Green reporting: getting the numbers to add up



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Transitioning to a greener economy and reaching sustainability goals start by measuring and reporting emissions as well as intangibles like climate risk. In this interview, IESE's Gaizka Ormazabal discusses the challenges of accounting for future change.

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Net-zero emissions and sustainable development are lofty aims. How might they be tackled in Accounting and Control? In this interview, Gaizka Ormazabal, holder of the Grupo Santander Chair of Financial Institutions and Corporate Governance at IESE, sheds light on what's happening in his field, based on his research on sustainability reporting and other Environmental, Social and Governance (ESG) initiatives.

Ahead of the COP26 climate change summit in Glasgow, you joined with leading scholars in recommending "Mandatory corporate carbon disclosures and the path to net zero." Why?

To achieve net zero — that is, to cut global greenhouse gas (GHG) emissions to as close to zero as possible by 2050 — we need to measure emissions *now* and we need to report them. Measuring and reporting may seem mundane tasks, but they are extremely important for making progress. In 2022, the overwhelming majority of listed companies still do not report their carbon emissions. Among privately held companies, rates are even lower.

As such, we proposed making the disclosure of carbon emissions mandatory around the world, focusing solely on *direct* emissions — those that come directly from a company's facilities (known as Scope 1 of the Greenhouse Gas Protocol). We exclude indirect emissions — those related to the company's consumption of electricity (Scope 2) or to its supply chain (Scope 3). Frankly, we thought it would be too complicated to force companies to disclose their indirect emissions at this juncture. But mandatory Scope 1 disclosure would at least get companies to start reporting now.

That seems straightforward. Is there resistance?

Yes. We have to recognize that it is costly for a firm to begin to disclose any emissions. Managers have to learn to do it correctly, in terms of the specific accounting procedures, which are not trivial, and there is a technical component, as with financial reporting. Also, these carbon disclosures may have real consequences on the market, affecting companies' valuations. And we realize some companies don't want to disclose because their emissions are high — which is all the more reason to make them disclose, and ratchet up incentives to clean up their operations.

Do you think we'll see mandatory carbon disclosures happen? When should executives be prepared for this?

With more pressure coming from academia and society at large, as well as from Wall Street

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investors, this is the direction we're headed. It will happen sooner rather than later.

For managers, this is a big deal. Introducing any disclosure rule is, generally, a very big deal. There are always complaints and unintended consequences. To be implemented globally, a rule like this will take a fair amount of coordination. And with the latest geopolitical developments, decision makers have diverted their attention to other issues. The world is not very well coordinated right now, but I'm still hopeful.

Moving from E to the Social and Governance aspects of ESG, tell us about another paper of yours, cowritten with your IESE colleague Pietro Bonetti.

We studied an initiative in Southeast Asia to promote foreign investment and development in the region. Known as the Corporate Governance Initiative, it was launched in 2011 by the Asian Development Bank and the ASEAN Capital Markets Forum (ASEAN stands for the Association of Southeast Asian Nations). Basically, it's a list of top companies deemed by independent assessors as having the most effective corporate governance practices in place.

The governance scorecards and data that go into creating their top 50 list are not disclosed to the general public. We got involved with this project via an IESE contact — visiting professor Jesus (Jess) Estanislao, who is an economist, formerly in the Philippine government. Thanks to him putting us in contact with regulators and other relevant people in Southeast Asia, we ended up with special access to proprietary data, which we used for the study.

We show that the list is a powerful tool for international investment. Companies on the list did better in trading, attracting more investors from around the world. And boosting investment is key for the region's development. It also encourages positive governance changes in companies that want to improve their ranking.

This would seem to underscore the importance of corporate governance.

Yes, the research has a strong, positive message. It also showed there was a demand for this sort of independent, expert assessment of corporate governance practices. The list served as a sort of certification for the companies that made the cut.

What else are you working on?

I have papers underway on the use of ESG metrics in compensation contracts; on the accounting of carbon allowances; on investor demand for corporate information regarding

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climate risk; and on a green premium, or greenium, in acquisition targets.

Which issues are keeping you and your peers in accounting up at night?

There is an active debate about whether accounting numbers are less informative now than they were in the past. On companies' balance sheets and income statements, accounting numbers may mean less because we have a new economy, one that is based more on human capital and intangibles, moving away from fixed assets and fixed investments.

This is an important debate because of our traditional accounting conservatism and questions around fair-value measurements. Following a principle of prudence or caution makes sense for many reasons but it has limitations: you cannot put something in your books if it is uncertain or not tangible enough; your auditor won't let you.

So, should we make accounting less conservative to adapt to our new economy? The tradeoff with that is, the numbers may be more relevant, but they may also be less reliable because they are based on estimations and assumptions about the future. In order to better account for intangible assets or uncertainty, we need another information system beyond the current accounting system.

Are we headed toward such a system?

Sustainability and ESG initiatives are certainly moving us in that direction. Many say we should be looking at a much longer horizon than what we currently use for financial performance. Sustainability, because it is very forward-looking, is hard to measure. How can we talk concretely about climate risk when we don't know what might materialize 10 years down the road? Who knows when there is going to be some sort of climate disaster? And when you talk about the S, well, some aspects of it are even harder to measure than E. Looking ahead makes things very complicated and poses a lot of challenges. That is what accounting is dealing with right now.

On top of that, how should we regulate this? What should we make firms disclose? That is to say, which of the millions of things that potentially matter should be reported?

Given the breadth and multiple dimensions at work here, it's not surprising that standard-setters and regulators haven't come to any agreement yet. It's hard to predict how this is going to end up, so there is a lot of material to analyze now.

MORE INFO

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"Mandatory corporate carbon disclosures and the path to net zero" by P. Bolton (Columbia), M.T. Kacperczyk (Imperial College London), C. Leuz (Chicago Booth), G. Ormazabal (IESE), S.J. Reichelstein (Mannheim and Stanford) and D. Schoenmaker (Erasmus Rotterdam).

"Boosting international investment: the role of expert assessments of corporate governance" by G. Ormazabal and P. Bonetti.

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