Proposals for boundary setting in mainstream reports

Discussion paper on organizational boundary setting by groups of companies or non-financial reporting purposes

May 2014
www.cdsb.net/boundary
Purpose of discussion paper on organizational boundary setting by groups of companies for non-financial reporting purposes

This discussion paper complements CDSB’s consultation on edition 2.0 of its Framework by exploring options for organizational boundary setting by groups of companies for non-financial reporting purposes. The purpose of this discussion paper is to invite comment on seven specific proposals and on the issues raised by the paper more generally. Responses received will inform the development of Edition 2.0 of the CDSB Framework and our work on this topic. The closing date for responses is 27th June 2014. For information on how to respond please visit http://www.cdsb.net/boundary.

This paper is designed to:

1) Explore the issue of organizational boundary setting for non-financial reporting purposes and to offer suggested answers to questions that have arisen in various forums in which CDSB participates, including questions about how to distinguish responsibility from control, outcome from impact of corporate activity, how to reconcile the approach used for preparation of financial statements with non-financial information;

2) Complement CDSB’s consultation on Edition 2.0 of its Framework by prompting discussion and exchange of views about the relative merits of a single approach to organizational boundary setting for mainstream non-financial reporting purposes by corporate groups that:

   i) Aligns as far as possible with, or is capable of reconciliation to, the financial reporting boundaries /consolidation rules that are used for mainstream reporting by corporate groups primarily to existing and potential investors. Boundary setting should take account of updates in the approach to consolidation for financial reporting purposes, including the introduction of IFRS 10, 11 and 12 and of the prescriptions of law that requires disclosure of climate change-related information.

   ii) Is practical to put into operation. The best technical solution might, in the first instance, present practical difficulties for reporting organizations although this paper contends that those difficulties may be overcome through cooperation between corporate departments working on financial and non-financial information respectively;

   iii) Encourages standardization of approach to organizational boundary setting in order to facilitate the use of information by investors to allocate capital in support of sustainable development goals. Research by CDSB showed that financial institutions were not generally using climate change-related information for this purpose, in part because comparisons cannot be made between companies that prepare information by reference to different organizational boundaries.

   iv) Acknowledges practices that have already gained acceptance. WRI’s GHG Protocol team has confirmed its support for CDSB’s objectives on organizational boundary setting for corporate groups but, in recognition of the long-standing practices that have been established through widespread adoption of the GHG Protocol, is anxious that CDSB’s approach should align with one of the GHG Protocol approaches (financial control, operational control or equity share). CDSB agrees that future approaches must not add confusion to or deviate unnecessarily from practices established under the GHG Protocol.

---

1. Executive summary

3) Draft Edition 2.0 of CDSB’s Framework sets out an approach to reporting of certain environmental information in mainstream corporate reports. Edition 1.1 and its predecessor focused on climate change-related reporting in mainstream corporate reports. This paper refers to organizational boundary setting for non-financial reporting purposes generally, (rather than for climate change or environmental reporting purposes specifically), on the basis that organizational boundary setting equally affects reporting of general sustainability and other non-financial information as well as specific aspects of social or environmental information. However, some of the proposals are informed by developments in climate change-related reporting as one of the most developed and advanced areas of non-financial reporting.

4) Following an introduction, the paper is divided into three sections as follows:

(1) Section 3 sets out the general background to organizational boundary setting for non-financial reporting purposes including:
   (a) What is non-financial reporting?
   (b) Who are the parties involved in organizational boundary setting?
   (c) The language of organizational boundary setting.

(2) Section 4 examines the current state of organizational boundary setting and examples of the practices that influence it including: the GHG Protocol, the GRI’s G4 guidelines, the IIRC’s International Integrated Reporting Framework, SASB’s Standards, International Financial Reporting Standards, developments in UK and EU law and examples of corporate practice.

(3) Section 5 proposes points for discussion about organizational boundary setting, including suggested positions designed to prompt discussion on how organizational boundary setting could develop and a number of specific questions for consideration and comment. The discussion section is informed by anecdotal and other evidence about some of the challenges faced by specific sectors including the transport, real estate and extractive industries as well as by recent legislative developments in the UK that have led to increased focus on boundary setting where financial information, management commentary and non-financial information are included in the same communication.

5) Invitation to respond to the discussion paper and join the debate

We invite comment on the specific questions asked in this Discussion Paper and on the subject of organizational boundary setting for corporate reporting purposes from:

a) Groups of companies – we particularly welcome comments about the practical and governance related aspects of boundary setting within groups of companies that report similar content (e.g.: greenhouse gas emissions information) for multiple purposes (e.g.: sustainability reporting and regulatory compliance);

b) Investors and financial analysts – we invite investors and analysts to express a preference for the way in which groups of companies should approach boundary setting for reporting purposes;

c) Advisors and assurors – we are interested in hearing whether and to what extent boundary setting presents challenges for advisory and assurance work;

d) Other stakeholders.
2. Introduction

The way in which a Group of companies determines its boundaries for non-financial reporting purposes is important for numerous reasons, including transparency, comparability and benchmarking. However, different requirements and interpretations exist on whether and to what extent non-financial reporting should include information about the activities of a parent company, its subsidiaries, joint ventures, associates, investees, suppliers, upstream and downstream activities and the impacts of the Group’s activities. The structure of corporate groups can change regularly, expanding and contracting with different priorities, opportunities and economic cycles worldwide. This affects the way in which management defines the boundaries of groups of companies for reporting purposes, as do other factors including legislation, voluntary protocols, the objectives of reporting, the placement of information, financial reporting rules, the structure of the corporate group and the availability of data.

The problem this paper seeks to address

For financial reporting purposes, International Financial Reporting Standards prescribe the way in which assets, liabilities and transactions are accounted for in relation to subsidiaries, joint arrangements, associates and investments and also what disclosures should be made about interests in subsidiaries, joint arrangements, associates or investments. In the absence of an equivalent standardized approach to organizational boundary setting for non-financial corporate reporting purposes, it is not always clear how information prepared at corporate entity or facility (i.e.: physical installation) level for national regulatory purposes or under voluntary schemes is “consolidated” into a mainstream corporate report for all entities included in a corporate group. This reduces the transparency, reliability and comparability of information. For example performance indicators and intensity metrics become difficult to create, compare and understand where the boundary selected for non-financial reporting does not align with the basis on which financial or production-related information has been prepared. Performance results and inventory figures may also be distorted. For example, unpublished research shows that the choice of boundary can change greenhouse gas emissions results by as much as 73% in one case.

This paper focuses specifically on the way in which organizational boundary setting affects the usefulness and understandability of non-financial information in mainstream corporate reports. However, it acknowledges the wider context in which various supranational organizations are examining the implications that corporate structuring can have on competitiveness and leakage of carbon and taxes. In the case of taxation, the OECD is considering (through the Base Erosion and Profit Sharing Project) the way in which legal structures can be used artificially to segregate taxable income from the activities that generate it with consequential leakage of taxation from jurisdictions in which the activities take place. In parallel, research and commentary examines the way in which the socio-economic costs of securing sustainable prosperity can be shared fairly and through acceptance of responsibility using approaches such as border adjustments. Against that context, we contend that organizational boundary setting will become increasingly important for decision-making as wider policy considerations take account of the relationship between legal structures, responsibility for sustainability outcomes and cross-border impacts of activity. Associated proposals, such as country-by-country reporting, will also affect reporting practices.

---

2. The term “non-financial reporting” is used here to describe any form of reporting other than financial statements prepared by reference to national and international financial reporting standards. The term “non-financial” information refers to information that falls outside the scope of but is complementary to financial statements prepared by reference to national and international financial reporting standards.

3. Mainstream corporate reports include financial statements together with explanatory notes prepared in accordance with a financial reporting standard or framework such as International Financial Reporting Standards, national standards or generally accepted accounting practices. For a full definition of mainstream report see Edition 2.0 of CDSB’s Draft Reporting Framework.


3. What is non-financial reporting?

9) For the purposes of offering a view on the meaning of “non-financial reporting”, we conducted a non-exhaustive review of the following law/commentary/guidance, collectively referred to as “reporting codes” in this document for ease of reference. The reporting codes have been selected to inform the meaning of non-financial reporting as they seek information that is designed to complement financial information and they are intended for mainstream reporting practices. In particular, this document considers the non-financial disclosures that certain companies are being invited or required to make according to:

a) The UK Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013 SI 2013/1970; and
b) The IFRS Practice Statement on Management Commentary – A Framework for Presentation, December 2010; and

c) The IIRC’s International Integrated Reporting Framework, December 2013; and

d) Proposed amendments (adopted on 15 April 2014) to EU Directive 2013/34/EU as regards disclosure of non-financial information by certain companies; and


10) The requirement codes listed above share certain characteristics that inform the meaning of non-financial reporting. Those shared characteristics can be further categorized into shared content, shared preparation themes and emerging trends as follows, see below.

11) Common disclosure content themes set out what an organization should report. The following content themes are shared by two or more requirement codes:

a) The business and its:
   i) Activities;
   ii) External context;
   iii) Objectives and strategies;
   iv) Business model;
   v) Policies, such as on the environment, diversity, bribery etc.
   vi) Resources needed to deliver strategy.

b) Risks and opportunities – in particular, the identification of principal risks and opportunities, how they affect the organization’s strategy and how the company is managing them.

c) Performance during the year – a fair or balanced and comprehensive review of the organization’s performance during the reporting year including qualitative and quantitative results and analysis of performance and development using key performance indicators.

Future outlook

12) Common disclosure preparation themes describe how an organization should report. The following preparation themes are shared by two or more requirement codes:

a) Provide material information;

b) Identify organizational boundaries (the exact provisions on boundaries are explored in more detail below);

c) Provide information for a particular reporting period (one year):
   Apply reporting principles such as relevance, reliability and completeness.
13) Emerging disclosure trends are themes that are referred to in requirement codes or associated guidance and commentary and that inform the objective and development of non-financial reporting:

a) Governance concepts such as due diligence, responsibility, accountability and stewardship – For example:
   i) One of the IIRC’s stated objectives is to enhance accountability and stewardship for the broad based of capitals (financial, manufactured, intellectual, human, social and relationship and natural);
   ii) The preamble to proposed amendments to EU Directive 2013/34/2014 states that they are informed by resolutions on Corporate Social Responsibility about accountable, transparency and responsible business behavior and that the non-financial statement should include information on due diligence processes implemented to identify, prevent and mitigate existing and potential adverse impacts;
   iii) The Companies Act 2006 amendments require a directors’ report to state the annual quantity of greenhouse gas emissions from activities for which the company is responsible.

b) Impact/externalities/trade-offs are referred to in some requirement codes reflecting the need for organizations to consider implications of their activities that are beyond their immediate control or influence. For example:
   i) The Companies Act 2006 amendments require certain companies to report information about social, community and human rights issues as well as the effectiveness of any policies on those matters;
   ii) Article 29a of the proposed amendments to EU Directive 2013/34/EU requires a non-financial statement containing information about the impact of the Group’s activity on environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters;
   iii) The International Integrated Reporting Framework requires consideration of the interdependencies and trade-offs between capitals.

c) Increasingly, organizations are being asked to report on their engagement with stakeholders. For example:
   i) An integrated report should provide insight into the nature and quality of the organization’s relationships with its key stakeholders including how and to what extent the organization understands, takes into account and responds to their legitimate needs and interests;
   ii) The IRFS’ practice statement on management commentary (paragraph 33) states that management should identify the significant relationships that the entity has with stakeholders including how those relationships are likely to affect the performance and value of the entity and how those relationships are managed;
   iii) A general policy under the OECD’s Guidelines for Multinational Enterprises is that organizations should take into account the views of other stakeholders in society, including the local community as well as business interests.

14) The brief review above shows that reporting codes and associated material are encouraging organizations to enter into policies and practices and report on a wide range of subject matter from the point of view of the organization itself and the activities that it can control and influence but also from the point of view of society and the environment. The reporting content requirements and general trends indicate that an organization might be expected to report on the full extent of the so-called “butterfly-effect” of its activity, outcomes and impacts even beyond those anticipated or capable of observation by the organization itself. These developments have major implications for organizational boundary setting.
Which parties feature in decisions about boundary setting?

15) Deciding whether and to what extent information is included within a group corporate non-financial report can involve identifying whether by whom and from which “resources” e.g.: buildings, assets, plant and machines, transport, livestock and other facilities results are achieved and performance is managed. These resources may be:

16) **Owned** – The owner of a resource usually holds the legal title to that resource or rights to it and in some cases will be registered through an appropriate authority as the owner of the resource. The owner is generally entitled to full rights to use and derive benefits from a resource as well as being responsible for any liabilities associated with it. However, in some cases, the holder (registered or otherwise) of the legal title to a resource may own it on behalf of beneficial owners such that the legal owners are obliged to pass any benefits from the use of the resource direct to the beneficial owners. In those cases, legal ownership should be distinguished from beneficial ownership.

and/or

17) **Used** – The user of a resource may own it or it may be owned by a third party or may not be owned by anyone (such as plants). The user is the party that has the right to use and/or direct the use or operation of the resource and to derive or control output or utility from the use of that resource. A party uses a resource when the owner allows, in return for consideration (such as rent) or otherwise, it to be used by the user to generate income or contribute to the users business processes and activities or for mixed purposes.

and/or

18) **Operated or managed** – The operation of a resource may be distinguished from use of a resource as follows. Where a resource is operated, it is used according to the specifications or agreement of the owner or party that appoints the operator. By contrast, where a resource is used, the user decides how the resource is to be used rather than according to the specifications of the owner. The user retains rights to the output or utility from the use of the resource. An operator is not therefore a user because the operator, whilst having some rights to control over day-to-day operation of a resource, does so by virtue of power that has been delegated by the user and only as agent for the user.

and/or

19) **Leased as a lessor / lessee by the reporting organization** – The owner of resources may allow those resources to be used by a third party under a lease arrangement which, either transfers all or some of the rights and rewards associated with ownership of that asset to the lessee for all or most of the economic life of the resource (generally known as a finance lease), or is a shorter term arrangement (i.e.: for less than the economic life of the resource) that allows the lessor to retain the rights and rewards associated with ownership of the resource. The party with the right to use a resource under a lease agreement of any type is therefore the user as defined above.

The language of boundary setting

20) As noted above, organizational boundary setting is important for helping preparers and users of information to define and limit the scope and extent of disclosures. However, defining, limiting and communicating that scope is an area of increasing complexity. This part of the paper explores whether the language used to describe boundaries, which originates from different disciplines, contributes to the complexity. In particular, the language of boundary setting borrows terms such as “consolidation” from financial reporting (referring to the entities whose results should be included in the financial statements of a corporate group), “life cycle” from the natural and social
sciences (maturation and generation of natural populations) and “scopes” from the Greenhouse Gas Protocol Corporate Accounting Standard to distinguish between greenhouse gas emissions attributable to an organization’s direct and indirect activities respectively.

21) Adopting terms from existing disciplines and devising new terms can both help and hinder the search for a commonly understood means of defining, limiting and communicating boundaries. In simple terms non-financial reports can include information about:

a) events, activities, targets, risks, etc. over which a reporting organization has control, and/or

b) events, activities, targets and risks over which a reporting organization has significant influence, for example through its investment in an entity or activity or through contractual arrangements with another party; and/or

c) events, activities and risks that, whilst outside the reporting organization’s control or sphere of influence, have the actual or potential power to affect the reporting organization’s business and/or society, the economy and the environment positively or negatively.

22) Non-financial reporting may therefore inform readers about:

a) The outputs from the reporting organization’s direct (controlled) and indirect (influenced) activities. These include greenhouse gas emissions and waste as well as tangible goods and services produced according to the organization’s strategy and business model;

b) The outcomes from the reporting organization’s direct (controlled) and indirect (influenced) activities. Outcomes are influenced by outputs, plans and external factors such as regulatory requirements. An outcome from greenhouse gas emissions may be climate change. An outcome from plans to mitigate climate change may be decreases in greenhouse gas emissions.

c) The impacts of the reporting organization’s activities, which are the long-term, fundamental and durable changes to which the activities contribute. Impacts may manifest themselves as changes to and effects on human and natural systems many years after completion of the organization’s activities.

23) Interpretations of control, influence, power to affect, outputs, outcomes and impacts depend in part on the perspective of the readers and users of corporate reports. The terms may be understood by reference to limited legal and financial definitions of control or, at the other extreme, by reference to wider notions of planetary and societal stewardship and accountability. This paper suggests that one reason for the increasing length and volume of corporate reports and their apparent inclusion of “clutter” is that organizations struggle to understand whether, at one extreme, they should be reporting only on matters under their direct control and influence and which affect the performance and condition of the company itself or at the other extreme, they should be providing a general discourse of care on all possible long term impacts of their activities both on the organization and on society and the planet, or something in between.

24) The extent to which an organization can assess and communicate the connections between its activity and long-term impacts therefore has practical limitations which organizational boundary setting seeks to define. This paper now goes on to explore examples of current practices and definitions for setting organizational boundaries.
4. The Current state of organizational boundary setting

25) This section examines the current state of organizational boundary setting and examples of the practices that influence it including the GHG Protocol, the GRI’s G4 guidelines, the IIRC’s International Integrated Reporting Framework, SASB’s Standards, International Financial Reporting Standards, developments in UK and EU law and examples of corporate practice.

What does the GHG Protocol say about organizational boundary setting?

26) The concepts of control, influence, responsibility and power to affect are reflected in the approaches set out in the GHG Protocol Corporate Accounting Standard and the Corporate Value Chain (Scope 3) Accounting and Reporting Standard, which are widely adopted and have done much to establish a degree of uniformity of approach to organizational boundary setting for GHG emissions reporting purposes. The Corporate Accounting Standard provides for GHG emissions reporting in relation to:

a) Entities over which the reporting organization has financial control; or

b) Entities over which the reporting organization has operational control; or

c) Entities in which the reporting organization has an equity share (such that it has influence over the investee or responsibility for the risks of the investee).

See Figure 4 in the Appendix.

27) The Corporate Value Chain (Scope 3) Accounting and Reporting Standard sets out how GHG emissions from upstream and downstream activities may be accounted for and also includes guidance on how to set the Scope 3 boundary. Scope 3 activities are from sources that are not owned or controlled by the reporting organization but are activities that can affect the reporting organization’s performance and/or activities over which the reporting organization can exercise influence through contractual relationships.

28) Table 1 below shows the organizational boundary approaches selected by the 402 Global 500 companies that responded to CDP in 2011. This shows that operational control is the most commonly selected approach. There is no obvious statistical evidence of trends within sectors. However, 20 of the 402 companies that make up the population in Table 1 are categorized as being in the utilities sector according to the Global Industry Classification Standard. Of those companies, six used the equity share approach, six financial control and six used the operational control approach, with two companies indicating that they used “other” approaches. Although based on a very small sample, this suggests an even spread of approaches amongst G500 utilities companies. Table 2 below shows the same information from CDP disclosures for 2012. Again, operational control is the most commonly used approach.

---

6. The GHG Protocol distinguishes between Scope 1 emissions, which are direct emissions stemming from the company’s own use of fuel and gases etc.; Scope 2 emissions, which are indirect emissions from purchased electricity, heat and steam and Scope 3 emissions which are indirect emissions from third party activities related to the company’s business such as the supply chain, customers, vendors and outsourced activities.
Table 1 – Organizational boundary approaches for reporting
Scope 1 and Scope 2 GHG emissions to CDP in 2011

<table>
<thead>
<tr>
<th>Organizational boundary approach</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity share</td>
<td>17</td>
</tr>
<tr>
<td>Financial control</td>
<td>103</td>
</tr>
<tr>
<td>Operational control</td>
<td>244</td>
</tr>
<tr>
<td>Other</td>
<td>38</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>402</strong></td>
</tr>
</tbody>
</table>

Table 2 – Boundary selection, CDP 2012 investor programme (CDP, 2013)

<table>
<thead>
<tr>
<th>Organizational boundary approach</th>
<th>Number of companies</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity share</td>
<td>1,248</td>
<td>55.15</td>
</tr>
<tr>
<td>Financial control</td>
<td>599</td>
<td>26.47</td>
</tr>
<tr>
<td>Equity share</td>
<td>78</td>
<td>3.45</td>
</tr>
<tr>
<td>Not specified</td>
<td>188</td>
<td>8.31</td>
</tr>
<tr>
<td>Other</td>
<td>150</td>
<td>6.62</td>
</tr>
</tbody>
</table>

29) Even where a particular approach is selected, it does not follow that the GHG emissions from all activities and entities within the boundary are reported. Of the 402 companies that reported to CDP in 2011, 213 of them said that they had excluded certain sources of GHG emissions from their disclosures. The main reasons given for such exclusions were that information from certain sources and activities was either unavailable or unreliable or that the omitted emissions were estimated to be insignificant or non-material.

What do the GRI G4 Guidelines say about boundary setting?

30) GRI’s G4 Guidelines require a reporting organization to list all entities included in the organization’s consolidated financial statements or equivalent documents (per G4-17). However, report content depends on the identification of “material Aspects”, i.e.: those that reflect the organization’s significant economic, environmental and social impacts or that substantively affects decisions of others. According to G4-20, for each material Aspect, the Aspect Boundary should be reported including:

a) Whether the Aspect is material within the organization; and

b) Whether the Aspect is material for all entities within the organization’s consolidated financial statements (per G4-17) and if not, for which it is not material or for which it is.

31) “Aspect Boundary” is defined by the G4 Guidelines as referring to “the description of where impacts occur for each material Aspect. In setting the Aspect Boundaries, an organization should consider impacts within and outside of the organization. Aspect Boundaries vary based on the Aspects reported.
Proposals for boundary setting in mainstream reports

What does the International <IR> Framework say about boundary setting?

32) Paragraph 3.30 of the IIRC’s International <IR> Framework states that the concept of the reporting boundary is key to the materiality determination process. It says that the boundary for an integrated report has two aspects:

a) The boundary used for financial reporting purposes (i.e.: the financial reporting entity). Paragraph 3.31 explains that the financial reporting entity is central to the reporting boundary because it is the entity in which providers of financial capital invest and therefore need information about and using the financial reporting entity enables the information in the financial statements to serve as an anchor or point of reference to which the other information in an integrated report can be related. The financial reporting entity is defined in paragraph 3.33 as identifying which subsidiaries’, joint ventures’ and associates’ transactions and related activities are included in the organization’s financial report. The financial reporting entity is determined according to applicable financial reporting standards, which revolve around concepts of control or influence.

b) Opportunities, risks and outcomes attributable to or associated with other entities/stakeholders beyond the financial reporting entity that have a significant effect on the ability of the financial reporting entity to create value. Paragraph 3.35 explains that the purpose of looking beyond the financial reporting boundary is to identify risks, opportunities and outcomes that materially affect the organization’s ability to create value. The entities/stakeholders within this portion of the reporting boundary are not related to the financial reporting entity by virtue of control or significant influence but rather by the nature and proximity of the risks, opportunities and outcomes.

What do SASB Standards say about organizational boundary setting?

33) Unless otherwise specified, SASB recommends:

a) That a registrant disclose on sustainability issues and metrics for itself and for entities in which the registrant has a controlling interest and therefore are consolidated for financial reporting purposes;

b) That for consolidated entities, disclosures be made and accounting metrics calculated for the whole entity regardless of the size of the minority interest; and

c) That information from unconsolidated entities not be included in the computation of SASB accounting metrics. A registration should disclose, however, information about unconsolidated entities to the extent that such registrant considers the information necessary for investors to understand its performance with respect to sustainability issues (typically this disclosure would be limited to risks and opportunities associated with those entities).

Organizational boundary setting in financial reporting

34) On the assumption that financial and environmental reporting will increasingly coalesce, developments in financial reporting are likely to have consequences for approaches to non-financial reporting and are therefore considered here. The approaches set out in the GHG Protocol, the GRI G4 Guidelines and the International <IR> Framework all acknowledge the way in which boundaries are set for financial reporting purposes. A new suite of financial reporting standards – IFRS 10, IFRS 11 and IFRS 12 - apply for accounting periods beginning on or after 1 January 2013. The standards are used both to determine how assets, liabilities and transactions are accounted for in relation to subsidiaries, joint arrangements, associates and investments and also what disclosures should be made about interests in subsidiaries, joint arrangements, associates or investments. Whereas the accounting provisions in IFRS 10 and 11 specify how assets, liabilities and transactions should be recognized and

accounted for in financial statements, the disclosure provisions in IFRS 12 require reporting of information that enables users of financial statements to evaluate the:

a) Nature of and risks associated with interests in other entities;

b) The effects of those interest on the financial position, financial performance and cash flows of the reporting organization; and

c) Boundaries of the organization for financial reporting purposes.

The relationship between IFRS 10, 11 and 12 and IAS 28 is shown in the illustration prepared by the IASB below.

Figure 1 - Interaction between IFRS 10, 11, 12, and IAS 28

35) **Subsidiaries** – IFRS 10 – Consolidated Financial Statements “establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities”. IFRS says that “an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee...an investor controls an investee if and only if the investor has all the following:
a) Power over the investee; and  
b) Exposure or rights to variable returns from its involvement with the investee; and  
c) The ability to use its power over the investee to affect the amount of the investor’s returns.

36) IFRS 10 refers to control being exercised by a single entity over another. Where two or more parties collectively control an entity, IFRS 11 (Joint Arrangements) or IFRS 12 (Disclosure of interests in other entities) apply.

37) Where an investor has control of an entity and is obliged to prepare accounts according to IFRS, 100% of the revenue, assets and cash flow of that entity must be included in the consolidated financial statements.

38) **Joint arrangements** - IFRS 11 applies to joint arrangements. Whereas previous standards had allowed a choice of accounting treatment for jointly controlled entities, IFRS 11 establishes a single accounting approach that is applicable to all joint arrangements. According to IFRS 11, a party to a joint arrangement must determine the type of joint arrangement in which it is involved by assessing the rights and obligations to which it is entitled under the contractual terms and legal form of the arrangement. In particular, a party to a joint arrangement must determine whether it is a joint venturer or a joint operator:

a) Where the parties to an arrangement have the rights to assets and obligations for liabilities, it is classified as a joint operation and the operator must account for the assets, liabilities, revenues and expenses relating to its interest in the operation;

b) Where the parties to an arrangement have rights to the net assets, it is classified as a joint venture.

**Associates, joint ventures and investments**

39) A joint venture or investor must recognize its interest in the venture or associate as an investment and account for that investment using the equity method in accordance with IAS 28 (2011).

**Spotlight on leases**

40) IFRSs currently distinguish between two main types of leasing arrangement - finance and operating leases respectively. A finance lease transfers substantially all risks and rewards relating to ownership of an asset to the lessee. The lessee has the right to use the asset for all or most of its useful economic life. An operating lease is any lease other than a finance lease. The majority of risks and rewards attributable to ownership of the asset remain with the lessor in the case of an operating lease.

41) As far as accounting treatment under IFRS is concerned, in the case of a finance lease, the asset and associated rewards appear in the accounts of the lessee, i.e. the lessor removes the asset from its balance sheet replacing it with a lease receivable for the payments from the lessee and the lessee recognizes the asset and a corresponding payable to the lessor for that asset. In the case of an operating lease, the asset and associated rewards continue to appear in the balance sheet of the lessor; the lessee recognizes an expense for rental expense. Table 3 shows the interaction between the financial reporting rules on which party recognizes an asset on their balance sheet and the GHG Protocol guidance on categorizing GHG emissions associated with leased assets.

---

9. IAS 31 distinguished between jointly controlled operations and jointly controlled entities. In the case of the latter, parties were offered a choice between proportionate consolidation and the equity method of accounting.

Table 3 - Interaction between financial reporting rules

<table>
<thead>
<tr>
<th>Asset is on the balance sheet of the</th>
<th>GHG reporting for lessee using equity share or financial control boundary</th>
<th>GHG reporting for lessor using equity share or financial control boundary</th>
<th>GHG reporting for lessee using operational boundary</th>
<th>GHG reporting for lessor using operational boundary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance lease</td>
<td>Lessee Scope 1</td>
<td>Scope 3</td>
<td>Scope 1</td>
<td>Scope 3</td>
</tr>
<tr>
<td>Operating lease</td>
<td>Lessee Scope 3</td>
<td>Scope 1</td>
<td>Scope 3</td>
<td>Scope 3</td>
</tr>
</tbody>
</table>

42) The GHG Protocol’s categorization of emissions attributable to assets leased under finance leases is consistent with financial reporting rules in that whether the lessee chooses to apply the equity share, financial control or operational control boundary, any GHG emissions from the asset are always the Scope 1 emissions of the lessee. In the case of an operating lease, the lessor and the lessee may choose under the GHG Protocol either to report the GHG emissions as Scope 1 or Scope 3 emissions depending on which boundary approach they choose. As the box above illustrates, where the lessor chooses the equity share or financial control approach and the lessee chooses the operational control approach, both report GHGs from the asset as Scope 1 emissions.

43) Changes are anticipated to IFRS rules on accounting for leases. In particular, the IASB is proposing changes to lease accounting rules from 2015 or thereabouts that would distinguish in future between an asset and the right to use that asset.

Legal/regulatory developments – implications for organizational boundary setting

44) Governments and regulators are increasingly requiring companies to include non-financial information in mainstream reports. Examples of requirements relating to non-financial reporting include:

a) In February 2010, the US SEC issued guidance confirming that existing SK Regulations under the Securities Act 1933 on risk, legal proceedings and business description should be interpreted so as to apply to climate change-related risks and proceedings;

b) The Danish Financial Statements Act requires companies within scope of the law to report on their corporate social responsibility activities;


45) Where reporting requirements are added to existing corporate, securities, financial or commercial law, the presumption is that reporting boundaries will be the same as those already specified in the relevant legislation for other reporting and compliance purposes. This paper considers two regulatory developments on non-financial reporting, in the UK and EU respectively, and their implications for organizational boundary setting.

Spotlight on UK regulatory developments

46) The UK Climate Change Act (section 87) gave the Secretary of State power to collect from UK quoted companies information about “GHG emissions for which organizations are “responsible”. By virtue of this power, amendments have been made to the UK Companies Act through the Companies Act 2006 (Strategic Report and Directors’ Report) Regulations 2013. The new provisions amend the Companies Act 2006 so as to require UK quoted companies to report their GHG emissions annually in their directors’ report or, if they choose, in the strategic report. By introducing the requirement to report into the Companies Act, GHG emissions information is ostensibly to be prepared according to the same organizational boundaries as apply to the preparation of the directors’ report. Those boundaries are, in turn, prescribed by International Financial Reporting Standards (see above). The proposed amendments to the UK Companies Act specifically state that the strategic report must be a “consolidated report relation to the undertakings included in the consolidation”, presumably as prescribed by IFRS 10.

47) Prima facie, for GHG emissions reporting purposes, a company must decide on what boundary to apply/on the scope of its reporting based on:

a) The existing requirements of the Companies Act on the entities to be included in a strategic report and directors’ report – essentially this follows financial consolidation; and/or

b) The wording of the new provisions that requires companies to report the annual quantity of CO₂-e from “activities for which that company is responsible”; and/or

c) Existing practice possibly based on the GHG Protocol approaches to organizational boundary setting.

48) Unless further clarification is provided, it is possible that different companies will take different approaches to scoping/boundary setting as far as GHG emissions reporting is concerned. Some companies might decide to change their existing practices to align more with financial consolidation rules. Some GHG emissions sources that might present the company with risk or opportunity or over which the company has some influence through operational control might be excluded from the directors’ or strategic report if they are outside the reporting boundary prescribed by IFRS/the Companies Act. For example, if the majority of a company’s GHG emissions arise from activities that take place on premises operated on behalf of a third party under an operating lease, the regulations suggest that those emissions do not have to be disclosed. Arguably, this gives stakeholders a limited or misleading view of the extent to which the company is exposed to risk or able to influence GHG emissions.

Spotlight on EU regulatory developments

49) Directive 2013/34/EU repeals the two accounting directives 78/660/EC and 83/349/EC and is therefore described here for ease of reference as the “new accounting directive”. The new accounting directive sets out requirements on the preparation of annual financial statements, consolidated financial statements and related reports of certain types of undertakings. Paragraph 29 states “many undertakings own other undertakings and the aim of coordinating the legislation governing consolidated financial statements is to protect the interests subsisting in companies with share capital.” Paragraph 31 states that “consolidated financial statements should present the activities of a parent undertaking and its subsidiaries as a single economic entity (a group).” Proposed amendments to the new accounting directive introduce (amongst other things) draft Article 29a, which requires a consolidated non-financial statement to be included in the consolidated management report.
50) Under proposed amendments to the new accounting directive, a non-financial statement is to include information “to the extent necessary for an understanding of the group’s development, performance and position and of the impact of its activity, relating to as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters...” including “the outcome of those policies” and “the principal risks related to those matters linked to the group’s operations [our emphasis] including, where relevant and proportionate, its business relationships products or services which are likely to cause adverse impacts in those areas.”

51) In common with amendments to the UK Companies Act, the proposed EU amendments on non-financial reporting are inserted into an existing body of law, which already contains prescriptions and definitions of consolidation. However, the scope, scale and type of amendments seem on the face of it, to extend the boundaries of the group beyond the existing definition of consolidation. The wording emphasized above – “linked to the group’s operations” – could be interpreted to mean that information should be reported only to the extent that it affects the group’s operations. We hope that the guidance on non-financial reporting promised by the European Commission will clarify that point.

Examples of corporate practice – hybrid approaches

52) There is evidence that some companies adopt hybrid approaches to satisfy particular stakeholders or reporting objectives, as illustrated in Figures 2 and 3 below.

Figure 2 – Extract from BT’s Carbon Emissions Statement 2011

---

5. Discussion

53) Based on the analysis in Section 2, it is clear that the concept of consolidation is firmly established in mainstream reporting practice in so far as the preparation of financial statements is concerned. Whether, to what extent and how “consolidation” is applied to non-financial reporting is less clear, although examples of regulatory activity in the UK and EU referenced above indicate that consolidation is required for non-financial reporting. The content and scope of non-financial reporting, particularly where it requires disclosures on social and environmental impacts, seems automatically to extend the boundary of the organization beyond those matters over which it has direct control and significant influence. Where non-financial reporting requirements are introduced to an existing body of law, such as the UK Companies Act or the new Accounting Directive, that already contains specific provisions on consolidation, it is unclear how those existing provisions should be reconciled with non-financial reporting requirements that, by definition, extend beyond the established boundary. Organizations have taken different approaches to resolving this dilemma. In CDSB’s original reporting framework, Edition 1.0, released in September 2010, we recommended a two-part boundary approach. The first aligned with financial consolidation and the second part required disclosure of GHG emissions that were not consolidated in part 1, but that were required disclosures under regulatory requirements or exposed the reporting organization to risk, opportunity or financial impacts. The IIRC adopted the same approach in its International Reporting Framework released in December 2013. SASB takes a similar approach, recommending that information beyond financial consolidation should be reported only when necessary for investors to understand the organization’s performance with respect to sustainability issues (typically this disclosure would be limited to risks and opportunities associated with those entities). By contrast, the GHG Protocol allows companies to choose between three different boundary setting approaches and the GRI’s approach in G4 is focused on the boundary associated with the “material aspect.” In summary then, existing practice is varied but there is evidence of some coalescence (at least by CDSB, IIRC and SASB) around the view that non-financial results should be prepared according to or should be capable of reconciliation with financial information prepared according to financial consolidation rules. This does not preclude other information being provided separately if it exposes the reporting organization to risk. In order to prompt discussion on the implications of these findings, section 3a below sets out proposals for bringing some order to the organizational boundary setting in non-financial reporting. Section 3b discusses the implications of those proposals.

5.1. Proposals

54) This paper makes six proposals for the development of organizational boundary setting for non-financial reporting purposes, which are summarized here and elaborated below.

i) Proposal 1 - Clarify the link between the objectives of non-financial reporting, materiality, the audience for reporting and organizational boundary setting;

ii) Proposal 2 - There should be a single, standardized approach to organizational boundary setting in mainstream reporting that should have the characteristics outlined in proposals 3 – 5;

iii) Proposal 3 - The consolidated group boundary should align with the way in which the profit and loss/comprehensive income statement is prepared (rather than with balance sheet entries);

iv) Proposal 4 - Within the consolidated group boundary, GHG emissions from the use of resources should be reported by the user as defined in paragraph 17 above;

v) Proposal 5 - No distinction should be made between financial and operating leases for GHG emissions reporting purposes – the GHG emissions should be reported by the user in all cases where the use of an asset is made possible under any contractual arrangements, including a finance or operating lease;

vi) Proposal 6 - A group’s policy for the preparation of consolidated climate change-related reporting should be clearly stated as part of the disclosure in the same way that financial statements include notes setting out the policies that have been applied for their preparation;

Proposal 1 – Clarify the link between the objectives of non-financial reporting, materiality, the audience for reporting and organizational boundary setting

55) In our research into organizational boundary setting, we observe a certain amount of conflation between the concepts of boundary setting, materiality, the intended objective of reporting and the audience for non-financial reports. There is a tension between requirements to consult with stakeholders on their view of what is material whilst also recognizing the limitations of matters over which the organization has control or influence. We contend that if the audience for and objective of reporting is clearly articulated, organizational boundary setting and materiality approaches can be determined primarily by reference to the audience and reporting objectives. Where the objective of non-financial reporting is to inform investors about the way in which management uses and manages resources for the promotion of the organization’s success, arguably, the boundary of the organization should be the same as for financial reporting (which has a shared objective), although risks “beyond” the boundary such as supplier vulnerability would be reported as risks (according to SASB’s approach). Where the objective is to demonstrate to society the organization’s stewardship, accountability and care for the environment and society, the reporting boundary might extend beyond those entities and activities over which the company has control and influence. In simple terms, the boundary can either be restricted to the organization as understood for financial consolidation purposes (i.e.: entities over which the reporting organization has control and influence) and/or to matters that affect the organization or it can be expanded to include the environment and society. In principal, a non-financial report could achieve both objectives provided that information destined for each audience is separately labeled and provided also that the resulting volume of information does not impede the usefulness of information for readers.

56) Unless the objective of and audience for non-financial reporting is clear and there is clarity on the extent to which the reporting organization is expected to report on impacts and outcomes beyond its direct control or influence, we contend that organizational boundary setting practices will continue to vary. We propose that where non-financial reporting requirements are added to existing mainstream reporting requirements, the boundary used for existing mainstream
reporting should apply equally to non-financial reporting requirements and that if any information is required about the outcomes or impacts of business activity beyond the boundary used for mainstream reporting, the circumstances in which such information should be provided must be specified and the resulting information separately labeled.

Proposal 2 – There should be a single, standardized approach to group organizational boundary setting in mainstream reporting that should have the characteristics outlined in proposals 3 – 6

57) Non-financial information can be prepared at activity, facility or entity level, often because of the requirements specified by regulators. CDSB understands that this can be because national regulators only want one point of entry for understanding activity in their jurisdiction and in order to satisfy their objectives it is not always necessary for the ownership and group structure within which the facility or entity operates to be known or understood. Local statutory financial accounts are prepared according to national rules relating to single entities within a particular jurisdiction. However, CDSB contends that in the same way that they rely on consolidated financial statements, investors need consolidated non-financial information disclosures for corporate groups. For financial reporting purposes International Financial Reporting Standards are used for preparing consolidated financial statements. Such consolidation does not involve aggregating local statutory accounts prepared for each of the entities within the consolidation. Rather, consolidation requires the preparation of a group account based on IFRS. Where a company is subject to different reporting demands (incl. boundary demands) from local authorities, these should be disregarded for consolidation as these reports are to be considered as local statutory reports, that cannot and should not be the base for a group report, which by definition only can allow for equal worldwide reporting rules.

58) CDSB proposes in this discussion paper that a similar approach to financial consolidation is taken for group non-financial information reporting and that such group disclosures should not simply aggregate the facility or entity level reporting prepared according to national requirements or voluntary initiatives as they can be defined differently in each country and for each business and therefore make comparisons difficult. Furthermore, in the case of large conglomerates with intercompany trading, an approach that simply aggregated national, entity level reporting could result in double counting, particularly where two or more entities within the group have prepared entity level results by reference to different boundaries.

59) We welcome discussion on this proposal. We also encourage groups that already consolidate non-financial information by reference to a single approach (rather than the aggregation of entity results) to share information about the systems they use for achieving a consolidated climate change related disclosure.

Proposal 3 - The consolidated group boundary should align with consolidated profit and loss/comprehensive income financial reporting

60) Financial statements include a balance sheet and a profit and loss or comprehensive income statement. A balance sheet shows the assets and liabilities available to an organization at the end of the accounting period that enable the organization to continue operating in future periods. A profit and loss or comprehensive income statement reflects the results of operation in the financial reporting period. We propose that non-financial information reporting should be aligned with the preparation of a profit and loss or comprehensive income statement as non-financial reporting reflects resources used and affected during the year in the same way that the income statement reflects revenue earned and expenses incurred during the reporting year. It follows from this proposal that the classification of joint arrangements as joint operations or joint ventures should follow IFRS 11 for non-financial reporting purposes.
CDSB understands that for financial accounting purposes 100% of income, assets, liabilities etc. from subsidiaries are consolidated and that profit, loss or comprehensive income attributable to non-controlling interests is shown as an allocation rather than as a deduction (see IAS 1 paragraph 83). Similarly, SASB states that for the purposes of consolidated reporting, information for the whole entity should be reported regardless of the size of the minority interest. CDSB contends that the allocation is unnecessary in the case of non-financial reporting but, if contributors disagree, we welcome comments on what the “allocation” of information to non-controlling interests would achieve in terms of decision-usefulness of non-financial information for investors.

Proposal 4 – Non-financial information should be reported by the user (as defined in paragraph 16) of resources

CDSB proposes that the user of resources should report outcomes from the use of resources for conducting business activities because:

1. the definition of user in paragraph 16 above aligns with the definition of control in IFRS 10; and
2. the user of an asset is in many cases more likely to have access to information that supports the production of disclosures on results and performance.

We welcome comments and discussion on our proposal. In particular, we seek views on the practical application of this proposal in cases where a single resource is used by multiple users under various types of contract and agreement. We also welcome comments on any implications arising from the proposal that reporting would not necessarily follow ownership of an asset or resource – rather reporting would follow use of an asset or resource such that GHG emissions arose from it, regardless of ownership/balance sheet entries.

Proposal 5 – No distinction should be made between financial and operating leases for non-financial information reporting purposes

Based on our proposal that the user of an asset or resource should report on the results and outcomes from that use, the type of arrangement under which use is permitted becomes irrelevant to reporting. We therefore propose that no distinction should be made between financial and operating leases for non-financial reporting purposes. We also believe that this position is consistent with the definition of control for financial reporting purposes.

Proposal 6 - Policies applied for the preparation of consolidated climate change-related disclosures should be stated

Financial statements are normally accompanied by notes that explain the basis on which information has been prepared, including which financial reporting standards have been adopted and how they have been applied. We propose that a similar approach is adopted for the preparation of explanatory notes to non-financial statements including narrative on how the group’s organizational boundary has been determined and what it includes.
5.2. Implications for climate change-related reporting as a sub-set of non-financial reporting

This section of the discussion paper examines some of the implications of the above proposals specifically as they affect reporting of greenhouse gas emissions. However, the implications are likely to be capable of extending to other forms of non-financial reporting. In particular, the questions we consider here are:

a) To what extent will measurement of GHG emissions and other quantitative data be affected by the proposals?

b) What do the proposals mean for Scope 3 reporting?

To what extent will measurement of GHG emissions and other quantitative data be affected by the proposals?

As noted above, results, including measurements used for national reporting at entity level cannot simply be aggregated for the purposes of preparing a consolidated group disclosure. A single, consistent approach to measurement must be applied. The underlying activity data on which GHG emissions calculations are based will remain the same. However, rather than applying the various measurement rules that apply at national and entity level, the consolidated group view will be based on a single approach to converting that activity data to GHG emissions. The A.P. Moller-Maersk group approach is described below.

---

CDSB invites discussion on the implications of its proposals for the measurement of GHG emissions and in particular whether measurements can always be prepared on a single consistent basis according to one measurement policy OR whether there need to be some exceptions, for example, in relation to Scope 2 GHG emissions where the measurement reflects the national energy mix.

---

What do the proposals mean for Scope 3 reporting?

69) Scope 3 GHG emissions reporting is important in the context of policy and societal objectives that encourage companies to manage their activities. Some of the most significant and environmental benefits may be found outside a company’s organizational boundaries, for example, in the supply chain. However, by definition, Scope 3 GHG emissions do not fall within the boundary of a consolidated group for financial reporting purposes because they relate to indirect activities of a company over which it has no control – although it might have some influence. The reason CDSB’s proposals do not require measurement of Scope 3 GHG emissions is that the objective of CDSB’s Framework is to support compliance with obligations to report environmental information through mainstream reporting channels. We therefore follow the boundaries set by most mainstream reporting requirements, which, in turn are often established through financial reporting standards.

70) However, CDSB’s proposals do not preclude Scope 3 reporting. Mainstream reporting normally requires that the consolidated group must include information about the risks and opportunities to which the group is exposed and the way in which management approaches those risks and opportunities. CDSB proposes that a distinction is drawn between information that is reported because it falls within the boundary of the consolidated group and information that is reported about the incidence and management of risk and opportunity. CDSB contends that issues associated with Scope 3 reporting fall into the latter category. SASB and the IIRC draw a similar distinction in their work.

71) CDSB therefore proposes that accurate, quantitative, verified/able information should be required in a group consolidated climate change-related disclosure only for those GHG emissions and other quantitative data that falls with in the consolidated boundary. Furthermore, that other information required for a complete view of the risks and opportunities to which a group is exposed and its management of them is quantified and verified where possible but is otherwise reported through narrative disclosures or estimates.

6. Conclusion

72) This paper has examined current practices for organizational boundary setting in non-financial reporting and has outlined proposals for encouraging coalescence around financial consolidation rules. However, this is just the start of what we anticipate being a much larger exercise that will need to investigate in detail questions such as whether:

a) A single approach to organizational boundary setting as proposed above will enable all sectors to make disclosures that provide investors with the full range of information they need for decision-making;

b) The single approach proposed above aligns precisely with the already established and widely used “financial control” approach under the GHG Protocol;

c) Certain entities should be specifically excluded from non-financial reporting such as discontinuing operations or those earmarked for disposal, and whether such an approach would align with financial reporting rules whilst satisfying the objectives of non-financial reporting;

d) IFRS 10, 11 and 12 are capable of translation to non-financial reporting in practice;

e) New terminology should be devised to communicate “credit” for contributions made to sustainable prosperity, such as the “direct, indirect and enabled” terminology15 used by the Crown Estate.

---

73) Non-financial reporting holds the promise of catalyzing important improvements in transparency, accountability and decision-making for a sustainable future. However, much is written about the gaps that need to be addressed before non-financial reporting can start to become really effective for these purposes. For example, some commentators criticize non-financial reporting as being unregulated, non-standardized, unaudited, public relations material. These criticisms distract from the potential power that non-financial reporting has to catalyze change. CDSB’s discussion paper invites comment and discussion on organizational boundary setting as an important part of non-financial reporting that can help to build the infrastructure needed to make non-financial reporting credible and robust.

7. Appendix

Figure 4 - Financial accounting categories

[Diagram showing financial accounting categories with details on Group companies / subsidiaries, Associated / affiliated companies, Non-incorporated joint ventures / partnerships / operations where partners have joint financial control, Fixed asset investments, and Franchises.]
