# The European Law Institute Report: Company Capital and Financial Reporting for Corporate Sustainability

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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 foundations for a sustainable future. To absorb the financial risks arising from asset impairments and liability provisioning.

Promoting the retention of shareholder equity rather than its aggressive extraction.

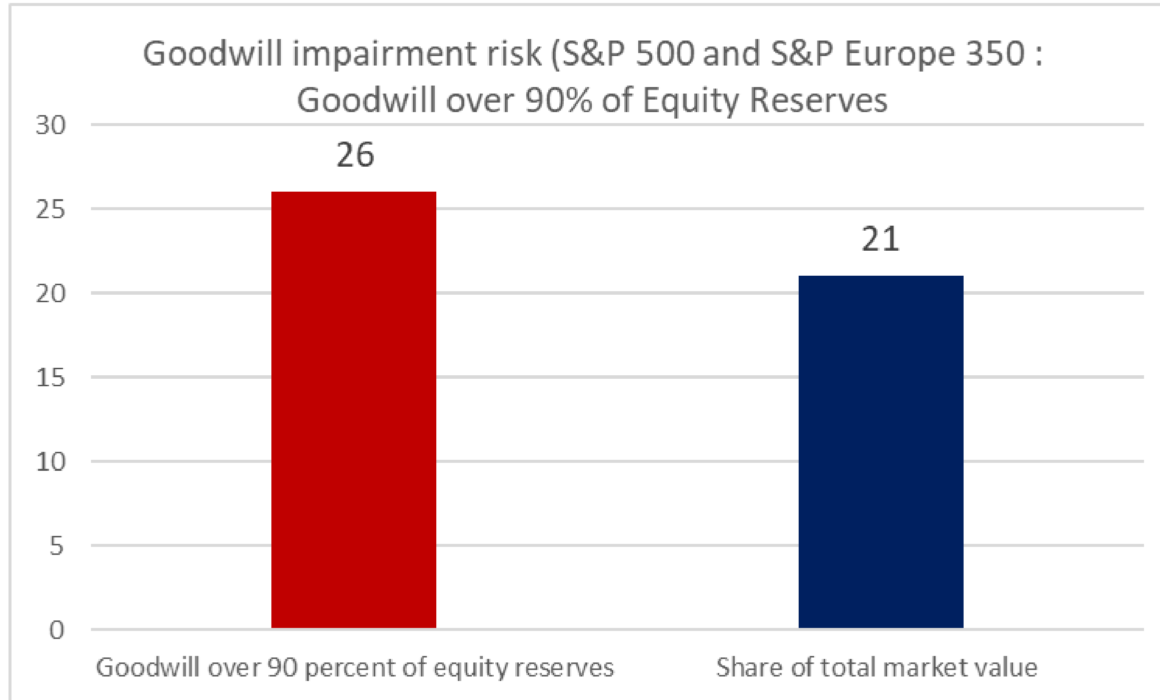
Corporate financial reporting and governance reflect a financialized world : pressure to deliver and account for shareholder value.

On delivery finding ways to boost cash extraction: dividends paid, share buy-backs capital reductions –all diluting the commitment to building equity reserves.

On accounting practice the adoption of fair value accounting (FVA) that adjusts a range of assets to putative speculative market values in the interests of 'better' information provisioning for shareholders

# Financialized companies are at risk: Reduced shareholder equity headroom to absorb asset value impairments and/or increased liability provisioning.

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




For example goodwill is the difference between the market and book value of assets acquired

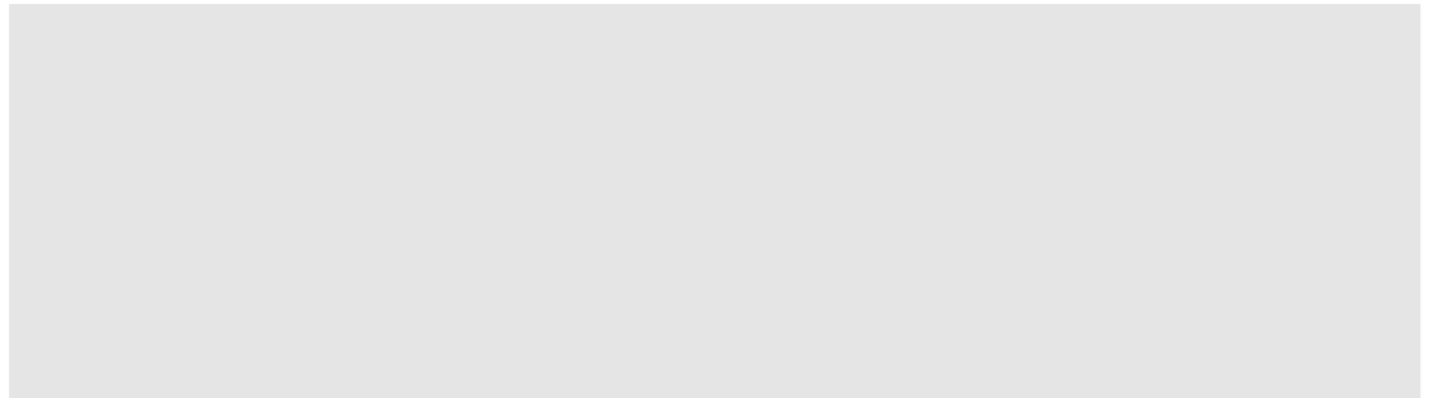
It accumulates over time valuations can become impaired.

Many companies have goodwill that is over 90 percent of equity reserves..26% of the S&P 500 and Europe 350

They account for 21 percent of total market value of this group of companies

But goodwill is just one type of asset risk: Property, Intangibles, financial instruments (marketable securities/derivatives) biological assets are all at speculative market value.

# Financialized companies are ill prepared for the looming climate risk

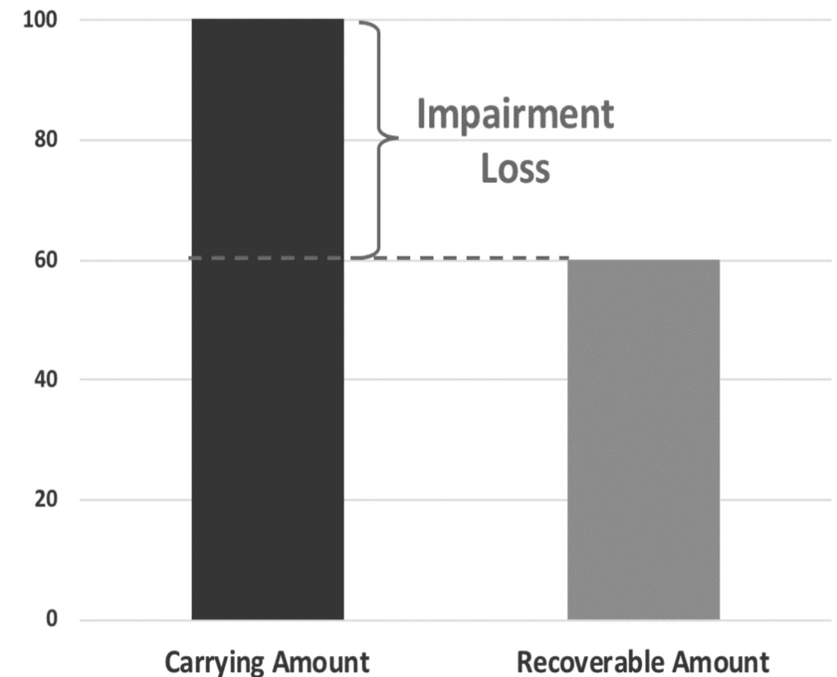


## Asset valuation risk from climate change

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

Environmental risk will 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 provisioning

Companies at risk from climate change should be making current time financial-risk provisions attached to climate change

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

Environmental risk should be translating into a higher liability provisions.

# Asset risk and liability provisioning in financialized companies

- For shareholder investors there may then be a question as to whether a company has provided enough information about its exposure to climate-related financial risks.
- If investors felt this information had not been provided, they might think twice about their investment positions
- 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 (shareholder equity)
- And remember net assets = shareholder equity reserves.
- And this is why equity reserves need to be strengthened.

# In our FTSE 100 green audit: Financial modelling washes out climate risk and auditor limited opinions evade material climate risk(s)

*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 valuations and liability provision modelling is about scenario building.
- Often this modelling assumes that we have moved into a future where we have transitioned into a low carbon era. Washing out the risk.
- Auditors are also reluctant to provide an opinion on climate induced financial risk(s) hiding behind *limited audits.*
- 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 financial risk(s) 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 a company 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.
- The ELI report calls for a reorientation in corporate governance, financial reporting practice and auditor responsibilities. To promote strong company financial foundations for a sustainable future.
- What we find is corporate governance, non-financial and financial reporting maintain the *status quo.* Focusing on and representing shareholder interests.
- While the auditors evade the provision of critical opinion(s) as to the viability and sustainability of financialized company business models.