

Why Nonfinancial Reporting Matters?

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Abstract— Governments, consumers, and investors are increasingly pressuring companies to be truly open on the economic, environmental and social impact of their business. Many companies publish nonfinancial reports, also known as corporate social responsibility (CSR) or environmental, social, and governance (ESG) report. International standards, such as the Global Reporting Initiative, provide non-obligatory guidelines for sustainability reporting, that aim to enable assessment of environmental impact from the activities of the companies and its supply chain. In December of 2014, the EU Commission has adopted a new Directive obliging large multinational companies to provide nonfinancial disclosures to the markets. The purpose of the paper is to point to the growing general importance of non-financial reporting, i.e. reporting on how business makes impact on the social and natural environment, as well as the gradual development of international nonfinancial reporting standards as a tool for comparing business results in the light of this environmental impact.

Keywords— sustainability, UN SDG, nonfinancial reporting, sustainable reporting, GRI standards, environment, social

I. INTRODUCTION

The business environment is complex, multidimensional, and dynamic. Besides basic business parameters, which can be expressed precisely mathematically through financial reports and financial indicators, the main decision-makers, policy-makers, and investors pay close attention to consequences of policies which they create or decisions they make.

Ideas and proposals on supplementing conventional accounting with the appliance of nonfinancial information have exerted a vigorous appeal in recent times [1]. Sustainable development has garnered greater attention and exerted increasing pressure on companies to be more transparent about their economic, environmental, and social impacts and consequently, sustainable reporting is being practised more frequently. Balanced scorecards and similar performance measurement systems have been advocated intensively and are widely used by organisations. Nonfinancial reporting (inclusive of sustainable reporting), which also supplements conventional financial reporting is highlighted because it satisfies the growing demands of stakeholders and decision-makers for additional information.

The 2030 Agenda for Sustainable Development and 17 Sustainable Development Goals (SDGs) set by United Nations (UN) [1], as the development of the highest level of global governance and a blueprint toward sustainable future, undoubtedly had an impact to awareness changes of decision-makers in the business environment.

II. INTERNATIONAL STANDARDS OF NONFINANCIAL REPORTING

A new database is available, which allows for a search of companies which publish nonfinancial reports [2]. Dominant providers of sustainability reporting standards are:

- „GRI (GRI's Sustainability Reporting Standards)
- The Organisation for Economic Co-operation and Development (OECD Guidelines for Multinational Enterprises)
- The United Nations Global Compact (the Communication on Progress)
- The International Organisation for Standardization (ISO 26000, International Standard for social responsibility)”

A total number of companies which made their reports available on the GRI platform [2], is 13.392, with 52.791 submitted reports. Out of these 52.791 reports, 31.783 were created by some GRI standards.

A. General Reporting Initiative (GRI)

GRI is a nonprofit institution [3], dealing with nonfinancial reporting applied to sustainable development. It was founded in 1997 in Boston, USA. In 2000, they released the first version of the guidelines for sustainable nonfinancial reports, as “the first global framework for comprehensive sustainability reporting”. In 2002, the headquarters were relocated to Amsterdam, Netherlands and were officially recognised as a United Nations Environment Programme (UNEP) collaborating organisation. Throughout the years, they continuously developed new, improved versions of the GRI guidelines toward a better and more adequate approach to sustainable reporting. In 2006, they gathered over 3000 experts from business, civil society, and the labour movement participating in the development of the GRI Standards.

It emphasised the multi-stakeholder approach. In 2007, they developed step-by-step guidelines for the report producers and users.

In parallel, GRI started to expand the network of focal points in other countries and continents (North America, Africa, South America, South Asia, Greater China Region). They operate as regional hubs, to advance reporting at the country level, and they are all guided by high-level advisory groups of local leaders. Furthermore, in 2013, the Fourth global conference “Information – Integration – Innovation” took place, gathering 1600 delegates from 69 countries, where the fourth generation of guidelines has kicked off. They expanded their influence even more in the next years, keenly focused on the feedback from the reporting market, including all different stakeholders such as experts, reporters, analysts, investors, government and other users of sustainable reports.

In 2016, the first global standards for sustainability reporting was promoted by GRI, thus enabling all types of organisation (regardless of size, industries they operate in, public administration or non-governmental organisations, or any other specifics for entities doing any business anywhere in the world) to be transparent and report publicly on their economic, environmental, and social impacts. The idea behind this new standard is that organisations are to be responsible and contribute fairly toward sustainable development. The 5th global conference organised by GRI took place in Amsterdam and hosted numerous leaders, analysts, and other practitioners in the area of sustainable reporting to embrace a new era of corporate disclosures. The global standards for sustainability reporting are designed in a flexible, modular structure; they can easily be updated, further expanded and relevant. The modular set of GRI Standards include three universal Standards suitable to all organisations: “GRI 101: Foundation, GRI 102: General Disclosures, and GRI 103: Management Approach”. Also, the set of GRI Standards include 33 ‘topic-specific’ Standards, organised into three series: “Economic, Environmental, and Social”. Organisations select from and apply these topic-specific Standards based on their specific business areas and characteristics.

B. Guidelines for Multinational Enterprises (The Organisation for Economic Co-operation and Development – OECD)

The alternative set of standards for some companies are the OECD Guidelines for Multinational Enterprises [4]. They are recommendations providing principles, guidelines and standards for responsible business contact for multinational corporations operating in or from countries adhering to the OECD declaration on international investment and multinational enterprises. The Guidelines cover business ethics on a range of issues, including environment, human rights, employment and other issues. Besides, the OECD has developed specific guidelines in many sectors such as agricultural supply chains, mineral supply chains, and in the financial

sector. Established National Contact Points (NCP) in adhering countries are in charge for the promotion of the standards on the national level. The OECD investment committee is the primary body responsible for inspection and overseeing the working progress (functioning) of the guidelines.

C. The United Nations Global Compact (the Communication on Progress)

Through its Global Compact platform [5], the UN has an aim to mobilise a global movement of sustainable companies and stakeholders to enable implementation of the SDGs. UN Global Compact supports companies to perform business responsibly by aligning their strategic operations with ten key principles on environment, human rights, labour, and anti-corruption. The Communication on Progress (COP) is an annual disclosure/report through which a business notify key stakeholders about its efforts to implement and apply the principles of the United Nations (UN) Global Compact. Its main goal is to serve as an agency, assembly point and a trigger for information on sustainability performance.

D. ISO 26000 Guidance on Social Responsibility (The International Organisation for Standardization)

This practice of companies to cope with growing demands led to the advancement of Corporate Social Responsibility (CSR). Another acronym that is widely used to reflect the growing demand for stakeholders’ requests for sustainability reporting is “ESG - Environmental, Social, and Governance”. Investors that are socially responsible are keen users of ESG criteria (as they recognize it as a set of standards for a company’s operations) to screen potential investments. The environmental factor is primarily concerned with the company’s influence on the environment. Social criteria consider the attitudes towards diversity, human rights, relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with the internal company’s affairs, i.e. executive pay, leadership, audits, internal controls and shareholder rights. ISO 26000 Guidance on social responsibility [6] is an international standard providing guidelines for social responsibility since its launch on 1st November 2010. Its intention is to contribute to global sustainable development by supporting business and other organisations to significantly improve their impacts on their employees, environments and communities. ISO 26000 is a voluntary guidance standard. It is not consisted of mandatory requirements such as those used when a standard is offered for certification.

III. VOLUNTARILY VS MANDATORY NONFINANCIAL REPORTING

Another aspect relevant for consideration is how many companies are prepared to create nonfinancial reports voluntarily, as well as to present them, or make them publicly available [7]. EU adopted a “Directive 2014/95/EU” [8] which obligates “large, public-

interest companies which have over 500 employees (inclusive of listed companies, banks, insurance companies, other companies designated by national authorities as public-interest entities)” to disclose relevant information in statements on the way they conduct their business and manage social and environmental challenges and enable all stakeholders, from consumers to investors to find out or evaluate more on nonfinancial performance of large companies. This directive amends the Accounting Directive 2013/34/EU. From 2018 onwards, companies must include non-financial statements in their annual reports. Yet, companies are not obliged to follow any specific standard (international or national) or to apply any kind of guidelines as mandatory. Directive 2014/95/EU provides companies with a significant amount of flexibility to publish relevant information in the way they consider most useful. Rather, companies may use “international, European or national guidelines” to produce their reports according to their characteristic and industries they operate in – for instance: the UN Global Compact, the OECD guidelines for multinational enterprises, ISO 26000 or other. Regardless of the guidelines they use, companies need to disclose information on “environmental protection, social responsibility, and treatment of employees, respect for human rights, anti-corruption and bribery, diversity on company boards (in terms of age, gender, educational and professional background)”.

Grewal, Riedl, and Serafeim [7] highlight a few assumptions as to why a company would not commit to nonfinancial reporting regularly:

- "Low pre-directive nonfinancial disclosure levels, consistent with investors anticipating these future disclosures to reveal worse-than-expected news.
- Weaker performance on nonfinancial issues, consistent with expectations for these firms to incur future costs to internalise current externalities.
- Lower ownership by institutional asset owners, consistent with such investors demanding further disclosures than mandated by the directive.”

IV. STANDARDISATION OF NONFINANCIAL REPORTING AND BENCHMARKING

Financial reports are standardised (international accounting standards/international standards for financial reporting) and are expressed easily through numbers. Apart from the template, the dynamic of submitting final yearly reports are clearly defined. As a consequence of the standard (methodology of reporting), business results which are expressed through financial reports can be compared, that is taken through a benchmarking process.

However, appetites for information of main stakeholders have grown to the extent where reading, analysing financial reports became insufficient. They require information, to bring better decisions directed towards sustainable development and enabling a more sustainable future to humankind.

Setting SMART goals (Specific, Measurable, Achievable, Relevant, Time bounded) and a proper choice of indicators contributes to more focused and effective decision making and better management of the available resources. Appropriate performance management needs to be in place to allow decision making and correcting the business course if implementation deviates from the strategy. The information which is received from regular financial reports is usually a lagging indicator [9]. They are easily measurable, output-oriented, past related and are difficult to influence. On the other hand, there are leading indicators, which are input-oriented, which are difficult to measure but are easily influenced. In that regard, the accounting database and financial reports which are created from that database are an important, relevant source of information, but an insufficient source. A need for a supplement through nonfinancial reports is growing.

To be useful to decision-makers and other stakeholders, it is necessary to standardise nonfinancial reports, make them available, advocate for their use and popularise them, and train experts to apply these standards onto their reports. Having in mind that nonfinancial reporting complements financial reporting, the process of standardisation of nonfinancial should follow the same logic while being developed. Additionally, standards of nonfinancial reporting should be applicable in all industries, more precisely service, manufacturing, and trade. Moreover, it ensures the benchmarking of companies, which is useful for all stakeholders, regardless whether they are performed within a single organisation (comparing two or more business years) or comparing multiple companies.

One of the main challenges in this area is how to design, or how to find a common and high-quality denominator for a variety of industries. Some authors in the field of nonfinancial reporting have directed their research towards a specific area of business, for example, towards the wireless industry [10], or airline industry [11]. The standardisation developed by the General Report Initiative (GRI) has been headed in this direction.

V. NONFINANCIAL REPORTING FOR INTERNAL DECISIONMAKERS

Another application of nonfinancial reports (for internal use) is such that it views the same (common) area in any company regardless of the industry in which it operates, for example, investing in IT system (hardware and software) and set to what extent nonfinancial reports should be implemented and applied.

Some authors [12] which deal with the issue of nonfinancial reports, observe this in the context of agency theory and usefulness of nonfinancial reports for internal decision-makers. The assumption is that the CEO, prone to risk and with questionable moral turpitude, wants to direct the profit towards paying dividends to shareholders and use his success in the

short term. Opposite of him, the Board of Directors, wants to consider an option of investing in IT systems, and consequently ensure long term success of the company, its flexibility and recurring profit. Investment in IT systems is presented as an expense in conventional financial reports. Also, it is necessary to invest in professional training of employees to learn new software.

Moreover, training is presented as an expense in the research and development section in the financial reports. Long term advantages of IT investing are not seen in conventional financial reports. They are lagging indicators which report about the past, are not future-oriented and are tangible. On the other hand, the flexibility of the company to respond to market demands is intangible. Furthermore customer satisfaction is also intangible and is crucial to whether a company is successful and to what extent. All of the aforementioned elements contribute to the need for nonfinancial reporting, as they would balance and improve communication between CEO and Board of Directors.

VI. A WAY FORWARD IN NONFINANCIAL REPORTING

Even though nonfinancial reporting has progressed in the last twenty years, it is still a developing field and warrants closer attention. A common criticism goes along non-binding nature of standards for nonfinancial reporting. Therefore, the experience in the implementation of the Directive 2014/95/EU, which sets the rules on disclosure of nonfinancial and diversity information, from 2018 onwards, by the large companies in their annual reports will provide further insight. In particular, since companies may use international, European or national standards to produce their reports, it will show their preferred choice of standards. This could lead toward prevailing usage and consequently more obligatory usage of particular standard for nonfinancial reporting. Also, it is reasonable to expect that the scope of the Directive could be challenged to include small and medium enterprises, as they currently do not fall in the group of the companies that must comply with mandatory nonfinancial reporting. There are also remarks that these standards lead toward more reporting, not better reporting or more usable or actionable reporting. Some even criticise nonfinancial reporting as a plain PR activity, without any substantial contribution to sustainable development. It would be important to explore further the link between implantation of UN SDGs and exercising nonfinancial reporting in business sector.

VII. CONCLUSION

The importance of nonfinancial reporting in making a realistic picture of the company's business is clear. Voluntarily nonfinancial reporting also contributes to the fact to make a better explanation of the image of business. Mandatory nonfinancial reporting can sometimes be motivated to fit the expected framework in order to meet regulations.

Sometimes it is said that the obligation to initiate that type of reporting – will motivate to present facts in „more beautiful light“ and potentially resort to fraud. The question is how to harmless forms.

Even in traditional financial reporting “within national economies, which select certain accounting policies to reach a specific goal, the reported financial positions are the subject of bias in financial reporting. The problem of determining bias in financial reporting arises from the lack of information. In the last twenty years, numerous studies have been published in the area of bias in financial reporting” [13]. That is maybe a new topic for the research — bias in nonfinancial reporting.

For example, “in the technology and knowledge-intensive industries, innovation and knowledge use are key elements for competitiveness. Companies are oriented towards increasing their potential for exploiting innovation and developing knowledge base internally through various techniques employed” [14]. Reporting about this type of information certainly becomes inevitable.

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