Can accountants save the world?

o International Integrated Reporting Council promotes comprehensive value-over-time reporting framework

CPA MALAYSIA | THE ACCOUNTANT'S PERSPECTIVE

THE need to ensure sustainable development in business, the emphasis on reporting non-financial performance by corporations to address climate change, and sustainability and governance related issues has been gaining momentum over the years.

The International Integrated Reporting Council (IIRC), formed in 2010, has been one of the pioneers in promoting a comprehensive value-creation-over-time reporting framework called Integrated Reporting (IR).

So, what is Integrated Reporting?

Simply put, the framework, founded upon integrated thinking, encourages corporations to communicate their value creation stories in the short, medium, and long term when utilising the various internal and external capitals to their stakeholders.

These capitals are:

Financial capital - refers to all forms of equity instruments whether ordinary or preference shares; debt instruments such as bonds, bank borrowings; and grants etc.

Manufactured capital – relates to "manufactured physical objects available to an organisation for use in the production of goods or the provision of services". Examples include buildings, plant and equipment; infrastructure such as roads, bridges, and waste water treatment plants.

Intellectual capital – Intellectual property such as patents, copyrights, software, rights and licences, or even tacit knowledge, systems, procedures and protocols within an organisation.

There are established reporting frameworks and standards, i.e. the International Financial Reporting Standards to govern the initial recognition, subsequent measurement and derecognition of these capitals in financial statements. Shareholders, analysts, bankers and creditors conventionally use this information to arrive at their funding and investing decisions.

According to the IR framework, there are three more capitals that exist, utilised by corporations in the production of goods and provision of services that may not be completely captured in the financial statements.

They are:

Human capital – Staff competencies, capabilities and experience.

Social and relationship capital – this is a little abstract, but to quote the examples in the IR framework, it includes "....shared norms, common values and behaviors; key stakeholder relationships, and the trust and willingness to engage that an organisation has developed and strives to build and protect with external stakeholders; and intangibles associated with the brand and reputation that an organisation has developed."

Natural capital – All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organisation. It includes: air, water, land, minerals and forests, biodiversity and ecosystem health.

The shortcoming of the current financial reporting framework is evident in the disparity between the market capitalisation of many listed companies versus the carrying value of their net assets. Investors know there is a "hidden value" not fully recognised in financial statements. To a large extent, they are attributable to intangible assets, for example goodwill, brand name, customers, technical know-how, in-house processes, quality and motivation of employees, etc.

In addition, most organisations have yet to integrate or measure sustainability risks arising from volatile market disruptions and climate change considerations into financial statements.

On an aggregated basis, the various capitals used by an organisation are captured and reported in the form of financial statements. These numbers are audited by external auditors, made available to members, and are subject to scrutiny by shareholders, creditors and analysts. Tough questions are posed to management and board members if the use of these assets is not generating the expected returns. There are currently proper processes, and reasonable levels of transparency to enable meaningful conversation, communication, monitoring and control over effective utilisation of these assets or capitals.

On the other hand, a commercial organisation uses natural capital such as water and air in the production of goods and provision of services. It also discharges waste and emits carbon dioxide into the environment. Corporations take for granted that these resources are of low value due to their easy availability. When air and water are consumed and recycled, how does it impact the environment? Another example is the building of factories at industrial areas that involve the hiring of workers. How has the establishment of these factories, and the employment of workers benefited the wellbeing and standard of living of their families and local communities? What is the social cost and impact of hiring foreign workers versus local? What more if some of them are illegal or child labor?

A company which adopts IR would be able to communicate value creation stories to its stakeholders in the short, medium and long run in a precise, concise and holistic manner, by explaining the effect and outcome of utilisation the various relevant capitals, both financial and non-financial.

Accountants know best that when assets get captured, measured and reported in the financial statements, it is necessary to implement the relevant internal controls to govern, monitor and safeguard their existence and to measure effective utilisation. The same controls and governance framework would be applicable to the other non-financial capitals and intangible assets should they be captured into the financial statements.

Imagine the day when corporations are capable of reporting their non-financial results and performance in a transparent and measurable manner. Those numbers or output are audited by auditors and scrutinised by stakeholders on a periodic basis.

Fund managers rely on this information to make conscious investment decisions. Management and board members are held accountable for non-effective utilisation of the non-financial capitals. And of course, accountants are the ones behind the scene responsible to produce the output and numbers.

When this happens, perhaps accountants can really save the world?

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