Reliability Risk of Non-Financial Information Reporting

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ESG initiatives to outcome reporting is trending

Financial reporting is rapidly changing through better and enhanced disclosure practices, in particular there is a growing momentum on the subject of Sustainability and ESG Reporting. Institutional investors, activists and shareholders are keenly observing the intentions, abilities, promises and annual disclosures of enterprises on the subject of Sustainability and ESG. Increasing number of businesses in India are reporting non-financial information, indicators, and their on-going progress in achieving sustainable development goals. Businesses, in addition to the traditional financial reporting, that opt for reporting a comprehensive set of factors on the subject of Environment, Social and Governance attract higher Valuations from asset managers.

We have in the past witnessed a rising graph of Fraudulent financial reporting [i.e this fraud occurs when Corporates misrepresent or deceive investors into believing that they are more profitable than they actually are, simply put it is alteration of financial statement figures for the purpose of wrongful gain]. Whenever there is a something trending on the horizon, fraudsters spot an opportunity to strike.

We are most likely to see the emergence of a new graph of Fraudulent - Non-Financial Information Reporting [F-NFIR].

A. Low independent assurance leads to lower reliability

Lack of Regulatory Oversight: -

Regulatory authorities have enacted laws globally that cast onerous responsibilities on the Board, CEO, CFOs, and Auditors to make sure companies report their financials truthfully. However, there is lack of regulatory oversight with respect to reliability risks arising out of Non-financial information reporting. At the moment there exists differing jurisdictional practices. In India SEBI has made Business Responsibility Reporting (BRR) mandatory for top listed entities on the basis of market capitalization and has recommended a format for reporting, however, this is not comprehensive and lacks depth as compared to global frameworks.

Lack of Standard Reporting Framework: -

NFIR is not as harmonized and standardized as is the case with traditional financial reporting. Corporates have some level of discretion in adopting their framework and nature of disclosures. Refer Exhibit 1 below from **IFAC's Benchmarking Global Practice – Sustainability Assurance 2021**: -

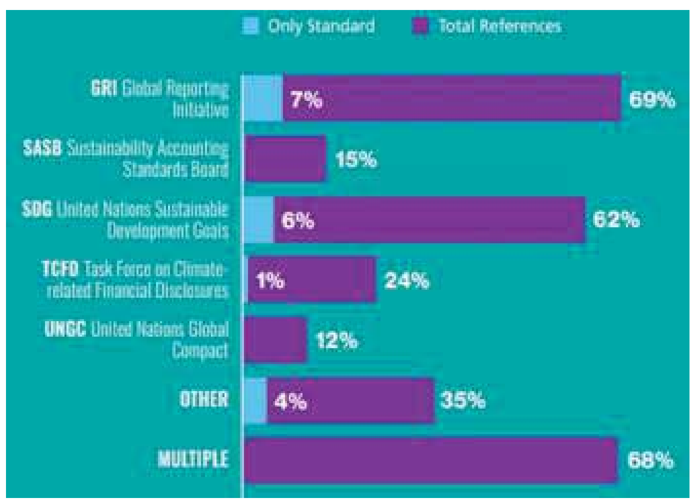

Exhibit 1 (from IFAC's Benchmarking Global Practice – Sustainability Assurance 2021)

Exhibit 1 shows **5 frameworks** that are commonly used by Corporates depending on their needs, suitability, and fitment. Few opt for multiple frameworks.

Mckinsey's survey insights reveal that 85% of respondents agreed that more standardized sustainability reporting would help them allocate capital more effectively and 83% agreed that standardization of sustainability reporting would help manage risks more effectively.

Diverse nature of Non-financial Information Reporting: -

Please look at **SASB's identified sustainability topics** (figure 1) that Corporates generally use for the purpose of sustainability related disclosures. The spread of the N-FIR topics is very wide, compiling such data is a voluminous exercise and demands involvement of multiple stakeholder chains across the universe of business. N-FIR output is a combination of quantitative and qualitative data.

Internal Control Systems: - Since Corporate Social Responsibility, ESG, Value Reporting, etc are relatively new concepts where internal control systems comprising of policies, SOPs, guidelines, etc are evolving and are not in a matured state as compared to the traditional financial reporting, thereby greater chances of discretion, errors, manipulation and miss-outs.

Missing Sox or IFC type testing approach: - Audit Committees exercise extensive oversight on the process of financial closure and reporting, however, similar rigour is not exercised in case of NFR. There are no mandatory certifications for NFR therefore, source validations, errors in compilation of key data sets on a variety of indicators such as Water, Waste, Human rights, Employee Safety, etc.

Figure 1 – SASB – Universe of Sustainability topics

Lack of Comparisons: - Generally when you can compare a set of information with corresponding period or industry benchmarks or technical standards reliability increases. In case of NFIR comparability is one of the concerns.

Zero or Low Audit focus: - Auditors tend to focus on auditing financial captions rigorously as per applicable auditing standards therefore there is lack of independent and objective evaluation of the source data and quality of NFIR disclosures.

A. NFIR - Merits closer scrutiny by Boards, Stakeholders and Auditors

Digital quality of contemporary of annual reports is incredibly attractive, however, looks can be very deceptive.

The state of Play in Sustainability Assurance – Benchmarking Global Practice publication released by IFAC in June 2021 flags Zero or sub-optimal quality of non-financial information reporting assurance as a significant reliability risk and a global investor protection issue. IFAC surveyed 12,69 entities out of which only 51% For example in India the rate of ESG assurance is only 37.8 % as per IFAC's findings. Further, as per the IFAC study most of the assurance reports do not cover all the reported information and 83% of assurance engagements result in limited assurance reports as far as Sustainability Assurance is concerned.

Watch out for: -

1. ESG Rating grades of Credit Rating Agencies or Sustainability Rating agencies to ascertain the level of disclosures and material impact factors.
2. Nature of Assurance standards cited by the auditors in the Sustainability Assurance reporting and whether the assurance providers are certified and subject matter experts
3. Compare the data in the N-FIR with the website disclosures of the company and financial reporting where possible.
4. Internal Audit scope and coverage whether includes reliability of NFIR.
5. Whether the organization is aligned to global frameworks such as COSO that can be applied to areas beyond the traditional scope of financial reporting. The COSO Framework provides a comprehensive basis for a company to develop and implement an internal control system relating to non-financial reporting.
6. Check the level of assurance provided by the auditor whether it is high, moderate, limited, or extensive.

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