

Financial reporting in a changing environment



Many industries are facing a changing environment in more ways than one. So the title of a stakeholder event in Brussels on 18 February 2020 jointly organised by the IFRS Foundation Trustees and the European Financial Reporting Advisory Group (EFRAG) seemed apt—‘Financial reporting: remaining relevant in a changing environment’. Not only do users of financial reporting have needs that are evolving, but the plight of the natural world has a larger bearing on financial reporting than might at first seem obvious.

Delegates heard a keynote speech from Valdis Dombrovskis, the European Commission’s Executive Vice-President for An Economy that Works for the People. He highlighted two of the most urgent changes happening in the world that directly affect not only what information investors need, but also how companies provide it. Executive Vice President Dombrovskis spoke of the ‘green and digital transformations’, and the subsequent panel discussion focused on the first of these.

Turning green

Stakeholders increasingly value not only traditional financial reporting, but various types of non-financial reporting. One of the more prominent is environmental, social and governance (ESG). Investors demand a much broader range of information than they did previously, seeking indicators beyond traditional financial metrics. Dombrovskis said that investors ‘need to know a company’s status in the wider value chain, what it stands for and where it is heading next’—things that a traditional statement of financial position does not by itself show.

Policymakers are not blind to changing investor demands. The European Commission intends to review its Non-Financial Reporting Directive this year, and invited EFRAG to start preparatory work on non-financial reporting standards with involvement of other bodies. EFRAG Board President Jean-Paul Gauzès welcomed the invitation and indicated that EFRAG was looking forward to set further steps in the non-financial reporting domain with its wide experience in financial reporting and experience with the European Corporate Reporting Lab@EFRAG activities.

Erkki Liikanen, Chair of the Trustees of the IFRS Foundation, moderated a panel discussion that highlighted the reasons why ESG is important in financial reporting. Sven Giegold, a Greens/European Free Alliance MEP, cited several examples from his native Germany, including how a life science company’s financial statements made no mention of how its activities affected biodiversity across the world, and how the balance sheets of German energy companies could be affected by climate-related risks that become material. In Mr Giegold’s view, quantified ESG risks, in particular climate and biodiversity risks, must be considered a part of corporate accounting. IFRS Standards ensure that investors see a true and fair view of a company, and the omission of future ESG risks may impede this view.

Sirpa Pietikäinen, a European People’s Party MEP from Finland, agreed that corporate reporting needs to include ESG measures. She listed some of the indicators already being used to measure environmental degradation: biodiversity, carbon dioxide emissions, water consumption. In her view, these need to be analysed and included in reporting disclosures. She believes that the time has come to stop talking about ‘non-financial reporting’ and integrate this type of reporting into accounting practice and company law.

Ms Pietikäinen argued that climate change is a global problem, so a global solution is needed in sustainability reporting. By her count, there are 270 ways to measure sustainability, so comparability is pretty well impossible without globally consistent standards. Mr Giegold agreed on the need for standardisation, but admitted that developing standards will be a challenge. Executive Vice-President Dombrovskis stressed the global scale of the challenge, acknowledging that the EU is happy to take the lead. He invited 'all public and private standard-setters from across the world to work together with the EU', especially the International Accounting Standards Board and the Task Force on Climate-related Financial Disclosures.

Mr Giegold also discussed the challenge of social acceptance around regulations to help the environment, such as emissions trading. He saw it as crucial for them to be seen not only as economically successful but also as socially just. Many people in Germany are angry with the government for not doing enough to fight climate change. The younger generation is driving change, with the German Green party gaining 40% of first time voters' ballots. 'They know that their interests are at stake and they are ready to make changes', he says.

Digital possibilities

The other theme in Executive Vice-President Dombrovskis's speech was the digital transformation. Digital tools remain 'largely unexploited', he said, but could play an important role in improving financial reporting. He gave examples such as predictive analytics using algorithms to carry out forward-looking analysis, and the European Commission's European Financial Transparency Gateway pilot project, which is testing whether blockchain technology can solve the issue of data fragmentation.

More pertinent to standards is the use of a taxonomy to make reports machine-readable. Were a set of standards for non-financial reporting to be developed, a taxonomy could also be developed—akin to the IFRS Taxonomy, developed for reports prepared according to IFRS Standards.