

IDW POSITION PAPER

FUTURE OF NON-FINANCIAL REPORTING AND ASSURANCE



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1. PRELIMINARY REMARKS

External corporate reporting is currently undergoing a far-reaching change, characterized especially by far more strongly articulated stakeholder interests: Whereas for decades the main focus of "classic" financial reporting was primarily on shareholders, there is now an increasing demand for (additional) non-financial information – especially in relation to ESG aspects – which serves a wide range of users, including investors and in particular those groups of people who (as non-shareholders) are exposed to the external effects of entities in terms of environmental pollution, human rights, etc. In this context, reference is often made to the **"license to operate"**, which their stakeholders only grant to transparent and sustainable entities.

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Reporting on the financial position of entities should therefore be extended to include the direct and indirect impact of such effects on the entity and its environment. In a first step, the European legislator reacted to this clear paradigm shift by imposing additional non-financial reporting obligations on certain capital market-oriented entities and large financial services providers in mandating CSR reporting. Mandatory assurance has not been envisaged to date.

The necessary further development of corporate reporting fits into the current European ("Sustainable Finance") initiative, which aims to channel huge financial sums into sustainable investments. Here, too, extended corporate information constitutes a necessary component. Initial approaches to this have already been incorporated into EU law, for example in the Taxonomy Regulation: From 2022 onwards, those non-financial entities that are obliged to report on CSR must publish, for example, the proportion of "green" turnover and investments.

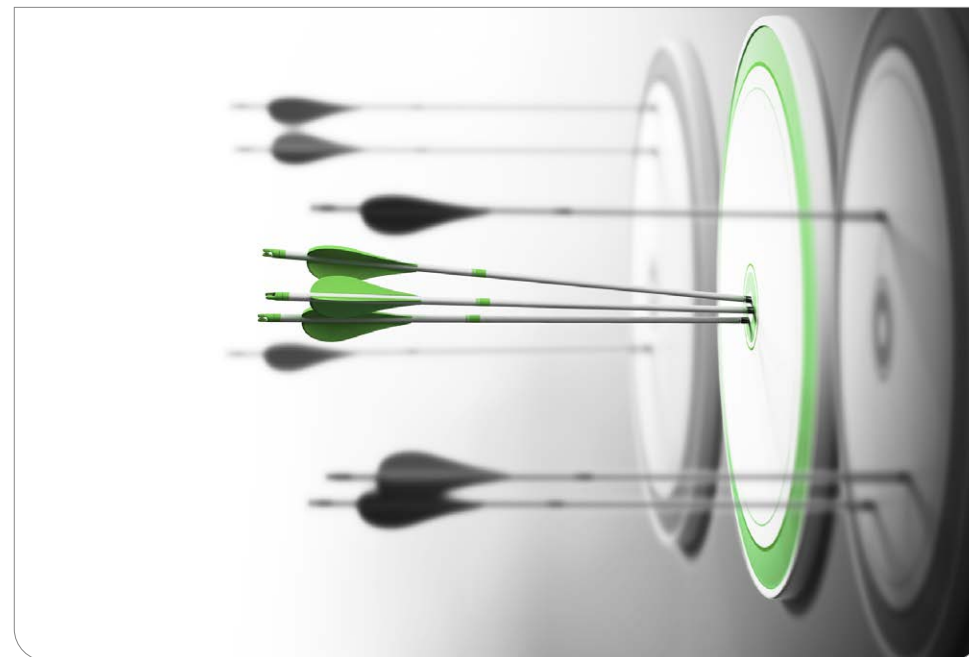
The experiences in recent years and months has shown, at various levels, that the measures European and national legislators have taken thus far cannot be the last word. The need for further action has also been recognized by international institutions, which is already leading to intensive discussions. The criticism is based on three main issues:

1. The first criticism is the **lack of (international) comparability** of (mostly qualitative) CSR reporting. The EU Directive contains only certain general requirements. Although these are supplemented by non-binding guidelines of the EU Commission, the comparability of CSR reporting in European and international practice by no means reaches the level of comparability of financial reporting. This problem is exacerbated by the (allowed) use of different global frameworks for non-financial reporting. This directly raises the question of greater standardization in this area.
2. Even though there have been efforts to achieve **integrated reporting** for quite some time, it is noteworthy that, according to the European concept and its implementation in practice to date, financial and non-financial information is presented in a largely unconnected manner (i.e., without a common framework and evaluation concept). Since the financial position of entities (extended to include additional stakeholder impacts) needs to be communicated, ultimately this can only be achieved with more extensive integrated reporting. Thus, considerable further development of the existing conceptual framework is needed.
3. The **mandatory audit** of entities' financial reporting is a well-established institution of functioning capital markets. Regulators and addressees recognize that without confi-

dence in financial reporting, an efficient allocation of capital and goods (e.g. investments) in open markets is not possible. The external audit by an independent auditor ensures this trust. However, non-financial reporting equally serves as a basis to inform an entity's stakeholders' decisions concerning the allocation of capital and "goods" (e.g. consumer behavior, employment choice, etc.). This directly raises the question of an assurance requirement for non-financial information with the same scope and level of assurance as for financial reporting.

In the following, this paper provides the IDW's position on and a brief outlook with regard to the above three issues.

The position paper refers, in particular, to the future of ESG reporting by those capital market-oriented entities that are currently within the scope of the CSR Directive. In order to meet the increasing demand for non-financial information, the IDW is supportive, in principle, of a moderate and gradual expansion of the circle of entities subject to reporting requirements. It would not seem to be constructive to immediately transfer the far-reaching requirements for large capital market-oriented entities one-to-one to small and medium-sized entities.





2. FURTHER STANDARDISATION OF NON-FINANCIAL REPORTING

Undisputedly, internationally standardized (and thus comparable) reporting standards serve the efficiency of international capital markets. For this reason, the EU also established IFRS as the reporting standard for capital market-oriented entities within the European Union. As users also have comparable information needs with regard to non-financial aspects relying on an **international reporting standard with broad acceptance** is an obvious choice. However, as yet there is no such standard giving the necessary precision and

holistic approach (see section 3). None of the many frameworks offered by NGOs is accepted consistently internationally. Nor is there currently a body which enjoys the necessary broad acceptance (as a standard setter). In the past, the International Accounting Standards Board (IASB) has been reluctant to set standards in this area, but there are now clear indications of an opening (more on this later). **Ideally, a standard setting structure should be established at international level as quickly as possible.**

The IDW generally follows the position put forward in the Accountancy Europe (AcE) Cogito paper "Interconnected Standard Setting For Corporate Reporting". In this paper, AcE examines various approaches (including a European solution), but appropriately expresses a preference for an international solution under the umbrella of the current IFRS Foundation, i.e., establishing a board for sustainability reporting alongside the IASB. To achieve this, the existing steering and supervisory bodies at the Foundation would need expanded know-how and extended rights.

Currently, one known initiative may accelerate the creation of an international standard setter: On 11 September 2020, five of the leading organizations (NGOs) that have already developed frameworks, standards, platforms etc. for sustainability reporting, proposed a joint approach to create a uniform and comprehensive solution. Involved are CDP, a platform for publishing environmental information, the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), whose standards have so far been most widely used in sustainability reporting, the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB), which offers industry-specific standards. Among others, the World Economic Forum (WEF) has called for a co-operation of these organizations. Of particular importance is that this initiative is directly seeking a connection to financial reporting (IFRS and US-GAAP), and

thus picks up on the preferred suggestion outlined above.

Concurrently, as the international organization of accountants, the International Federation of Accountants (IFAC), directly called for the establishment of a new standard setter under the IFRS Foundation, also calling for the International Organization of Securities Commissions (IOSCO), as the global organization of stock exchange supervisors to be involved in the development. IFAC believes that the new standard setter should work with the five organizations mentioned above. In the meantime, the trustees of the IFRS Foundation have published a consultation paper to identify the need for global sustainability standards and to examine what role the Foundation could play in the development of such standards. This paper also proposes that standard setting for sustainability reporting could be taken over by a Sustainability Standards Board alongside the IASB under the Foundation's own umbrella.

In contrast to the international approach, the EU, as a major (supranational) driver with legislative competence, is currently examining the possible development of **a reporting standard at European level**. To this end, the EU Commission has asked the European Financial Reporting Advisory Group (EFRAG) to carry out initial preparatory reviews and draw up recommendations. The concrete implementation would require European legislation. The extent to which the frameworks etc. of the previous standard setters (e.g. IIRC, GRI) will be taken into account appears open. It also remains to

be seen how the EU will react to the initiatives outlined above, in particular to the initiative of the trustee of the IFRS Foundation.

If the establishment of global standards under the umbrella of the IFRS Foundation cannot be realized within a reasonable time frame, the IDW considers it a feasible intermediate step to first develop a solution at European level using existing reporting frameworks, with the possibility of adopting a global solution later. The search for an ideal model must

not be the "show-stopper" for further development, which is urgently needed.

Ideally, a European standard could also serve as a starting point for an international standard. Analogous to the current IFRS endorsement process, it would then be necessary to include this in the European endorsement process.

The IDW will follow the developments closely and actively participate in the discussions in order to contribute to a uniform and efficient solution as far as possible.



3. FURTHER DEVELOPMENT TOWARDS INTEGRATED CORPORATE REPORTING

Based on the objective to communicate the economic situation of entities in a holistic way, the current concept of financial reporting needs to be developed further towards integrated reporting. Reporting would thus encompass both financial and non-financial information. The status quo can therefore (also) be accepted only as an intermediate step. Ideally, the development of an international non-financial reporting standard should focus on such an integrated solution from the outset. Since this would require considerable time, an interim solution might also be conceivable, i.e., to further develop and firm up current CSR reporting. Here, for example, the ESG indicators of the World Economic Forum could be used, which have been developed together with the large accounting firms. The same applies to the recommendations of the TFCF. **There is an pressing need to ensure that reporting on non-financial aspects has to be treated as part of the management report such that it cannot be presented in a different way, either in terms of**

its placement or time of publication. This also reflects to the character of non-financial information which, at least subsequently, may also have financial consequences for an entity (e.g. through the reactions of consumers, investors, etc.) and may therefore also referred to as "pre-financials".

But this also paves the way for a far-reaching further development of external reporting: The main objective of external accounting is - in a nutshell - to provide comparable information about the entity's results in a past reporting period and components of those results (historical reference) and on the possibility of achieving results in future reporting periods (future reference). The latter, particularly, has recently gained in importance. In this respect, it is obvious that the hitherto **non-financial aspects should also be monetarized to facilitate preparation of a full "statement of comprehensive income"**, which can be used both to measure the achievement of objectives and to assess future results. Such a further development may seem difficult at first sight, but it should be borne in mind that the entire history of external reporting is based on the recognition of new relevant facts and their evaluation for the purpose of inclusion in accounting. In addition, various methods and data sources already exist today that allow for a corresponding measurement of (up to now!) non-financial aspects for accounting purposes.

The IDW therefore supports the EU Commission's measures to develop a new uniform standard for the measurement and monetary valuation of ESG impacts of entities ("**Green Accounting Principles**"). The Commission has engaged the assistance of the Value Balancing Alliance (VBA), among others, who explicitly follow such an approach. Of course, integrating the approach into entities' governance structures and process organization ("Integrated Thinking") is then initially the task of management and supervisory boards.





4. ASSURANCE RELATING TO NON-FINANCIAL REPORTING

Report users must be in a position to base their decisions on published entity reporting. The IDW therefore advocates mandatory assurance for both financial and non-financial information. In addition to the financial information that has already been audited with reasonable assurance by auditors, the IDW believes that non-financial information must also be subject to

an assurance engagement with reasonable assurance. Assurance engagements with limited assurance relating to non-financial information should also be permitted, but only in a manageable transitional phase. An appropriately developed international or – if necessary, as an intermediate step – European reporting standard for non-financial information (later for a fully

integrated reporting) could constitute suitable criteria for a mandatory external assurance engagement.

There is no question that an assurance engagement in relation to non-financial information requires specific expertise. This is, however, the same as the current situation, as certain audit issues have always required specific know-how (e.g. actuarial work regarding pensions) so audit firms, for this reason, ensure they have access to necessary expertise.

Furthermore, an assurance engagement relating to non-financial information (mainly based on ISAE 3000 (Revised)) is not new, as management reporting already contains non-financial information that cannot be derived directly from conventional accounting records either. Auditors therefore have a long history of applying a corresponding assurance methodology, which in Germany, for example, is manifested in the revised version of IDW AsS 350 as a relevant assurance standard for assurance relating to the management report. This also includes assurance in relation to prognostic information. In addition, assurance engagements on (separate) sustainability reports are already performed by auditors today with reasonable assurance. The auditors also have the appropriate

tools for performing assurance engagements relating to risk management systems. Furthermore, in contrast to other professional groups, auditors are subject to strict professional principles and requirements (e.g., on independence and quality assurance). In this respect, the IDW also calls for the auditor to obtain a uniform level of assurance in relation to this integrated reporting as a whole. With a progressive integration of financial and non-financial information, there is no justification to require different parties to carry out various examinations of the relevant component parts of this information anyway. In addition, auditors are knowledgeable as to entity-specific systems, processes, and risks from their audit of the entity's financial statements. They can apply this knowledge when performing assurance engagements in relation to non-financial information.

Of course, extended and integrated reporting also requires the entities to implement new systems and processes, including internal controls. These are the direct subject of the assurance procedures described. Creating these prerequisites requires know-how and time. Together with stakeholders and the reporting entities, however, auditors are prepared and ready to go down this path.



5. CONCLUSION AND OUTLOOK

A comparable and trustworthy external reporting that satisfies the information needs of different stakeholders is necessary and achievable. The further development of accounting towards a fully integrated reporting is thus definitely possible. A corresponding assurance requirement would demonstrate a comprehensive and reliable model in the sense of "extended market information". In the medium-term careful consideration needs to be given to extending the circle of entities subject to the relevant reporting requirements. The scalability of the regulations and the "connectivity" also to the EU Accounting Directive or national regulations (HGB etc.) are prerequisites in this context.

The IDW expressly supports this approach!

For your notes:

This position paper was prepared by the IDW Trendwatch Committee and the IDW Steering Committee Sustainability.

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