Beyond the Numbers: The New World of Nonfinancial Reporting

Only a few years ago, investors and analysts had access to relatively little nonfinancial business information about an organization. Today, however, the public understands that financial statements present only a partial, and arguably limited, view of corporate performance. As a report issued by The IIA, Beyond the Numbers – Internal Audit’s Role in Nonfinancial Reporting, explains, nonfinancial reporting shares quantitative and qualitative information outside of the scope of traditional financial statements about an organization’s activities related to issues such as environmental impact, diversity, and equal opportunity. Some examples of nonfinancial reporting include integrated reporting; sustainability reporting; corporate social responsibility (CSR) reporting; and environmental, social, and governance (ESG) reporting.

Nonfinancial reporting offers increased transparency into an organization, which can improve decision-making by both internal stakeholders and investors.

While traditional financial measures such as earnings and return on assets are generally trailing measures, nonfinancial measures can be leading indicators of future performance. Further, nonfinancial reporting can lead to improved financial results: The Harvard Business Review reported a study indicating that, on average, businesses produce significantly higher returns on assets and returns on equity over a five-year period if they adopt nonfinancial measures and then establish a causal link between those measures and financial outcomes.

While the benefits of nonfinancial reporting are clear, implementing an effective reporting program is complex. Ideally, nonfinancial reports must be tailored to the organization, made internally available to relevant decision makers, reflect information that is material and accurate, and inspire a culture of integrated thinking throughout the organization. What’s more, the rules are evolving rapidly, and it’s important for business executives and directors to understand just how requirements and expectations for nonfinancial reporting are changing and how these changes affect their responsibilities.

Public Disclosure: Changing Requirements, Changing Expectations

Multinational businesses face a bewildering array of nonfinancial reporting requirements, many of which relate to environmental and social issues. In 2013, KPMG published the results of a survey on corporate reporting in 45 countries. The survey found 134 mandatory policies and 53 voluntary policies related to at least some aspect
of nonfinancial reporting among countries such as Australia, Brazil, China, France, India, Indonesia, Japan, Mexico, Singapore, and South Africa.

Since then, the number of requirements has grown and more are on the horizon. In the European Union, for example, the European Directive on nonfinancial reporting will soon require many organizations to disclose nonfinancial information regarding environmental topics, social and employee-related matters, respect for human rights, and anticorruption and bribery issues. Individual EU Member States may also require that information contained in nonfinancial reports be verified by an independent assurance services provider.

**Internal Reports**

The need for public reporting on nonfinancial issues is clear, but internal nonfinancial reports also play a fundamental role in organizational governance. Simply put, an accurate and well-designed nonfinancial reporting program can provide a holistic view of the organization, thereby contributing to a company culture of integrated thinking, and helping board members, executives, and managers identify how disparate functions within the organization interact.

Further, in today’s business and regulatory environment, organizations must take into account more than financial information when they make decisions. “When organizations decide where to locate a plant or what new product to develop, they are increasingly held accountable for the impact on the community,” explains Eric Hespenheide, chairman of the Global Reporting Initiative Global Sustainability Standards Board and of the AICPA Sustainability Assurance and Advisory Task Force. “Information from nonfinancial reporting should be available internally, and decision-useful.”

**The Need for Assurance: Internal Auditors, External Auditors, and Other Specialists**

It’s a given that executives and directors need periodic reports of nonfinancial information. It’s less clear how they should ensure the information they receive is accurate, complete, and timely. The rules regarding publicly disclosed information vary between jurisdictions. Just as investors expect (and most jurisdictions require) external assurance for financial reports, they may also expect that external assurance providers might be involved in nonfinancial reporting. But the specific type of assurance may vary: there are no consistent, universal guidelines regarding assurance, and much nonfinancial reporting requires little to no external assurance today.

In some cases, particularly when nonfinancial information has a significant financial component, assurance might be sought from external auditors. In other cases, such as evaluating statements related to pollution control or water purity, assurance might be more easily obtained from engineers or other subject matter experts.

In many situations, one of the most efficient and cost-effective sources for assurance may be the organization’s internal audit function, because of its in-depth understanding of the processes and internal controls related to the organization’s value drivers. An adequately sourced, independent internal audit function that operates in accordance with the *International Standards for the Professional Practice of Internal Auditing* is well positioned to help assure that nonfinancial reports are purposeful, reliable, timely, and, most importantly, credible.

**Interpreting the Rules: Transparency Versus Materiality**

Although there are various new nonfinancial reporting requirements, protocols as to how to address the requirements are still being developed.

“Deciding which information is material can be a challenge,” Hespenheide said. “Materiality is a very contextual concept, and more information does not necessarily equate to better information. It can be a colossal misunderstanding to assume that more indicators are good without first having gone through the step of narrowing down what is material.”

At a manufacturing firm, for example, the most important nonfinancial metrics might involve environmental issues such as air pollution or emissions control. On the other hand, a professional services firm will have little or no impact on air quality but extensive impact on gender equality or
diversity. Each organization must therefore tailor its nonfinancial reports to fit its specific situation.

To help assure adequate attention is paid to a variety of nonfinancial issues, many companies use nonfinancial measurement frameworks, such as a balanced scorecard approach. But because each organization is unique, no widely available nonfinancial measurement framework is likely to be a perfect fit. It takes time and effort to tailor these frameworks to an organization’s specific needs, but doing so can offer significant benefits.

A Holistic View: Looking to Internal Audit

Despite the challenges of implementing a successful nonfinancial reporting program, boards and audit committees have an obligation to their companies and stakeholders to offer a more holistic view of the organization and its activities, and also potentially improve corporate performance. The organization’s leadership could look to the internal audit department to play a critical role in organizational governance and assurance over all external reporting.

Editor’s note: This article and accompanying sidebar are adapted from The IIA’s report, Global Perspectives and Insights: Beyond the Numbers – Internal Audit’s Role in Nonfinancial Reporting, published in Oct. 2015. Learn more: https://global.theiia.org/knowledge/Pages/Global-Perspectives-and-Insights.aspx

Internal Audit’s Role in Nonfinancial Reporting

Internal audit has a broad view of the organization’s systems and processes and risks and controls, which positions it to contribute to the organization’s approach to nonfinancial reporting. Boards and audit committees can rely on internal audit to play at least four critical roles in supporting organizational governance over nonfinancial reporting:

■ **Be a change agent for integrated thinking.** Nonfinancial reporting processes can help leaders make real-time, strategic business decisions, especially in a culture of “integrated thinking,” where goals and strategies are aligned across the organization. In its role as an assurance provider on the effectiveness of governance, risk management, and controls, internal audit can focus on recommendations that promote integrated thinking in the organization.

■ **Participate in project teams.** Provide guidance on implementation of plans and performance, such as making recommendations that address enhancing the control environment over nonfinancial data.

■ **Provide assurance.** Internal audit can provide assurance on the preparation of nonfinancial reports, and on the processes that produce the data and information.

■ **Partner with external audit.** Many organizations rely on external audit firms or other consultants to provide assurance and other services related to nonfinancial reporting. Internal audit can partner with the external provider to ensure that the engagements are performed efficiently, reliably, and cost-effectively.