

Annual Report and Sustainability Report: a Theoretical proposal for an Integrated Reporting

Massimo POLLIFRONI*

University of Turin, Turin, Italy

ORCID ID: <https://orcid.org/0000-0002-2533-490X>

*Corresponding author, e-mail: massimo.pollifroni@unito.it

Gheorghe MILITARU

University POLITEHNICA of Bucharest, Bucharest, Romania

ORCID ID: <https://orcid.org/0000-0003-4650-8427>

e-mail: ghmilitaru.militaru@gmail.com

Ionela Luminita CANUTA (BUCUROIU)

University POLITEHNICA of Bucharest, Bucharest, Romania

ORCID ID: <https://orcid.org/0009-0007-9733-0266>

e-mail: canuta.ionela@gmail.com

Francesco POLLIFRONI

University of Turin, Turin, Italy

ORCID ID: <https://orcid.org/0009-0006-3529-6181>

e-mail: francesco.pollifroni@edu.unito.it

Abstract. *The objective of the article is to propose a theorization regarding ethical reporting and the proposal – particularly relevant for listed companies – consists in reporting to investors and to stakeholders the ESG performances measured through an accounting model in which, on the one hand, sustainability reporting can acquire from the annual report the accounting information necessary for the drafting of its documents and, on the other hand, it is able to return the environmental, social and governance performances in the annual report, thus influencing the accounting results contained in the document.*

The novelty of the model derives from the fact that in current documents and in those relating to the ethical reporting model (such as, for example, the social report, the environmental report, the sustainability report, etc.) the information flow from the annual report to the sustainability report is unidirectional (the directionality is from the annual report to the sustainability report). In other words, the accounting data included in the annual report has never been directly influenced by the information provided by non-financial reporting (or sustainability reporting): the only identifiable connection has been in the use of the sustainability reports of some quantitative data produced by the accounting records.

In the theoretical proposal, pertinent to the ethical accountability model, a bidirectional connection is instead envisaged between traditional accounting information and ethical information.

This would materialize through the inclusion of the accounting valuation of the ethical dimension in the annual report, with a significant and positive impact on the accounting valuation of the company itself.

The topics of the paper are addressed to a heterogeneous audience of subjects made up of academic researchers, stakeholders and shareholders: for academic researchers the implications of the paper should serve to create a new theoretical model of connection between annual report and sustainability report disclosure; for stakeholders the model could provide greater transparency in financial reporting, which is particularly significant in companies listed on stock exchanges and for shareholders the proposal could provide a significant revaluation of the financial investments made.

Keywords: Business Ethics, ESG Reporting, Ethical Reporting, Ethical Accountability, Sustainability Report.

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Introduction

The concept of sustainable development – introduced for the first time in 1987 in the Report of the “World Commission on Environment and Development” (also commonly known as “Brundtland Commission”, after the Norwegian president Gro Harlem Brundtland), subsequently accepted and expanded in the “5th Program of Action on the Environment” of the European Union in 1993 – was defined as “(...) *economic and social development that does not cause damage to the environment and the natural resources on which the continuation of human activity and future development depend (...)*” [1].

The declination of the concept of sustainable development has highlighted its own intrinsic three-dimensionality, essentially attributable to the aspects: “(...) *environmental, as the ability to maintain the quality and reproducibility of natural resources; social, as the ability to guarantee conditions of well-being and growth opportunities in compliance with human and labor rights; and economic, as the ability to generate income, profit and stable and lasting work (...)*” [2].

In Business economics, this three-dimensionality can be found and characterizes numerous theories, including the triple bottom line model and the concept of corporate social responsibility. The triple bottom line theoretical model - proposed and developed in the second half of the 90s by Elkington - was characterized by signaling to the business system the need to provide a report on the three main dimensions of its performance, economic, social and environmental, through the drafting of a single document intended without distinction for investors, customers and stakeholders [3], [4] and [5].

Elkington’s theorization, in fact, was influenced - providing it with a balance sheet dimension - by the previous model of corporate social responsibility (CSR), an archetype proposed by Carroll at the end of the 70s, in which a multidimensionality of conceptual analysis was introduced applied to the company, in the economic-legal, ethical and philanthropic aspects [6], [7] and [8].

The concept of CSR, originating from the discipline of Business Economics, was subsequently taken up again with insights and pronouncements proposed by the European Commission, that has therefore defined – in its initial formulation, which is considered more exhaustive than other proposals put forward in subsequent periods – CSR as “(...) *the voluntary decision to contribute to the progress of society and the protection of the environment, integrating social and ecological concerns in corporate operations and interactions with stakeholders (...)*” [9].

From the definition of the European Commission, therefore, it is clear that the concept of CSR must necessarily include the acquisition of awareness by companies - entities assumed as the primary object of study, in our analysis - that being key players in the context in which they operate, not only presupposes the implementation of an economically correct and balanced management, but must also imply the manifestation of their own orientation towards the protection of the concept of sustainable development. According to this approach, therefore, acting in a socially responsible way means consolidating one's value taking into account the effects induced on one's stakeholders, strengthening intangible assets (reputation, dialogue and transparency in communication), reducing negative externalities (environmental pollution, social imbalances and predatory belligerence) and enhancing positive ones (employment, valorization of diversity and support for sustainable development, understood in a social, environmental and economic sense).

The definition of CSR, promoted by the European Commission, underlines the following profiles pertaining to the same concept, that appears to be:

- characterized by an environmental profile of the underlying activities;
- distinguished by a social dimension of the same;
- oriented towards the concept of sustainable development;
- and qualified by a voluntary aspect of the underlying initiatives that can be implemented.

It would be quite evident that the two concepts under analysis – sustainable development and CSR – are almost completely superimposable, in which the environmental, social and economic aspects appear to be common to both, while the aforementioned voluntary profile of the actions represents a characterizing element of the actions attributable to CSR (consequently, the activities carried out in compliance with a mere imposition dictated by the legislation should be excluded from it). The approach – aimed at drafting an annual report integrated into the non-financial information initially aimed at the financial sector – was implemented in 2014 at Community level by Directive 2014/95/EU, also known as the “Non-Financial Reporting Directive” (NFRD), “amending Directive 2013/34/EU as regards the disclosure of non-financial information and diversity information by certain large undertakings and groups”.

The focus on non-financial information in the “Non-Financial Statement” (NFS) has been further expanded in recent years by a series of European Union (EU) measures, including:

- EU Regulation 2019/2088 of the European Parliament and of the European Council of 27th November 2019 on “Sustainability-related disclosures in the financial services sector” (SFDR), immediately binding throughout the EU on the date of its entry into force.
- Report of the European Banking Association (EBA) on the subject of “Guidelines on loan origination and monitoring”, dated 29th May 2020.
- Directive 2022/2464/EU, so-called Corporate Sustainability Reporting Directive (CSRD), which aims to promote transparency and disclosure of information by companies regarding environmental, social and governance impacts (concerning – the latter – the transparency and effectiveness of corporate management: aspects overall summarized in the acronym ESG).
- Directive (EU) 2024/1760, dated 13th June 2024, also known as the Corporate Sustainability Due Diligence Directive (CSDDD).

CSDDD completes the European regulatory framework on sustainability, integrating with the previous CSRD Directive [10] and [11]. While the CSRD focused on introducing the reporting obligation, imposing on certain groups of companies the publication of a detailed and ESG-oriented sustainability report, the latter, the CSDDD, introduces the concept of due diligence placing attention on the entire supply chain of companies [12], [13] and [14].

Discussion

As stated in the previous paragraph, a process of revision of the attentions of the European legislator has emerged in recent years, which from the initial declination of CSR, sensitive to the protection of environmental, social and economic aspects, as reported in the previous pages, arrives at the current one, which promotes an ESG communication, initially aimed at the financial sector (and subsequently extended to other sectors, as reported above) and oriented to the analysis of environmental, social and governance impacts: this revision of the approach in CSR communication to ESG communication, can find its justification simply by observing that the economic aspect present in CSR (and replaced by that of governance in the ESG approach) is already included - in the annual report - in the aspects of relevance of accrual accounting, together with those of a financial and patrimonial nature.

At the date of writing this contribution, it is necessary to point out that - as a consequence of the new EU policies aimed at defense and accepted by the “Readiness 2030” plan - the European Green Deal has been significantly reduced by the Omnibus-I and Omnibus-II provisions, which will lead as a final effect - according to the estimates of the European Commission itself - to a contraction of 80% (approximately) of the companies subject to the obligations deriving from the last two directives cited in terms of sustainability (CSRD and CSDDD).

The element that has however united the various phases of the process of reviewing the areas of attention implemented by the European legislator on CSR, can be summarized by the simple observation that the accounting data, present in the annual report of the company, has never been in any way conditioned in the quantitative aspects, that is, it has always appeared - in accounting terms - neutral with respect to the environmental, social and now governance information contained in the various documents proposed over time such as the sustainability reports. In other words, the financial, economic and equity information included in the annual report has never been directly conditioned by the non-financial items included in the sustainability reporting: the only identifiable connection was in the use by the ESG reports of some quantitative data present in the annual reports.

The aim of the paper, therefore, is to propose a theorization relating to ethical accountability - which can be summarized in the obligation for the company - but particularly relevant for companies listed on regulated markets - to report to investors on their actions and decisions, ensuring full responsibility for the ESG performance achieved and measured by an accounting model that can implement this two-way connection, providing for a process of mutual exchange of information flow, in which on the one hand sustainability reports can acquire from accrual accounting the information they need for supporting their accountability and on the other hand they are able to reallocate inside the annual reports the environmental, social and governance performances detected, thus subsequently and quantitatively influencing the accounting values contained in the same documents.

From what has been stated above, it is therefore possible to derive the following categories of documents:

- documents pertaining to the ethical reporting model,
- documents pertaining to the ethical accountability model.

In the documents pertaining to the ethical reporting model (such as, e.g., social report, environmental report, sustainability report, ESG report) there is only a connection derived from the information flow from the annual reports to the ethical ones. In this case - which is reflected in the current international practice - the accounting data is not conditioned by the ethical profile of the company, which is analyzed separately in the different categories of reports mentioned previously.

In those pertaining to the ethical accountability model, the annual report is in turn conditioned by the ethical performance detected by the sustainability report: this would be implemented through the inclusion of the accounting valorization of the ethical dimension already in the process of drafting the annual report itself, having - as a final effect - a significant impact on the equity valorization of the same company. In this case, the accounting data of the annual report would be directly influenced by the ethical profile of the company (be it a business enterprise, or a public institution, or a non-profit organization) and the need to account (both to stakeholders and to the shareholders themselves) for its ethical orientation would be already satisfied in the annual report: the name of ethical accountability model would therefore result from this outlined bidirectional change in perspective of the information flow that is the object of ethical accountability.

The search for criteria that can be traced back to the evaluation of rewarding ESG performance (and that can obviously be extended to non-mandatory practices oriented towards CSR principles), implemented by the company, would have the objective of identifying those actions that highlight that “plus” to be rewarded compared to what was achieved in the simple fulfillment required by current legislation (such as, e.g., the construction of a purifier for a textile company), which – therefore – would not highlight that profile of voluntariness and proactivity that can be found in other corporate initiatives (such as, e.g., the construction of a nursery school as a tool to support the needs of its workers). The legitimacy of our reasoning is supported not only by common sense, but also by the definition of CSR set out by the European Commission, cited in the previous pages: the proposal for a theoretical model of ethical accountability is offered in the following paragraph.

The proposal of the theoretical model of ethical accountability

The proposed theoretical model of ethical accountability takes as a premise two considerations set out in the previous pages:

- the process of reviewing the attentions implemented by the European legislator in recent years, which from the initial CSR declination, sensitive to the protection of environmental, social and economic aspects, arrives at the current one, which promotes ESG communication, oriented to an ethical analysis of environmental, social and governance impacts [15], [16] and [17];
- the identification of those actions that highlight that profile of voluntariness and proactivity to be rewarded, compared to those carried out as mere regulatory compliance.

Given this, the model proposes an articulated approach in the analysis of 1) current operations (or operational operations) separated from 2) non-current ones (or investment, financing and extraordinary operations).

1) Current operations (or operational operations).

As regards current operations, any subsidies received for ESG purposes (i.e. environmental, social and governance purposes) should be subtracted from the related costs.

In this case, the formula relating to the quantification in the financial year (t) of the bonus to be recognized for voluntary actions oriented towards ESG principles, definable as ESG Intangible Asset from current operations (IA-ESGco) – which can be classified (inside the balance sheet statement) within an item included in the intangible fixed assets with a counterpart in a net equity item – could be:

$$IA - ESGco(t) = \sum_{i=1}^n [(C - ESG_{i(t)} \times (1 + r_{(x-t)})] - \sum_{i=1}^n [(S - ESG_{i(t)} \times (1 + r_{(x-t)})] \quad (1)$$

with:

- IA-ESG_{co(t)} = ESG Intangible Asset from current operations, quantified in the financial year (t), the year in which the ESG performance assessment is carried out;
- C-ESG_{i(t)} = Total ESG Costs (i) pertaining to the period (t);
- S-ESG_{i(t)} = Total ESG Subsidies (i) pertaining to the period (t);
- r (x – t) = monetary revaluation rate (r) relating to the period between the financial year of competence (t) of the ESG Costs and Subsidies detected and the financial year (x), year in which the ESG performance assessment is included in the annual report for accounting purposes.

The rate of monetary revaluation (r) would obviously be zero, if an exact coincidence was found between the financial year of competence (t) of the ESG performance assessment and the financial year (x), the year when the accounting value is included in the annual report. The opposite case would occur when the ESG performance assessment is included in the annual report in a different financial year (for example the following financial year), or

when there is a delay between the year of issue of the law and that of its punctual application. As for the rate of monetary revaluation (r) used in the model, it should be defined by the reference legislation directly, or indirectly by referring to specific price indices for monetary revaluations produced by official national or international institutions (e.g. Eurostat).

2) Non-current operations (or investment, financing and extraordinary operations).

Also, in this case regarding the non-current operations, any capitalized subsidies received for ESG purposes (i.e. environmental, social and governance purposes) should be subtracted from the related assets.

In this case, the formula relating to the quantification in the financial year (t) of the bonus to be recognized for voluntary actions oriented towards ESG principles, definable as ESG Intangible Asset from non-current operations (IA-ESGco) – which can be classified (inside the balance sheet statement) within an item included in the intangible fixed assets with a counterpart in a net equity item – could be:

$$IA - ESG_{nco}(t) = \sum_{i=1}^n [(A-ESG_{i(t)} \times (1 + r_{(x-t)})] - \sum_{i=1}^n [(CS-ESG_{i(t)} \times (1 + r_{(x-t)})] \quad (2)$$

with:

- IA-ESG_{nco(t)} = ESG Intangible Asset from non-current operations, quantified in the financial year (t), the year in which the ESG performance assessment is carried out;
- A-ESG_{i(t)} = Total ESG Assets (i) pertaining to the period (t);
- CS-ESG_{i(t)} = Total ESG Capitalized Subsidies (i) pertaining to the period (t);
- $r(x-t)$ = monetary revaluation rate (r) relating to the period between the financial year of competence (t) of the ESG Assets and Capitalized Subsidies detected and the financial year (x), year in which the ESG performance assessment is included in the annual report for accounting purposes.

To identify the investments referred to in the model, a useful tool to help investors identify environmentally sustainable economic activities could be the EU taxonomy on sustainable investments [18], [19] and [20].

This tool is very interconnected with the Regulation on the disclosure of information on sustainability in the financial services sector (SFDR) and related to the CSRD and CSDDD Directives (illustrated in the previous pages): by the EU Taxonomy the objective of the European legislator is to provide a regulatory framework that facilitates transparency and traceability of sustainable investments: a brief illustration of the EU taxonomy on sustainable investments is provided in the following Figure 1.

In conclusion, therefore, the quantification of the Final ESG Intangible Asset (IA-ESGf(t)) in the financial year (t), would be determined by the following formula:

$$IA-ESG_{f(t)} = IA-ESG_{co(t)} + IA-ESG_{nco(t)} \quad (3)$$

with:

- IA-ESG_{f(t)} = Final ESG Intangible Asset (AI-ESGc), quantified in the financial year (t), the year in which the ESG performance assessment is carried out;
- IA-ESG_{co(t)} = ESG Intangible Asset from current operations, quantified in the financial year (t);
- IA-ESG_{nco(t)} = ESG Intangible Asset from non-current operations, quantified in the financial year (t).

In the event that a reduction in the value of the new intangible asset were to occur in subsequent financial years – asset that could be called, for example, Goodwill from Relevant ESG Performance (in acronym GRP-ESG) – this would be compensated by a corresponding sterilization (or reduction) of the related equity counterpart: this would be the eventuality, for example, resulting from a subsequent sale of assets considered in previous financial years to be relevant from the point of view of ESG performance. Furthermore, the equity counterpart could take the name of Undistributable Reserve from Relevant ESG Performance (in acronym URRP-ESG).

Given the above, therefore, the new asset called GRP-ESG should be subject to the problems of amortization of traditional goodwill, since the conditions set out in international accounting standards would exist, although the same would at the same time be compensated by a corresponding sterilization (or reduction) of the related equity counterpart called URRP-ESG, thus ensuring neutrality in the income statement.

What the EU Taxonomy is	What the EU Taxonomy is not
A classification system to establish clear definitions of what is an environmentally sustainable economic activity	It's not a mandatory list to invest in
Tool to help investors and companies to make informed investment decisions on environmentally sustainable activities for the purpose of determining the degree of sustainability of an investment	It's not a rating of the "greenness" of companies
Reflecting technological and policy developments: The Taxonomy will be updated regularly	It does not make any judgement on the financial performance of an investment
Facilitating transition of polluting sectors	What's not green is not necessarily brown. Activities that are not on the list, are not necessarily polluting activities. The focus is simply on activities that contribute substantially to environmental objectives.
Technology neutral	
Fostering Transparency by disclosures for financial market participants and large companies related to the Taxonomy	

Figure 1: Illustration of the EU taxonomy on sustainable investments

Source: European Union (see at: <https://ec.europa.eu/sustainable-finance-taxonomy/>)

Finally, this model would provide direct visibility of the relevant ESG performances, or in broader terms CSR performances, pursued by the virtuous company already in the annual report, consequently overcoming that unidirectionality between the results of the accounting reporting and those deriving from the sustainability reporting, highlighted as a critical element in the previous pages.

Conclusions

This contribution – in its essential lines – wanted to propose a purely theoretical model, oriented to the consolidation of the interdependence between sustainability reporting processes and those of traditional reporting: the illustrated methodological proposal has allowed to quantify in terms of assets a new intangible item defined, in the previous pages, as Goodwill from Relevant ESG Performance (in acronym GRP-ESG).

It is therefore evident that the aspects analyzed, and the consequent solutions proposed, require a natural consolidation obtainable exclusively through the realization of a constructive comparison between the actors of the system involved (scientific community, public companies, interested professional orders, institutions guaranteeing the procedure, etc.), oriented to the determination of a scientific method of evaluation of the model that is commonly shared by all the subjects interested in the process. Further reflections and in-depth studies, associated with adequate experimentation in the field of research, can only therefore verify the value and coherence of this proposal, formulated also with the aim of arriving at a review of the concept of sustainable development, identifying new study and analysis profiles, more pertinent to the discipline of Business Economics.

The final hope is that the content of the proposal put forward can, in some way, stimulate common interest in defining a reporting system in which traditional aspects of analysis (linked to the economic, financial and equity dimensions) are more integrated with ESG performance.

Additional information

Although the paper oriented to Business economics is the result of the joint work of the authors, the following is noted: Massimo Pollifroni has implemented the theoretical framework of the paper, Gheorghe Militaru followed the supervision, Ionela Luminita Canuta has carried out the research study of the European legislation underlying the topics developed in the paper, while Francesco Pollifroni followed the editing and corrections of the paper.

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