

Dialogue with standard setters

The creation of the International Sustainability Standards Board: Evidence from the steps undertaken by the IFRS Foundation for Sustainability Reporting

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1. Introduction. The demand for global sustainability standards

From climate change and biodiversity loss to growing inequality, modern slavery, and scarcity of resources, our society and planet face the most significant challenges of all times (Rockström et al., 2009). The task of building a sustainable future is a responsibility shared by all (Sachs, 2015). Companies must play their part by aligning long-term corporate strategies with people and the planet (Porter and Kramer, 2011).

To contribute to sustainable development, companies must understand and manage their positive and negative impacts in a way that is transparent, trusted and objective (Eccles and Krzus, 2010). This understanding has led to a growing demand for sustainability reporting and a call for a global solution that reflects the needs of reporting companies, together with the information requirements of their stakeholders and those of the jurisdictions in which companies operate (Adams, 2015).

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The demand for sustainability information continues to grow as investors, and stakeholders more generally, are increasingly focused on environmental, social and governance (ESG) issues associated with the companies in which they invest (Grewal et al., 2019). Investors need high-quality information that allows them to assess how companies are managing these issues and their impact on a company's long-term performance (Dhaliwal et al., 2011). Investors and other stakeholders want to understand how the risks and opportunities faced by business translate into long-term financial value creation (Eccles et al., 2014; Stolowy and Paugam, 2023). Such information should be connected to financial information and prepared rigorously to the same quality standards (Eccles and Serafeim, 2013).

As ESG issues gain prominence in the investing and business worlds, many companies and investors have expressed interest in further adopting sustainability strategies (Friede et al., 2015). The effects of these efforts, however, can be impeded by a lack of reliable data (Goss and Roberts, 2011). The lack of consistent and universal metrics to measure companies' sustainability performance is often cited as the key obstacle to investors' integration of ESG issues into their investment process and to companies' ability to compare their performance to that of peers (Amel-Zadeh and Serafeim, 2018; Stolowy and Paugam, 2023).

A number of sustainability frameworks and standards already exist, but this has led to a patchwork of reporting requirements that needs rationalizing (Churet and Eccles, 2014; Stolowy and Paugam, 2023). Currently, there are several sustainability reporting requirements, each with a different focus (Barth et al., 2017). For instance, some focus on frameworks for non-financial information, while others focus on non-financial standard-setting, and still others focus solely on climate-related disclosures. Also, the standards vary in focus between the impact of risks on an entity itself and/or on an entity's impact on the environment (Leuz and Wysocki, 2016). Some focus on financial value creation while others address the objectives of other stakeholders and of civil society (Krzus, 2011). The diverse approaches and objectives threaten increasing global fragmentation (Eccles and Saltzman, 2017). Investors and stakeholders are calling for convergence and a single framework (Hahn and Kuhnen, 2013). The standardization of metrics and disclosures regarding the effects of sustainability issues on companies' present and future results is needed to bring consistency and comparability in sustainability reporting (Serafeim, 2021; Stolowy and Paugam, 2023).

The demand for common disclosure of sustainability information is urgent (Stolowy and Paugam, 2023). This lack of coherence in sustainability

reporting will consequently cause difficulty in engaging capital markets to smooth the transition to a low-carbon economy (Busch et al., 2016; Stolowy and Paugam, 2023). Many jurisdictions have committed to target dates to achieve net-zero emissions, and reporting standards could play a vital role in assisting with these targets¹.

In this context, the International Financial Reporting Standards (IFRS) Foundation proposes to create a set of high-quality globally comparable sustainability standards utilizing existing sustainability frameworks and standards². These standards would also benefit from the increasing interconnectedness between financial reporting and sustainability reporting.

Standards act as instruments of power (Mattli and Buthe, 2003; Bengtsson, 2011) and power relations influence how accounting standards are constructed (Cooper and Sherer, 1984; Cousins and Sikka, 1993; Broadbent and Laughlin, 2002; Durocher et al., 2007; Contrafatto et al., 2020). Private standardisers cannot constrain power over distributional conflicts, but interest groups are redirected into a proxy battle over control of the standardiser itself (Mattli and Buthe, 2003). The control of accounting standard-setting bodies (via their values, vocabulary and agenda) therefore provides the means to define those issues that will receive attention or be marginalised (Sikka, 2002). Power relations influence what is and what is not on the regulatory agenda, and the nature of the choices available (Rowbottom, 2023).

The purpose of this paper is to provide readers with an overview of current developments of the IFRS proposals on the recognition and development of sustainability reporting standards.

3. The development of Sustainability Reporting Standards

The landscape of sustainability reporting has undergone substantial evolution, marked by the progressive development of regulatory frameworks and standards.

The International Sustainability Standards Board (ISSB), an initiative of the IFRS Foundation, has emerged as a pivotal player in the global sustainability reporting landscape, proposing standards aimed at unifying and strengthening the corporate disclosure of sustainability-related information.

¹ United Nations (2015), “Adoption of the Paris Agreement”.

² The IFRS project is described at this link: <https://www.ifrs.org/projects/completed-projects/2021/sustainability-reporting/#about>.

This has been further refined and specified within the EU context by the EFRAG's (European Financial Reporting Advisory Group) ESRS (European Sustainability Reporting Standards)³.

The publication of the first ISSB standards marks a significant milestone in the evolution of sustainability reporting. As organizations and markets increasingly recognize the importance of environmental, social, and governance (ESG) factors in assessing corporate performance and risk, the need for robust and universally applicable reporting standards has become paramount. Afolabi et al. (2023), Baumüller and Sopp (2022), Rossi (2022) and Rowbottom (2023) provide critical insights into the development of these standards, their potential impacts on existing sustainability reporting frameworks, and the broader implications for corporate transparency and accountability.

The ISSB was established with the objective of developing a comprehensive global baseline of high-quality sustainability disclosure standards to meet investor needs for ESG information. Afolabi et al. (2023) describe the ISSB's influence and behaviour as indicative of a strategic intent to redefine the sustainability reporting arena, potentially affecting the Global Reporting Initiative (GRI)'s Guidelines and Standards⁴ longstanding position.

The EU's Modernization Directive initiated a shift towards more comprehensive reporting requirements, which was expanded upon by the NFI Directive. The subsequent proposal for the CSR Directive reflects an advanced understanding of sustainability reporting, emphasizing the principle of double materiality. This principle, which accounts for both the impact of the company on sustainability issues and the impact of these issues on the company, has become a cornerstone of the ESRS developed by EFRAG.

EFRAG's ESRS builds upon the global baseline proposed by the ISSB, adapting and expanding it to align with the EU's specific policy objectives and the double materiality concept.

The ESRS aims to integrate the broader impacts of business activities on society and the environment, going beyond financial materiality to encompass a wider range of stakeholders' interests. Baumüller and Sopp (2022) emphasize the importance of the 'double materiality' concept in the European context, which the ISSB's investor-centric approach may not fully encompass. This divergence in materiality perspectives raises questions about the future alignment of global reporting standards.

³ The work of Baumüller and Sopp (2022) provides a critical lens through which to view this evolution, particularly with regard to the principle of materiality in sustainability reporting.

The divergence in materiality concepts between the ISSB and EFRAG presents both challenges and opportunities for harmonization. While the ISSB standards provide a global starting point, EFRAG's ESRS embodies the EU's distinct approach to sustainability reporting. The interplay between these frameworks will likely shape the future of corporate disclosures, with potential implications for global convergence or divergence in reporting practices.

4. The process history of the IFRS Foundation Consultation Paper and descriptive analysis of comment letters

In October 2019, in the context of the IFRS Foundation's five-year review of its strategy, a task force presented the Consultation Paper on Sustainability Reporting⁵ to identify stakeholders' demands in the area of sustainability reporting and to understand what the Foundation could do in response to those demands. The main purpose was to understand whether there was a need for global sustainability standards, whether the IFRS Foundation should play a role in meeting this need and the scope of that role.

The task force's research and stakeholder contacts revealed a growing and urgent demand of sustainability reporting, and, as a result, found that a wide range of voluntary principles and standards are in use.

Preparers are faced with reporting according to multiple standards, metrics or frameworks with limited effectiveness and impact, high risk of complexity, and increasing cost. Consequently, a difficulty in engaging capital markets to smooth the transition to a low-carbon economy emerges. Therefore, the IFRS Foundation can be identified as a main actor in fostering the creation of a common set of sustainability reporting standards that are globally accepted and used and that bring transparency, accountability and efficiency because of its expertise in standard-setting and its relationships with global regulators and governments.

⁴ The Global Reporting Initiative Sustainability Reporting Guidelines were first developed with the aim of assisting "reporting organisations and their stakeholders in articulating and understanding contributions of the reporting organisation to sustainable development" (GRI, 2002, introduction). In 2016, GRI transitioned from providing guidelines to setting the first global standards for sustainability reporting – the GRI Standards.

⁵ For a comprehensive overview of the topic, refer to the IFRS Consultation Paper on Sustainability Reporting issued September 2020, available at: <https://www.ifrs.org/content/dam/ifrs/project/sustainability-reporting/consultation-paper-on-sustainability-reporting.pdf>.

To achieve coherence and comparability, the approach recommended by the Task Force and supported by the Trustees of the IFRS Foundation was to create a new Sustainability Standards Board (SSB) under the governance structure of the IFRS Foundation to develop and maintain a global set of sustainability-reporting standards, initially focused more on climate-related risks and coherence with financial reporting standards.

For the reasons stated above, the public consultation was launched in September 2020, and comments were welcome to be submitted by December 31, 2020. The IFRS Foundation published this consultation paper containing 11 questions for consultation. The first questions asked whether different stakeholders perceived the need for a global set of internationally recognized sustainability reporting standards and whether they agreed with the development of a board under the IFRS Foundation governance structure. Moreover, the questions for consultation tried to gather any comments or suggestions about the requirements for the success of the initiative, building upon existing initiatives in sustainability reporting. Another important aspect addressed by the questionnaire concerned the decision to begin SSB activities with the development of standards and disclosures related to climate factors and risks. Then, the last questions asked for opinions regarding the concept of materiality of information proposed in the conceptual paper and whether such information needed external assurance. By the end of December 2020, 577 comment letters had been received from all over the world⁶. Most of the letters answered each question in depth, while some commented on the initiative more broadly.

With the aim of deeply analysing the content and the suggestions obtained from different stakeholders, we decide to filter the 577 letters using two criteria for the senders: the first considers the geographical area of senders' activity, circumscribing it to Europe; the second criterion concerns the institutional form by which senders conduct their activities, not considering individual scholars or practitioners but selecting only national or supranational representative bodies.

The final sample studied consists of 60 letters. We performed some descriptive statistics, and we found that more than 83 percent of the letters in the sample responded analytically to the first 10 questions, while only 52 percent responded to the last question, which requested additional comments or relevant matters that had not been analysed by the conceptual paper and deserved the IFRS Foundation's attention.

⁶ The full set of comment letters is available at: <https://www.ifrs.org/projects/completed-projects/2021/sustainability-reporting/consultation-paper-and-comment-letters/#view-the-comment-letters>.

Notably, we can assert that from the first reading of the letters that the vast majority of commenters agree with the assumption of the IFRS Foundation's consultation paper, especially about the need for a board able to set international sustainability reporting standards within the institutional and governance structure of the IFRS Foundation.

5. Discussion

From the letters received by the IFRS emerges a common view about the actions needed to establish global sustainability standards. First, respondents highlighted the extent to which there is a need for a global set of international sustainability reporting standards that are industry specific and investor focused and that, in this context, the IFRS Foundation could play a crucial role in setting these standards.

The SSB should begin by reviewing current standards and understanding the conceptual frameworks in place. Then, it should focus on the standards and frameworks that focus on enterprise value creation; build upon existing initiatives by consolidating, harmonizing and clarifying terminology; learn lessons from the successes and failures of adopting these frameworks and standards; and adopt those standards and frameworks on an interim basis. The SSB could then blend existing frameworks with the current International Accounting Standards Board (IASB) conceptual framework to develop the SSB sustainability conceptual framework and establish processes to develop and amend standards.

Another interesting concern emerging from respondents regards the definition of materiality. Some letters highlight that prior to developing standards that deal with material information for investors and other market participants, the IFRS Foundation must define materiality as it relates to sustainability information. The question of the definition of materiality must be resolved satisfactorily and is currently a source of considerable debate. At the moment, there is confusion about materiality in relation to a) materiality to whom, b) materiality in relation to financial, social or environmental capital/impacts/dependencies and c) materiality over what time horizon.

A clear the concept of materiality is crucial in sustainability reporting. Some stakeholders believe that the SSB should work towards supporting investors and other market participants by focusing on producing relevant information insofar as it affects the entity. Others believe that SSB should develop standards based on a principle whereby the reporting entity must

also disclose its impact on the wider environment, as this would also be material to stakeholders, known as ‘double materiality.’

Most of the respondents claimed that the double materiality approach would cause complexities and lead to delays in standard-setting. Therefore, they suggested that sustainability reporting should initially be focused on information that is most relevant to investors and other market participants.

On the other hand, the double-materiality approach seems to be appropriate, covering both financial materiality and social and environmental materiality and considering the long-term-horizon when it comes to non-financial reporting. Investors, especially institutional ones, need detailed information based on all constituents of sustainable development.

Another issue of concern emerging from respondents is the need to develop initial climate-related financial disclosures before potentially broadening its remit into other areas of sustainability reporting. A climate-only solution will not solve the sustainability disclosure problem. Indeed, climate is only one factor in a complex range of ESG issues that drive companies’ long-term performance. Providers of financial capital have increasingly called for a comprehensive approach to sustainability disclosure, recognizing the important interrelationships between ESG factors. Again, strong performance on climate issues does not necessarily correlate to strong performance on all financially material issues; for instance, a company may have strong environmental performance but weak performance on human capital issues. The SSB could initially prioritize codifying the climate-related guidance in the existing frameworks and standards into one comprehensive standard.

Respondents called for high-quality global financial reporting standards and support the convergence of IFRS and US General Accepted Accounting Principles (GAAP) because they believed that common, high-quality language for interpreting financial results would be beneficial to investors and stakeholders generally. While companies report based upon their country of domicile, investors seek investment opportunities globally, and a common language would make comparison much easier.

Several respondents supported the notion of integrated reporting (IR) and the efforts to provide a useful conceptual framework for considering the value creation process. They noticed that the IR framework does not provide sufficiently detailed guidance to result in the comparable, consistent and reliable data needed by investors, suggesting a dialogue to bring all stakeholders towards a converged solution relating to ‘non-financial information’. What is measured and disclosed is then monitored by

management and others. This is true with ‘non-financial information’ as well, but the added step of demonstrating the linkage of the information to financial value creation is essential to investors’ global acceptance of the need for such information and preparers’ agreement to provide this information. Said differently, this information cannot be valued only qualitatively and intuitively. Without linkage to measurements that demonstrably connect to financial value creation, they will not be widely adopted.

Central to effective communication is knowledge of the audience and the communication objective. With a wide variety of audiences and communication objectives, convergence will always be more challenging. For that reason, the report must clarify the audience and the communication objective of financial reporting before considering an oversight structure that seeks to integrate them with the audience and communication objective of “non-financial information.”

One issue is that lack of clarity about the audience for the standards (both financial and non-financial) and whether they will be focused on investors or all stakeholders. This crucial issue must be clear, as several respondents claim that an organizational structure or conceptual framework that conflates the information needs of investors with those of a wider group of stakeholders cannot be supported.

The report does not mention the location of ‘non-financial information’ or where it will be reported. This is a crucial question to be answered. While in some countries, all companies prepare accounts and annual reports, in other jurisdictions, only publicly listed companies must release information publicly.

Some who support additional ESG and sustainability information for a variety of objectives (values and civil society) are pushing for the inclusion of such information in the annual reports of listed companies, which creates push-back from companies and regulators whose focus or objective is to provide information only financially value relevant to investors. They are averse to the inclusion of such information in securities regulatory reporting requirements, believing and asserting that it creates an unequal burden on publicly listed companies. To ask publicly listed companies to provide disclosures that support values- or civil society-based objectives (simply because they have a public reporting obligation to investors under securities laws) may penalize publicly listed companies by placing that disclosure burden on them simply because of an existing public disclosure regime. They should not have greater burden than other companies when it comes to values- or civil society-based reporting objectives. This will have the impact of pushing more companies out of the public market. Such dual

objectives and the use of disclosure regimes for publicly listed companies to effectuate the desired disclosures and change will slow support for and adoption of such disclosures. For that reason, the report must define the new obligations of reporting companies and the location of such disclosures based upon their existing reporting obligations as publicly listed companies.

From the letters, it emerges that consistency in sustainability reporting can be achieved more robustly at a global level if the sustainability information reported by entities is externally assured. One of the barriers to providing assurance is the need for a reporting framework against which to 'audit' (today, the assurance providers mainly give limited assurance). Several respondents underline that this assurance on sustainability information can be provided by consultants with specific competences in ESG issues rather than by traditional auditors with accounting and assurance expertise.

Globally, respondents recommended that IFRS develop and include sufficient instructions for abiding by its most important principle: the Sustainability Context principle⁷. This principle is arguably the most important element of sustainability reporting because it calls for assessments of performance to be made relative to sustainability norms, standards or thresholds. Short of taking steps to clearly identify such criteria and then measure performance against them, the most an organization can do is report impacts in purely incremental or relativistic terms (i.e., more of this type of impact this year, less of this type). Authentic sustainability reports, by contrast, disclose the sustainability performance of organizations per se (i.e., whether or not an organization's impacts were sustainable as measured and reported against sustainability norms and standards for sustainable impacts).

⁷ The essence of the Sustainability Context Principle is that sustainability reporting draws significant meaning from the larger context of how performance at the organizational level affects economic, environmental and social capital formation and depletion at a local, regional or global level. Reporting organizations should consider their individual performance in the context of the limits and demands placed on economic, environmental or social resources at a macro-level. In other words, Sustainability Context calls for making the *micro-macro link* between organizational-level impacts on ecological, social and economic resources and systems-level carrying capacities of these capitals (natural, social, human, built and economic). Stated slightly differently, Sustainability Context calls for respecting ecological, social and economic *thresholds* at the macro systems level via fair, just and proportionate *allocations* of accountability at the micro-organizational level (Sustainability Reporting Guidelines, Global Reporting Initiative, 2002).

To simply say that less water, for instance, was consumed this year than last only begs the question of whether the amount of water consumed in either year was empirically sustainable. The same goes for greenhouse gas emissions, solid wastes, biodiversity and many other social and economic impacts. The fact that few organizations committed to the use of GRI's Guidelines and Standards have ever incorporated Sustainability Context into their reports is demonstrably due to GRI's failure to provide clear guidance for doing so. This was a fatal mistake in the short history of sustainability reporting and should not be repeated by the IFRS. Otherwise, we can expect yet another twenty years of poor reporting by which the sustainability performance of countless organizations will never be known.

One main factor limiting sustainability reporting convergence in the short term is the coexistence of the ISSB and the current approach of EFRAG. By proposing competing standards and refusing to endorse ISSB standards, the EU is indirectly undermining the legitimacy of the IASB in sustainability reporting. The ISSB either needs European firms to comply with both the EU and ISSB approach or another important economic area to adopt its sustainability standards. For European firms, complying with both sets of sustainability standards seems counterproductive (Stolowy and Paugman, 2023).

More broadly, having a plethora of sustainability standards and organizations involved in sustainable development and sustainability reporting has adverse consequences. First, the multiplication of sustainability standards decreases the legitimacy and effectiveness of each standard. Indeed, it adds confusion to the credibility of each standard and casts doubt on the theoretical foundation of the concept of sustainability. Second, multiple standards increase disclosure processing costs for investors who may be truly looking to assess sustainable performance. Multiple standards complexify the integration of sustainability information into investment decisions. It also increases the cost for external auditors providing assurance on sustainability information. Third, multiple standards create regulatory arbitrage opportunities for firms, as they may select the standards leading to their most favourable outcomes. Finally, the proliferation of standards also creates opportunities for the management of legitimacy, as compliance with standards can be used as a stamp of approval, increasing the legitimacy of the firm's activities. The evolution of sustainability reporting standards from the ISSB to EFRAG's ESRS represents an ongoing journey towards more comprehensive and stakeholder-responsive corporate disclosure. The EU's legislative history, as explored by Baumüller and Sopp (2022),

provides a contextual understanding of this progression. As sustainability reporting continues to mature, the harmonization of standards will remain a pivotal area for both practice and research, with the goal of fostering transparency and accountability in the corporate sector. Nevertheless, to conclude this essay on a less pessimistic note, we can highlight one exception in sustainability reporting convergence. Climate-related disclosures seem different from other sustainability dimensions. Indeed, most climate-related disclosure regulations (or proposed rules) are built on the Task Force on Climate-related Financial Disclosures (TCFD) framework; therefore, the regulatory requirements are converging across standard-setting organizations. Due to the factors identified in this essay, we view this as an exception rather than a sign of global convergence for other dimensions of sustainability.

The first ISSB standards on sustainability represent a transformative step in standardizing ESG disclosures globally. However, the shift they signal towards investor-oriented materiality has profound implications for the inclusivity and comprehensiveness of sustainability reporting. As standard setters like the ISSB and GRI navigate this new landscape, the need for a balanced approach that accommodates diverse stakeholder interests becomes increasingly critical. The future of sustainability reporting will likely be characterized by a complex interplay of power dynamics, with the potential for greater harmonization or fragmentation of reporting practices, depending on the collaborative or competitive interactions among the various standard-setting bodies.

Considering the underlined deficient understanding of sustainability reporting practices, there are extensive opportunities for future research in this field. It emerges from our study, and interpretation of the comment letters and from the analysis of the Foundation's steps after the consultation, that the accounting scientific research activity on this topic does not appear to be sufficiently appreciated by the IFRS Foundation. Notwithstanding this, the constitution of the SSB clearly suggests that widening and deepening academic research on this field could be useful.

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