Corporate reporting – Poised for a Paradigm Shift

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The year 2020 was a watershed year for the world at large, including corporates, as the Covid-19 crisis put heightened emphasis on the need for reprioritizing corporate objectives and look at a more inclusive and sustainable future. This in turn is setting new expectations on corporate reporting on areas beyond financial performance, with an emphasis on the organisation's focus and efforts on environmental and social aspects, commonly referred to as the Environment, Social and Governance (ESG) agenda. The push in this area is coming from both investors and regulators.

This change also comes at a time when corporate financial reporting, globally and in India, has been under significant scrutiny. The enhanced focus has largely been in response to the many corporate failures, whether it was caused by a genuine business failure, a governance failure (including financial reporting/audit failure) or a combination of both.

There is certainly room for improvement in the governance and reporting practices. Afterall, the corporate financial reporting and audit ecosystem is such that it is only as strong as its weakest link, and therefore, if any of the stakeholders in this ecosystem do not play their role in ensuring high quality reporting, there is room for failure.

Time for a shift – a paradigm shift

The focus of investors and users is quickly widening from pure financial performance and returns to a more holistic assessment of both financial and non-financial performance on a foundation of sustainable and responsible businesses conduct. Therefore, it is an apt time for a paradigm shift in corporate reporting, paving the way for an integrated approach covering both financial and non-financial aspects, including the much talked about ESG elements. It's time for integrated corporate reporting.

This will also require the various stakeholders who are essential to the efficient functioning of the capital markets to also shift focus and embrace change in tandem; from the step-up required in the roles of auditors and independent directors, to more importantly looking at how the other stakeholders from management, boards, internal auditors, standard setters and regulators embrace change and ultimately seeing how the ecosystem as a whole evolves – and whether it should be a process of evolution or revolution.

From short termism towards longer-term view on value creation

For corporates to truly walk the talk in embracing this change, there needs to be a conscious shift towards developing a longer-term view on value creation, rather than having management energy focused on meeting short-term / quarterly results. With large global institutional investors increasingly looking at long term sustainability with a focus on ESG, it's an opportune time to wean the corporates and the capital markets away from short-termism towards this longer-term vision. A bold step in this direction could be the abolishing of quarterly financial reporting, and instead brining focus on broader integrated corporate reporting on a periodic basis, with a half-yearly report on financial health and performance.

Integrated corporate reporting standards

It has taken several years, with the commitment of the G-20 countries, to achieve a high level of convergence to a single set of high-quality accounting standards; today International Financial Reporting Standards (IFRS) have gone on to become the de-facto global language of financial reporting, with significant convergence with US GAAP, the other major set of standards. There is still some ground to be covered in ensuring consistent application of these standards.

However, on non-financial reporting, specifically on sustainability related reporting, there are a several sets of standards today. While the Global Reporting Initiative (GRI) Standards are more well known, there are also standards or guidelines developed by the Task Force on Climate-related Financial Disclosures, the Value Reporting Foundation (incorporating the Sustainability Accounting Standards Board and the International Integrated Reporting Council), and the Climate Disclosure Board.

As more and more investment decisions are driven by non-financial information reported by corporates, there is an urgent need to achieve convergence and to develop a single language in this area as well, with the objective of improving quality, consistency, transparency and accountability. The first step has been taken by the IFRS Foundation, with broad support from G7 Finance Ministers, IOSCO and investors and corporates from across the world to develop a global baseline of sustainability-related disclosures to facilitate comparability for investment decision making. This needs to be quickly followed by an integration of the IFRS and sustainability related standards, so that corporates can use a globally accepted framework to achieve their integrated corporate reporting requirements. A unified report that tells an integrated story of value creation and performance is ultimately what investors and users need, as they make their investment and capital allocation decisions.

Generating reliable and high-quality information

While corporates have reasonably mature systems, processes and controls to generate financial information, the same can't be said about the non-financial reporting. The level of maturity varies across the board, with many companies being at the lower end of the maturity curve. With investors increasingly seeking independent assurance on such information, corporates on their part will need to focus on putting the foundation in place for generating non-financial information, with a set of systems, processes and controls, akin to what's done for financial reporting. Companies should also leverage the power of technology and data analytics as they enhance their internal reporting capabilities. Over time, they will need to be at the same maturity levels, as companies move towards an integrated approach towards reporting and assurance.

Governance and monitoring

To ensure high quality reporting on ESG and non-financial topics, companies would need to focus on both the implementation of internal controls (akin to internal financial controls under the Companies Act for financial reporting) and effective monitoring by the internal audit function.

Considering that ESG is very much a Board agenda, it is imperative that the Board take ownership for the quality, consistency, transparency and accountability of the ESG and other non-financial reporting, with adequate oversight being provided by the Audit Committee. Just as the Board and Audit Committee put in oversight mechanisms to prevent any fraudulent financial reporting, it must take suitable steps to prevent any similar fraudulent reporting (through greenwashing or social washing) on the non-financial or ESG matters.

Enhanced assurance and role of auditors

Non-financial information is also important for investment decisions, with trillions of dollars of investments being committed based on the ESG and related parameters, there is also a need to focus on the assurance on such reporting. There is growing concern about the extent of greenwashing or social washing that's prevalent in the non-financial reporting done by corporates. Hence, there is an urgent need in the short-term to step up both the extent of assurance provided, if any, and bring consistency on the matters on which assurance is provided on non-financial information. The medium-term goal should be to develop an integrated approach towards assurance as well, covering both financial and non-financial elements, in line with the development of integrated corporate reports.

Further, with the growing interlinkages and inter-dependencies in the corporate ecosystem, with newer business models and ways of doing business, the relevance of information in its traditional form or based on conventional boundaries of the legal entity or single economic entity need to be re-evaluated, and the need for coverage of the relevant components of the eco-system beyond the entity may also need to be considered.

Proactive and constructive regulatory support

Regulators across the globe are stepping up their focus on ESG and sustainability reporting, with the US and European regulators leading the efforts on introduction of new disclosure requirements in this area. In India as well, the introduction of Business Responsibility and Sustainability Reporting by SEBI is a step in this direction. The focus of these regulators should be aligning to the global baseline of standards being developed by the IFRS Foundation and then putting in place effective monitoring and enforcement mechanisms rather than introducing additional reporting requirements.

Further, the stakes for investors will continue to increase as more and more investments are driven by ESG metrics, and therefore the regulators role in investor protection becomes all the more critical. As regulators develop and step up their monitoring role, they should ensure that their overall approach is more forward looking and constructive, with adequate avenues for remedial actions, rather than only penal action.

Further, the regulators should also focus on adequate capacity building to discharge their regulatory oversight function, including through more effective use of technology and data analytics. The regulatory oversight function should also be seen to be both effective as well as fair, with the principles of proportional liability being applied when considering enforcement action. The effectiveness of the regulatory function would also be seen if it ultimately deters wrongdoing and instead encourages the adoption of higher standards of reporting.

The stated intent of NFRA to carry out Financial Reporting Quality Review is a welcome step, to enhance the quality of financial reporting in the country. A similar approach to cover the quality of ESG and other non-financial reporting is also essential to ensure that corporates adhere to the highest standards as they report on these increasingly important elements of their overall performance.

Conclusion

The above points throw light on the growing importance of ESG and other non-financial reporting for investors in their capital allocation and investment decisions, and the related impact that ESG is having on the medium to long-term strategy of corporates. Therefore, it is important that corporate reporting evolves significantly with an integrated approach covering both financial and non-financial aspects. This is a great opportunity for all stakeholders including regulators, standard setters, corporates, boards and auditors to step up and change the game towards a more holistic integrated corporate reporting landscape.