Part 2: Corporate Reporting: communicating resilience and sustainable value creation
25 June 2020, 1600 hours

In these unprecedented times of economic uncertainty, timely corporate disclosure demonstrating resilience and long-term prospects is more important than ever. This webinar assessed the practical challenges faced by companies, investors and auditors in the wake of Covid-19. We also discussed reporting beyond financials with a particular focus on human capital management and climate change.

ICGN is grateful to our Speakers as follows:

- Anne Simpson, Director of Board Governance and Strategy, CalPERS
- David Pitt-Watson, Chair of Advisory Board, Sarasin Investment Partners
- David Barnes, Global Risk, Regulatory & Public Policy Leader, Deloitte
- Karin Ri, Director, Responsible Investment, Asset Management One

Annex 1: Powerpoint slides from Deloitte setting out reporting challenges
Annex 2: IASB Opinion provided by David Pitt-Watson

Logistical challenges

Making judgements and estimates during the Covid crisis is fraught with difficulty and uncertainty. Companies are required to look at future operating results and cash flows to make assessments on things like deferred tax assets, goodwill, recoverability of Debtors, and so on. This requires an assessment of what is going to happen in the future which nobody can predict.

Remote working poses another challenge, e.g., on internal controls or the degree of interaction between finance staff and others. For auditors, this presents difficulties in terms of attendance at stock takes or accessing original documentation. In many markets working papers are not allowed to be shared in electronic format so audit teams review documentation at company offices which is now restricted.

Taking these challenges into account we need to balance the timeliness of financial reporting while ensuring it is trustworthy and insightful. It has been helpful that a number of regulators have allowed for a degree of flexibility in terms of reporting deadlines to give companies more time to determine appropriate estimates and enabling more time in preparing financial statements.

Responsibilities of management and those charged with governance

It is important to remember the responsibilities of management and those charged with governance. This includes ensuring that forward-looking and transparent disclosures are based on their best judgements. Some regulators have been helpful in providing management with the confidence to make the disclosures that investors require.

For example the US Securities and Exchange Commission (SEC) published a statement to say that "companies are often cautioned to limit their forward-looking disclosures and particularly specific estimates to those required by our rules to limit legal risk in the event
that forward-looking information proves to be incorrect. In this regard we encourage companies to avail themselves of the safe harbours for forward-looking statements and we do not expect to second-guess good-faith attempts to provide investors and other market participants appropriately with forward looking information."

Going concern

Another challenging area is going concern assessments. The UK Financial Reporting Council has issued guidance on COVID-19: Going Concern Risk and Viability which encourages directors and those charged with governance to clearly state the estimates, judgements and assumptions used in arriving at the going concern basis for preparing accounts.

Interim reporting

Interim reporting is another challenging area. It has been difficult for companies with a March year end or for those companies with quarterly filings, or half year filings. The practice of interim reporting is different in markets around the world. In some places interim reports are issued by management without any audit. In other countries interim reports are required to be issued with an audit opinion in accordance with IAS 34. Investors should recognise that the level of scrutiny that half year reports are subject to is significantly less than the full year audit reports.

Reporting on human capital

Investors need information in the short term and in the long term. CalPERS has assets of $400 billion which is globally invested, half of which is in public equities. After the financial crisis of 2008, CalPERS reviewed their investment approach and developed a set of investment beliefs which recognize that long-term value creation requires the effective management of three forms of capital: financial, human and natural. A reporting regime is therefore need that enables the tracking of these drivers of value and the sources of risk. Generally, IFRS and US GAAP are not providing enough insight into these other dimensions of risk and return.

In accounting terms human capital tends to be considered as a cost rather than as a source of value. CalPERS has been engaging the SEC, as part of the Human Capital Management Coalition of investors, to take a fresh approach to reporting around human capital. Data has shown that, 30 years ago, 85% of the market value of companies in the S&P 500 was assessed as coming from tangible assets. Today, 85% comes from intangible assets.

The Human Capital Management Coalition has made recommendations to the SEC to improve reporting around human capital. For example, the stability of the workforce (voluntary and involuntary turnover), health and safety (not just frequency, severity, time and lost time but also the percentage of the first tier suppliers that were audited for health and safety compliance), staff training, diversity (including race, ethnicity and gender) and employee engagement (e.g., surveys on employee satisfaction).

The way people are treated is a competitive issue. This should be reflected in performance targets developed for executives to motivate the top team to drive this forward. CalPERS also asked the SEC to work with FASB and to update US GAAP accordingly.
The SEC chair, Jay Clayton, emphasized the importance of the human capital dimension to the pandemic in a statement discussing the need to maintain connections amongst markets, businesses and workers in our fight against COVID-19. He highlighted a range of areas where companies are encouraged to start reporting including the issue of health and safety for workers and the knock-on effect on communities and customers. He said “I believe that the strength of our economy and many of our public companies is due in significant and increasing part to human capital and, for some of these companies, human capital is a mission critical issue.”

As we go forward in rebuilding the economy, we should renew our focus on the reporting regime to pick up on the elements that are relevant to long-term sustainable value creation. For a pension fund like CalPERS this is essential for future generations but also so that in the short term we have the information in a timely manner so we know that companies are able to manage through the current pandemic and into the future.

**Climate change reporting**

Climate change is being addressed by a coalition called Climate Action 100+, which includes investors representing assets of USD 40 trillion. The Coalition is calling for three things:

1. Board responsibility and accountability for climate change transition.
2. Disclosure of targets to reduce emissions in-line with 1.5% warming.
3. Alignment with the Taskforce for Climate Related Financial Disclosures.

In terms of reporting, IFRS covers all companies outside of the United States. The US is still under its own regime of US GAAP. The requirements within TCFD can be integrated within the current accounting framework. There are many good reporting frameworks however it would be a mistake to begin to build a new organization for non-financial reporting.

**IASB Opinion on climate change**

There has been a lot of progress with climate related reporting in the front end of the annual report; TCFD, GRI, SASB etc. However, the area that people have ignored is how climate is integrated into accounting, i.e, the ‘back end’ of the financial report. It is after all the accounts which determine profit, bonuses etc.

Until recently companies could just ignore climate. Until this year, for example, BP was valuing its oil wells as though the oil which came out of them would achieve a price of $75 a barrel into the infinite future, a figure inconsistent with a sustainable environment.

However, recently campaigners have questioned why this has been allowed to happen within accounting standards. Climate change is material in two ways: (1) it is becoming an emergency; and (2) materiality in accounts depends to a large degree on what is it that investors are interested in in order to deploy their capital. Climate change is very central to investors interests and it is material.

Campaigners want to change the interpretation of standards to insist that climate must be considered in their implementation. This was achieved late last year when the International Accounting Standards Board (IASB) issued an opinion which states that whenever companies interpret standards, they must take climate change into account where that is material. Note this is just IFRS not US GAAP. Nevertheless, if it is implemented it is a game
changer in 140 countries. However, because this was published as an opinion rather than as a standard it has not received huge publicity.

By way of example when Deloitte were auditing BP’s accounts for last year, Deloitte followed this guidance and noted that BP was valuing its oil wells at a price that was inconsistent with the Paris agreement for a sustainable environment. Last week BP announced that they will be reducing that oil price and writing off $17.5 billion worth of assets. They will also review new exploration activities to seek to ensure that there is nothing on the balance sheet that becomes a stranded asset.

We need to be sure that the IASB opinion is understood and is a part of the production of accounts and audits going forward. This is a big step forward but there is one more thing that needs to be done. We must now ask for assumptions to be sustainable. If they are not, we risk investing in assets that are likely to be stranded. What happened at BP is the new normal and investors must continue to push to require the application of climate related accounting standards and audit.

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Overview

In November 2019, the IASB published a paper written by board member Nick Anderson on climate change and its implications for reporting under IFRS – International Financial Reporting Standards, the accounting standards applied in most countries.

The paper does not set new standards but merely reflects on the existing reporting requirements. Nonetheless, its implications are fundamental and should lead to a significant change in the financial reporting by many large companies. From now on it is absolutely clear that corporations following IFRS standards should reflect material climate change considerations in the numbers that they report. Investors will for the first time have a clearer view on the performance and balance sheets of companies in a climate change affected world and will be better able to invest appropriately.

Prior moves to make the implications of climate change risks apparent in corporate reporting have focused on the narrative reporting. Whilst narrative reporting is important, investors clearly need to see how climate impacts the audited numbers.

What the paper says

Materiality: The paper notes that a key driver for judging what is material and so should be reported in IFRS accounts is what matters for investors. Given that investors have made clear that climate change is material to them, this should be reflected in IFRS financial statements.

Affected areas of reporting: The paper sets out a list of IFRS standards where climate change impacts should be taken into consideration. These include: asset valuations and impairments; useful lives of assets; potentially unprofitable contracts;
provisions and liabilities arising from fines or penalties; and credit losses for loans and other financial assets. This means that much of the balance sheet of many businesses will be affected by considerations of climate risk, and this will also impact profitability and wider financial performance.

The paper notes that the following standards are particularly implicated by its analysis: IAS 1 *Presentation of Financial Statements*; IAS 36 *Impairment of Assets*; IAS 16 *Property Plant and Equipment*; IAS 38 *Intangible Assets*; IFRS 13 *Fair Value Measurement*; IFRS 9 *Financial Instruments*; IFRS 7 *Financial Instruments: Disclosures*; IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Additional disclosures: The paper suggests that companies should disclose the assumptions that lie behind the numbers that are reported in their financial statements. It references IAS 1 in noting that even where the disclosure of these assumptions is not specifically required under other standards, it may still need to be disclosed in order to enable investors to understand material issues such as those highlighted above as climate change-affected.

*Global temperature stripes image credit Prof. Ed Hawkins, www.showyourstripes.info*

**What happens next**

Companies will need to respond to the paper from the IASB and properly reflect the implications of climate change in their financial statements.

Auditors will need to challenge and question companies that have not fully reflected climate change implications in their financial statements. In particular, auditors may need to press for the disclosure of the underlying assumptions that have driven the reported performance and balance sheet position.

Regulators will need to question both companies and auditors to ensure that they are following IFRS requirements with respect to climate risk.

Investors will need to make clear their expectations around financial reporting, especially their view that climate change is a material factor to their investment decision-making.

Where companies are not reflecting this in their accounting, or are using assumptions that seem inappropriate or unsustainable, investors are likely to challenge them and their auditors.

*For further information, please contact Paul Lee, pcle27@googlemail.com*