entity creates for itself as 'enterprise value'"*.

Businesses recognise that value creation for the enterprise is dependent on creating value for a range of stakeholders. However, research demonstrates that without *explicit* encouragement there is little disclosure of matters that are: a) not quantifiable in monetary terms; and/or b) unlikely to affect enterprise value in the short term[5]. This is demonstrated by the nature of pandemic and climate risks disclosed by large, highly impacted companies - for example, limited disclosure of the physical risks of climate change even where they have potentially significant consequences for cash flows and enterprise value[6]. Ascertaining the likelihood of such risks and the nature and magnitude of their impact on 'enterprise value' or cash flow is fraught with difficulty. It is a resource intensive exercise that cannot provide a complete picture. **Corporate leaders need to be able to manage complexity and information in different forms. Investors need information to assess their ability to do so.**

The para 3.11 definition will curtail disclosure related to areas of content listed in para 4.1 (such as strategy, resources and relationships, risks, trends). It will curtail reporting on sustainable development risks and opportunities where monetary implications are uncertain. An alternative conceptual approach that encourages such disclosures is provided in the *SDGD Recommendations* which draw on existing frameworks and consultation input[7]. This aligns with the TCFD recommendations, GRI Standards set by the Global Sustainability Standards Board, International <IR> Frameworks and the approach taken by EU[8].

[5] The submission to the IFRS Foundation Trustees on their consultation on sustainability reporting from Professor of Accounting researching sustainability accounting and reporting noted: "A profit and financial materiality focus leads sustainability reporting to make a negative impact on or reduced contribution to sustainable development" (Adams, 2017a; Michelon et al., 2020; O'Dwyer and Unerman, 2020; Schaltegger and Burritt, 2018; Schneider et al., 2017; Unerman et al., 2018). This applies to reporting on sustainable development risks and opportunities.

[6] See Abhayawansa and Adams (2021) or this summary.

[7] See Adams with Druckman and Picot (2020) and Adams (2020) both available here.

[8] See Double materiality high level policy dialogue key-takeaways

Identification of key matters

Key matters considered in para 4.7 are those that are *"fundamental to the entity's ability to create value and generate cash flows, including in the long term".*

Many of the matters that pose the biggest threats to a business cannot be directly linked with enterprise value or cash flows. The guidance on risks that should be disclosed (para 8.7) is a good starting point but unlikely to be adhered to, nor other key matters disclosed, where the overarching criteria is cash flows and enterprise value. **There is a mismatch between the conceptual approach you propose and what you seek to see reported.**

A contradiction

This mismatch is underscored by para 12.6:

> "Narrative reporting requirements or guidelines published by, for example, an industry body or an organisation with an interest in sustainability reporting could help management identify information that might be material. *This is more likely to be the case if the requirements or guidelines have a reporting objective that, like the objective of management commentary set out in this [draft] Practice Statement, focuses on the information needs of investors and creditors. If the requirements or guidelines have a different reporting objective, they might not specify all information about a matter that is material to investors and creditors* or, conversely, might specify some information that is not material to investors and creditors." *[Emphasis added]*

Identifying all material matters from an enterprise value perspective (para 5.7 c) requires considering the material sustainable development impacts *of* an organisation from a multi-stakeholder perspective. If this is not done, it is possible that material financial impacts resulting from a company's impacts on sustainable development will be missed. These financial impacts might be a consequence of reputational damage, loss of customers, social unrest, physical climate change risks, etc arising from a negative impact on sustainable development[9]. Waiting until the enterprise value and cash flow implications of the impacts is clear is too late. You make an exception with respect to the disclosure of greenhouse gas emissions in para 5.10, where the link with enterprise value and cash flow may not be obvious. It will become obvious over time that further exceptions are needed to meet reporting demand. A double materiality approach is required to first identify an

[9] See the sustainable development risk disclosure recommendations in the SDGD Recommendations, Adams, Druckman and Picot (2020) and the consultation input to the development of the SDGD Recommendations in Adams (2020)

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organisation's social and environmental impact and then consider how, when and by how much such impacts might influence cash flows[10].

The inclusion of para 12.6 seems illogical and not backed by evidence. In effect it recommends that the Standards that are most used (those developed by GRI's Global Sustainability Standards Board[11]) should not be used. I argue that it is critical that these Standards *are* used (in addition to other commentary) to better understand the impact on stakeholders and hence the influence of key matters on enterprise value and cash flows.

Multiple capitals

Businesses increasingly think in terms of multiple capitals and seek to be accountable across them. This has been driven by the increase in the proportion of intangible assets relevant to business value and recognition that businesses rely on a range of inputs other than cash, some of which (particularly natural capital) are limited. This development was championed by The Sigma Project and Forum for the Future[12]. Consultation and research[13] commissioned by the former International Integrated Reporting Council confirmed this shift away from limiting attention and visibility to financial capital. As organisations develop approaches to their impact on the United Nations Sustainable Development Goals some are linking it to the process of enhancing or depleting capitals[14].

In summary

In summary, I believe a Management Commentary Practice Statement needs to be cognisant of: the audience for narrative reporting at the front end of annual reports; trends articulating value creation in corporate reporting; and, the urgent need to encourage wider thinking and accountability in connection with climate change and sustainable development. This requires a different conceptual premise from that articulated.

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[10] See Adams, Alhamood, He, Tian, Wang and Wang (2021) for a summary of the implications of academic research on double materiality.
[11] See KPMG (2020)
[12] See *The Sigma Guidelines – Toolkit* by Bent and Richardson (2003), Forum for the Future (2009)
[13] See the IIRC's Capitals Background Paper by Adams, Coulson, Emmelkamp, Klüth and Nugent (2013)
[14] Adams, 2017a and 2017b)

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