ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability : Presentation 2

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Environmental, social and governance (ESG) considerations rank high on the EU agenda

Companies' actions have significant impacts on life in the EU and around the world, in terms of products and services, jobs and opportunities, and working conditions, human rights, health, the environment, innovation, education and training.

Non-financial Reporting Directive

This initiative aims to improve the EU regulatory framework on company law and corporate governance. It would enable companies to focus on long-term sustainable value creation rather than short-term benefits.

Sustainable Corporate Governance

How and why does the ELI Guidance report matter ?

The ELI report recommends the need for companies to enact a prudent use of resources.

That is to ensure we have a solid company financial foundation for a sustainable future. To absorb the financial risks arising from climate change.

Promoting shareholder equity value retention rather than extraction to sustain and grow equity reserves.

In our financialized world the pressure to deliver shareholder value impacts on corporate behaviour. Boosting dividends paid, share buy-backs and capital reductions—these payouts all about inflating stock prices and fund liquidity for investment banks.

For many companies this process is undermining shareholder equity reserves. Leaving little headroom to absorb environment risks that will translate into and impact company reported financial numbers

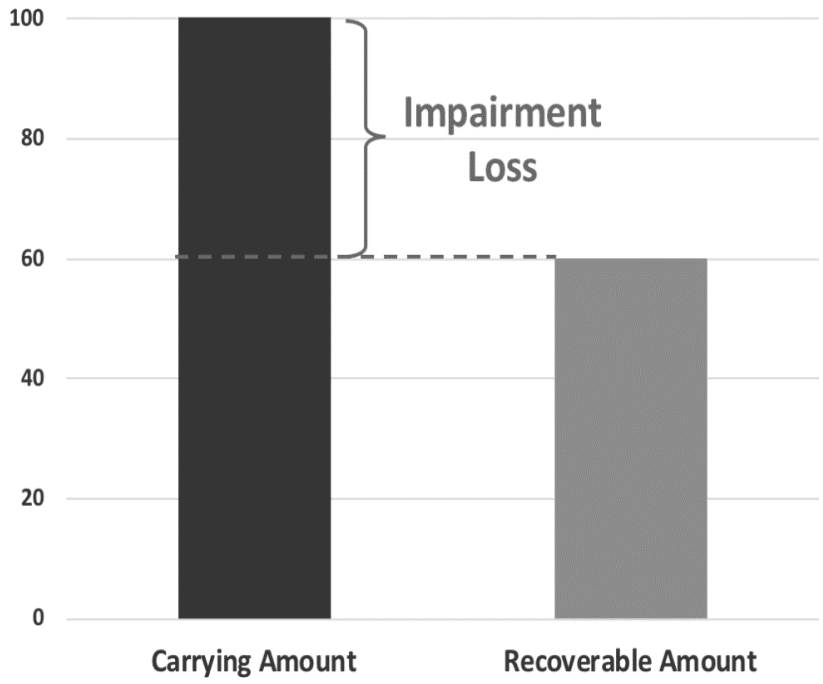
Against Hollow Firms

https://www.sheffield.ac.uk/news/polopoly_fs/1.892482!/file/Against-Hollow-Firms.pdf

The valuation of assets are often constructed on future discounted cash flows.

Environmental risk should translate into higher discount rates or lower cash flows.

Company's may need to impair current tangible and intangible asset values talking an impairment loss into income and equity reserves.



Liabilities should contain provisions that account for future risks attached to climate change

Provisioning is prudent accounting as liabilities are inflated in current time if risks from climate change increase into the future.

Environmental risk should translate into a higher liability provisions in current time to anticipate and be prudent about the going concern

Asset risk and Liability provisioning

- For shareholder investors there may then be a question as to whether a company has provided enough information about its exposure to these climate-related financial risks.
- If investors felt this information had not been provided, they might make a claim against the business
- If company's are to reduce asset values and/ or inflate liability provisioning this will have a significant impact on the value of net assets.
- And remember net assets = shareholder equity reserves.
- And this is why these reserves need to be strengthened.

Where are we now. Our research on the FTSE 100 reveals that climate risk modelling avoids climate risk and auditors evade it too!

https://www.taxresearch.org.uk/Blog/wp-content/uploads/2022/07/The-green-audit-evidence-from-the-2021-uk-audit-season-July-2022.pdf

Accounting and auditing for climate change risks

- Asset valuation and liability provision modelling is more about scenario building rather than real financial sensitivity analysis.
- Modelling assumes that we have moved into a future where we have transitioned into a low carbon era.
- Auditors are also reluctant to provide an opinion on climate risks: the issue is beyond their *limited audit or that risks are deemed not financially material in current time*
- The FTSE 100 accounts for 40 per cent of UK climate emissions on a consumption basis
- The 34 audit reports that explicitly state the issue to be immaterial cover 85 per cent of FTSE 100 emissions and one third of total UK emissions on a consumption basis
- In summary there is little willingness to indicate the need to address issues relating to climate change within financial statements and audit reports.

Summary

- ELI Guidance on Company Capital and Financial Accounting for Corporate Sustainability complements the EU initiatives on Non-financial reporting and Sustainable Corporate Governance.
- But it starts with the need to build a strong financial foundation that protects and builds equity reserves
- Limiting the extent to which these equity reserves are hollowed out.
- Equity reserves that will be needed to absorb asset impairments and / or additional liability provisioning.
- If shareholder investors are enlightened climate risk avoiders they should call out and support for these changes.
- What we find is that governance is working to protect the *status quo*: managerial risk modelling and the audit profession response can be summarized as not facing up to *reality.*