

# **Financial Materiality of ESG: Accounting implications**

By

Prof. Ya'u Damagum, FCNA

# Financial Materiality of ESG: Accounting implications

## Introduction

Economic , Social and Governance Reporting (ESG) has come to gain relevance in the corporate world due to factors including; pressure for control of global warming and environmental degradation, corporate stakeholder agitations, customer drive and patronage, corporate competitiveness and survival concerns. The corporate world thus become an arena for various information disclosure strategies in order to meet the growing demand for what can be described as corporate socio environmental fitness. Meaning corporations trying to provide economic and socio–environmental information towards showing the level of concern for the environment and the society at large. Because ESG reporting do come with associated financial implications, there appears the need to establish to role of the accounting in ensuring effectiveness efficiency and prudence in pursuit of such reporting so as to ensure that the ends justify the means in the entire process. The paper in trying to address the embedded issues is divided into three segments viz; Conceptual issues about ESG, the Processes of ESG reporting and the Role of the Accountant in ensuring financial sanity particularly given the cost implications of the process which can be of material significance to the over all budgets of the reporting organizations.

# ESG Reporting: Conceptual Issues

For purpose of the current discuss it pertinent to provide conceptual understanding of the various terminologies the paper intends dwelling on so as to pave way for practical appreciation of each of them as they apply to the accounting profession.

the main concepts that need dissection in this regard are the following:

- ❖ Corporate organizations
- ❖ Corporate Reporting
- ❖ Accounting Reporting
- ❖ Social Reporting
- ❖ Environmental Reporting
- ❖ Economic Reporting
- ❖ Corporate governance Reporting
- ❖ Reporting Standards
- ❖ Corporate stakeholders

Fig 1. ESG Reporting Structure

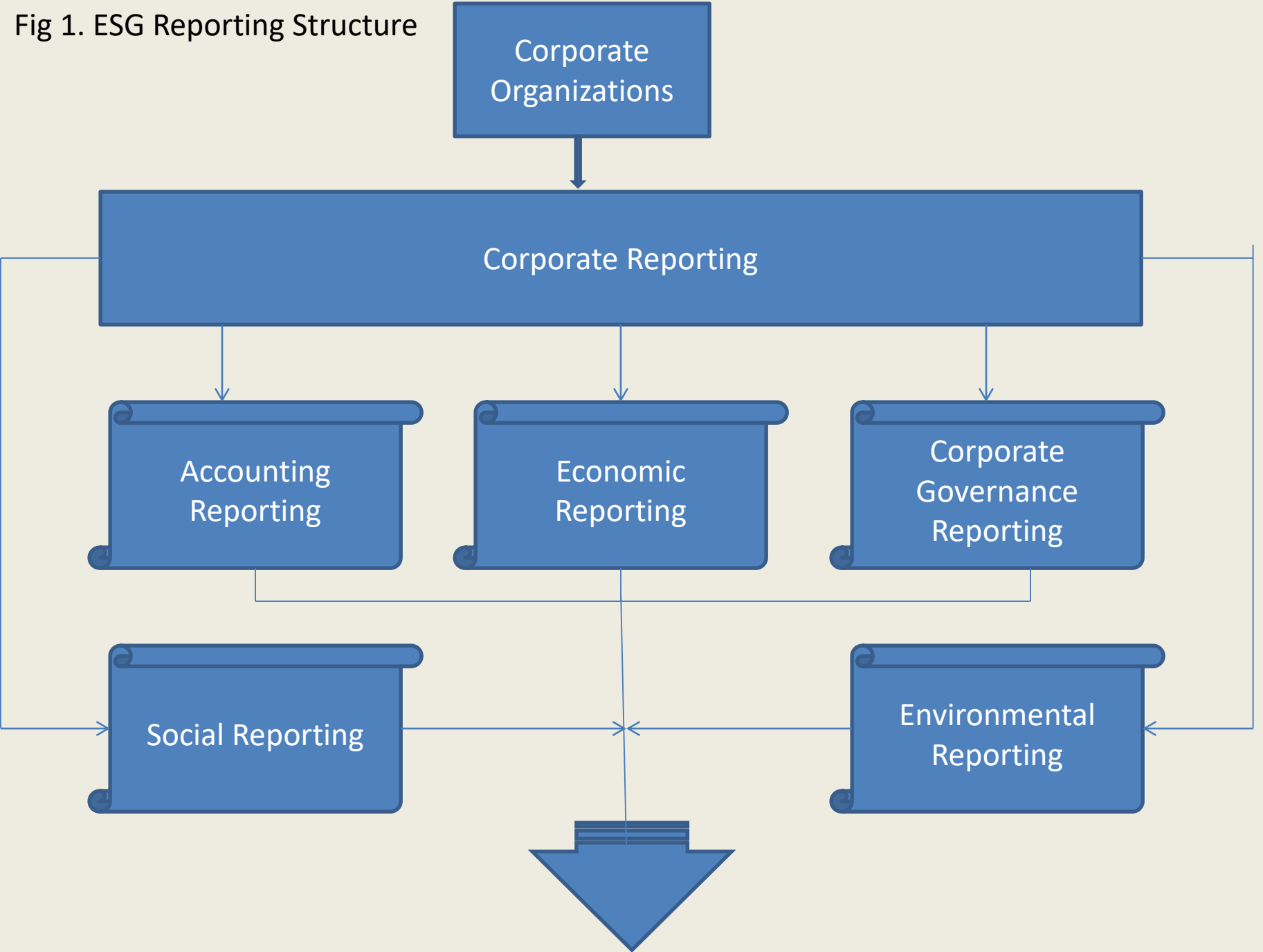
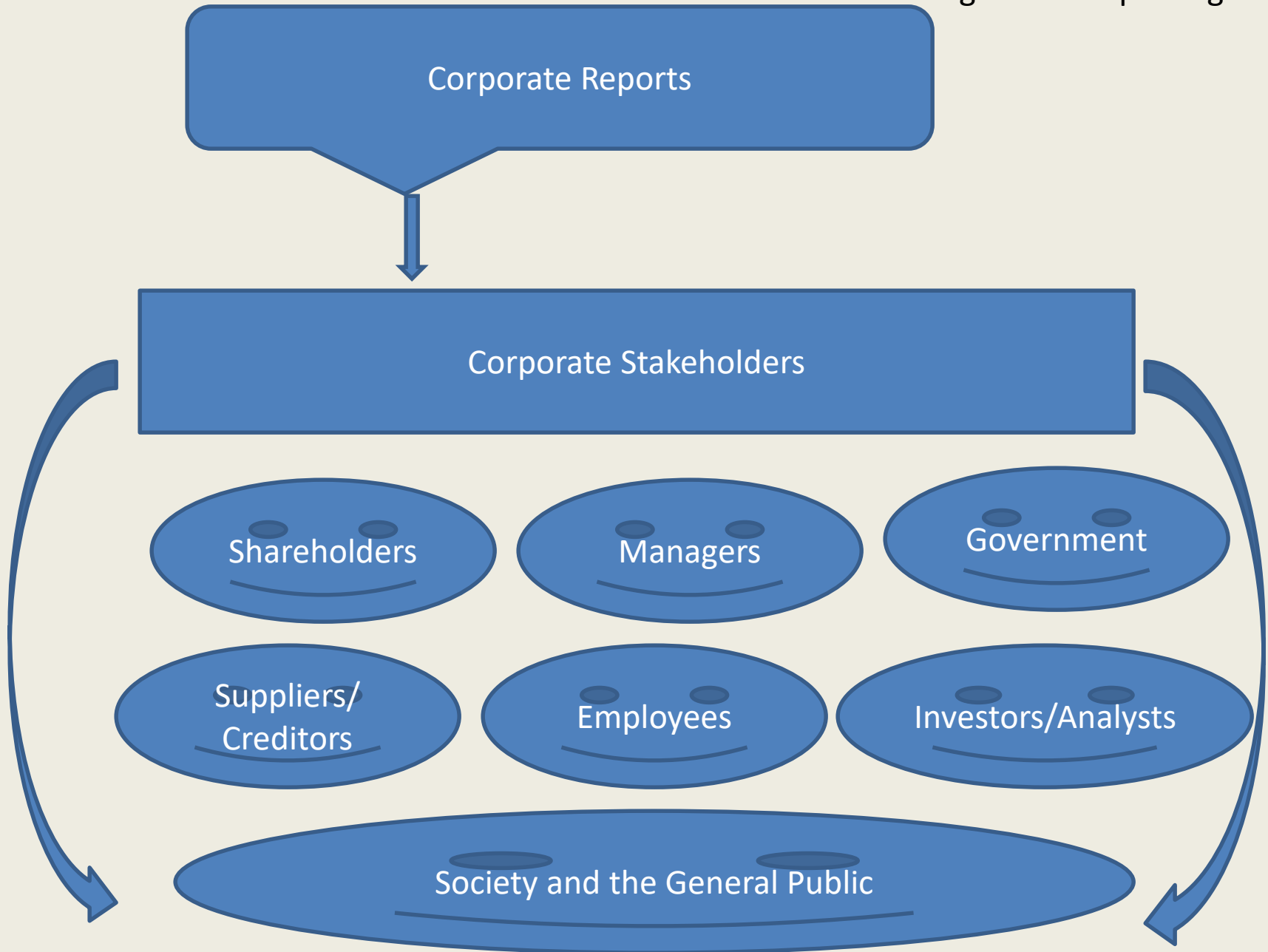


Fig 2. ESG Reporting Target



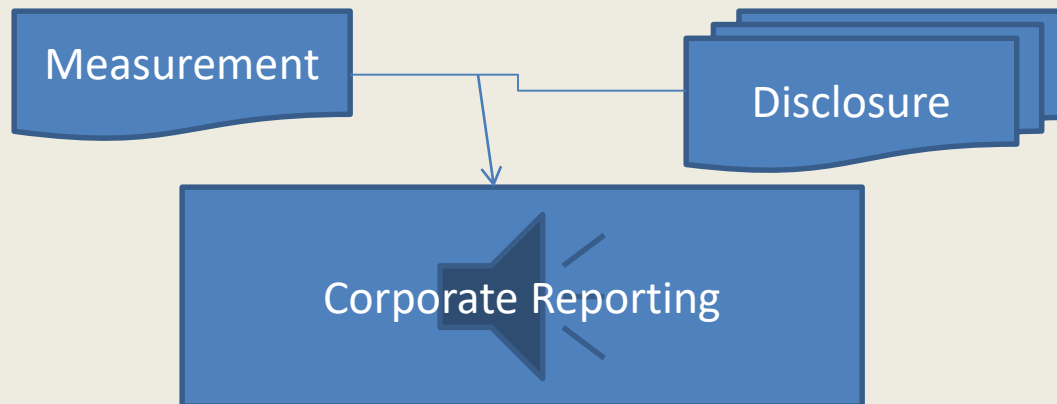
# CORPORATE ORGANIZATIONS

All economic entities the activities of which are directly or indirectly affecting the society can be defined as corporate organizations. These may include, firms in the Manufacturing, Banking and Finance, Service and Hospitality, Transportation, Selling and Distribution and Oil and Gas sectors of any given economy.

Depending on the nature of their operations and activities, corporate organizations affect their environments or the society in which they operate in different manners.

## CORPORATE REPORTING

This is the totality of the processes followed by organizations in order to bring the report of their operations to the general stakeholders which may be due to accountability, stewardship or other reasons anchored on corporate survival and acceptability by the environment. Corporate reporting is achievable through a combination of two main activities . These are:



## MEASUREMENT

Refers to all the processes involved in determining the value of a transaction for purposes of financial reporting; the five ingredients required to achieve measurement are;

- ❖ Source Documents
- ❖ Accounting principles
- ❖ Accounting Skills
- ❖ Accounting Standards
- ❖ Professional Ethics



## Source Documents

These are the very roots of every transaction details of which are to be captured And included in the accounting cycle and system for accounting reporting Purposes.

These include Vouchers, Receipts, Invoices, and any other Commitment certificates.

The role of the Accountant here is that he/she must ensure that the right documents are used as evidence or part of the audit trail of any transaction. Right documents are also supposed to be complete and Accurate in terms of both form and substance.

All documents should be real and carry required data necessary to serve as Evidences of transactions ; for instance, dates, purposes, amount, description Recipients name, address, signature, other conditions and terms. Authentication By way of seal.

## Accounting Skills

These are the skills and competencies attained by the accountant through training Which are supposed to result in the ability to interpret and apply correct treatments And procedures for the recording of transactions. For example the ability to calculate Depreciation in respect of non-current assets, prepare cash book etc. This is where the issue of being an **FCNA counts. Why? because skill is not in the tittle but in the ability.**



## **Accounting Standards**

These are the technical guide lines prepared either locally like the Statements of accounting standards (SAS) obtainable in all countries and those prepared by the International Federation of Accountants (IFAC) the international financial Reporting Standards (IFRs).

IFRs S1 General Disclosure Requirements for Sustainable related Financial information and IFRs S2 Climate related Disclosures

Carbon Disclosure Project (CDP)

Global Reporting Initiative (GRI) Sustainable Accounting Standards Board (SASB)

Task force on Climate Related Financial Disclosure (TCFD)

European Union Directive No. 95 of 2014 requiring larger firms to disclose Economic Social and Environmental impact information

The reporting Accountant should be conversant with these Standards and ensures compliance in his organizations reporting process.

These will apply to

Determination of qualifying expenditure, maximum amount allowed, method Of disclosure including issues of capitalization and amortization

## **Accounting Concepts, Principles and Conventions**

These include all Generally Accepted Principles that are supposed to be applied in ascertaining the amounts to disclose from a given number of transactions. The Concepts and principles include the following:

- ❖ Materiality
- ❖ Money measurement
- ❖ Consistency
- ❖ Prudence/Conservatism
- ❖ Accrual
- ❖ Periodicity
- ❖ Matching
- ❖ Entity
- ❖ Going Concern
- ❖ Others

The reporting Accountant is expected to therefore ensure proper interpretation of the applicable principle when the value of a transaction is to be captured in the financial reporting process.

In particular, he must be conversant with the application of these principles at the time of preparing data for purposes of measurement. For example, a case may arise where a sum is expected to be expended on a social responsibility project and questions may arise as to whether it is material, relates to two accounting periods, etc. At this point the accountant is expected to use his skills to interpret these principles accurately and then apply them by suggesting the actual amount to record and eventually disclose in the Financial statement.

## Accounting Skills

These are the skills acquired and available within the competency Aperture of the reporting Accountant. This is why the MCPD is necessary towards bringing out the capability of the person claiming professional desiderata including; CNA, FCNA, FCA, etc.

Does the person know how to treat every transaction in terms of the techniques of recording, adjusting and disclosing? What amount is required to be disclosed, in which part of the financial statement, how is the transaction to be processed through the accounting system i. e. from the state of primary entry (journal) to Ledgers, Trial Balance and eventually the final Accounts?

Where there are accruals or prepayments, how are they to be reflected in the current year financial statements?

Are notes to the accounts required and what goes into such notes?

All of these are the critical questions that a professional accountant is

Required to ready to answer through his actions. We should also remember that

out there in the field of practice, there are members of other professional

accounting bodies willing to give us a serious challenge

In the area of competence.

## **Professional Ethics**

These are those elements of ethics that are supposed to guide an Accountant in the

Course of performing his duties including those to do with ESG financial reporting

showing social, economic and environmental costs.

The major elements of ethics for the accounting profession are:

- ❖ Independence
- ❖ Objectivity
- ❖ Integrity
- ❖ Confidentiality
- ❖ Relationship with colleagues in the profession

Objectivity for example suggests that we should report with out bias. So for instance, do not exaggerate the amount being expended in respect of Corporate governance, Social or Economic/environmental protection activities. This requires correct and Unbiased documentation of all items comprising such expenses.

## DISCLOSURE

This has to do with all the steps taken by an organization to bring to public Domain information whether for purposes of meeting statutory requirements Or out of voluntary considerations.

There are several ways these can be achieved such as ;

- ❖ Annul reports and Accounts
- ❖ News Papers
- ❖ Professional Journals
- ❖ Internet
- ❖ Magazines
- ❖ Social media facilities
- ❖ Etc.

Given the relative costs (both Material and Social) which may be associated With particular disclosure methods, the accountant is supposed to serve as An adviser to the management in this respect. There is also the question of Sustainability and need for consistency. Can the organization be able to Sustain this method of disclosure and on consistent basis? These are the Questions that the Accountant should be able to find answers to.

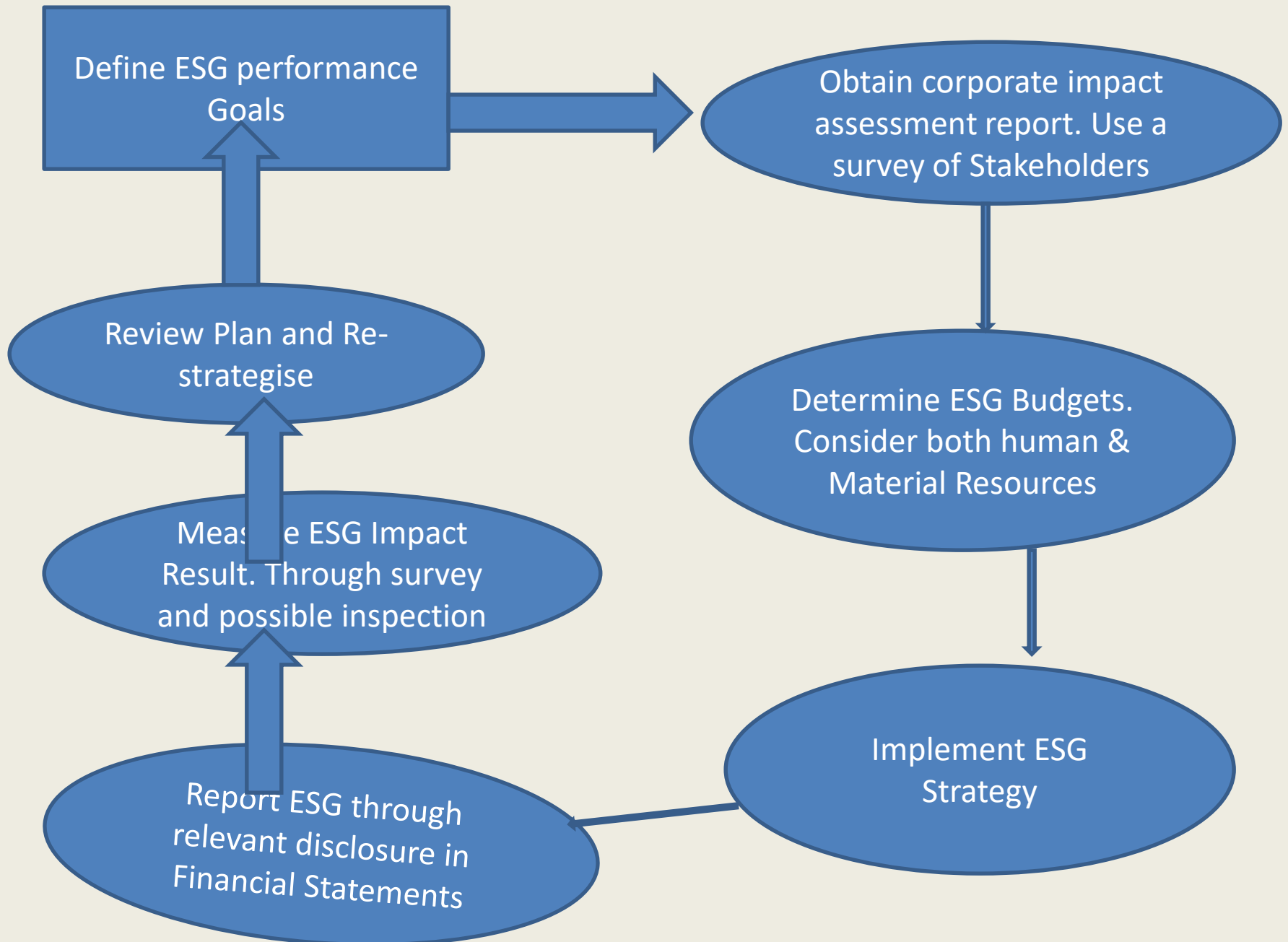
## **The process of ESG Disclosure**

Based on the recommendations of the CDP, GRI and TCFD, the process of financial Disclosure in respect of Economic, Social impact, Environmental impact and Governance, the following steps can be adopted.

- ❖ Define performance target or goals in line with objective
- ❖ Obtain corporate impact assessment report through stakeholder engagement
- ❖ Determine ESG budgets in line with resource availability (both human and material)
- ❖ Implement ESG strategy
- ❖ Measure ESG performance through evaluation and feed back
- ❖ Review plan and make amends for sustainability purposes



Fig 3. ESG Reporting Process



## **Defining ESG performance Goals**

That is to say an organization must address this issue by looking at its mission vision and objectives bases on which to define the limits metrics for its ESG financial reporting activities. Factors like nature of operations, products services, location etc. Are all critical in this decision.

## **Obtaining Corporate Impact Assessment Report**

This is the report that tells an organization the feeling of stakeholders including customers, government, employees, environmental protection groups and others about its impact in the society. This could be both positive and negative. The use of Questionnaire survey is very much recommended with field follow up where necessary

## **Determination of ESG Budget**

At this stage, the accountant plays a vital role by contributing towards providing the Financial strength of the organization and the elasticity of spending in this area vis.a. vis other areas of need. Possibility of external collaborations and other sources of funding Should also be brought into the analysis. Cognizance should also be taken of human resources that may be deployed to meet ESG reporting needs

## **Implementation of ESG reporting Strategy**

This the point where an organization has to decide on the means to adopt towards releasing funds for purposes of ESG projects. Both internal and external personnel can be involved in the process. For example ,the Special duties or Public Relations departments can be involved. At the same time, Consultants can be engaged and given contract to execute ESG expenditure budgets. The only consideration is that extra care should taken to ensure judicious application of all Funds budgeted in the regards.

## **Report ESG in Financial Statement**

Appropriate sections of the financial statements should be used to disclose ESG Expenses with relevant notes where necessary. The use of trends and graphical Presentations can also be necessary for the benefits of lees informed users For example part of the disclosure can include ; Photographs, Tables and Graphs. All of these should also be in line with the provisions of relevant reporting standards.

## **Measure ESG Impact Result**

This could be through the use of questionnaire administered to stakeholders, physical inspection and on-sight meetings with stakeholders so as to generate data about the Impact of ESG projects on the society. At this stage, there is serious need for objectivity and ensuring the collection of actual data from the environment or those directly affected. Issues of Laboratory tests, other physical statistics and first hand information are all critical. This process will show whether the **Ends have justified the Means.**

## **Review impact Report and Re-strategize**

Review impact report by comparing results with budget expectations. Care should be Taken to account for genuine variations as well as abnormalities. Possible reasons and Explanations should also be assessed. By this process, an organization should be able To identify exceptions so as to map out possible strategies towards addressing the Issues raised and making better plans in respect of the ESG disclosure strategy .

## Implications

The main implications of ESG are that:

- ❖ There are cost implications which may have serious toll on the finances of an organizations. Budgets for ESG disclosure include preparation and processing, publishing and use of experts and consultants.
- ❖ The benefits may not be quantifiable with objectivity so the possibility of wrong decisions being taken e.g. to stop a particular ESG fund due to lack of idea about perceived benefits.
- ❖ Need for sustainability irrespective of responses and expected benefits. In this case a particular service or project can be to act as a loss leader
- ❖ The society may develop a wrong perception about the social projects, their aim and the information provided.

## **Re starting the Process**

At the end of the assessment, the result should provide a guide as to what steps to take next so as to correct the anomalies observed. It is these anomalies that will be use to fashion out a new and probably more effect ESG Reporting strategy. for example if the budget was found to be insufficient, steps can be taken to find alternative ways of beefing it up. This is what tends to make ESG reporting to have a lifecycle as observed by some scholars in the Financial Reporting Literature (B. Eliott and J. Elliot, 2006, D. Crowther, 2000)

## **CONCLUSION**

Going by the dimension recently taken by corporate financial reporting in general and ESG in particular, there is no doubting the fact that the idea of ESG has come to stay and will continue to more prominence within the realms of corporate reporting globally. In view of the above given their intrinsic role in the process have to sharpen their skills and technical competencies so as to play that role effectively as the main instruments responsible for the gathering, measuring, processing and disclosure of ESG information. As such any failure on the part of the Accountant to play such a role has the potential to truncate the efforts of organizations nursing genuine intention to adopt ESG. Consequential to, this, organizations are likely to be victims of negative vices like loss of customer confidence negative societal pressure and even loss of revenue or income. All eyes are therefore on the Accountants as the main anchors to sustain the ever rising global momentum towards ESG.

THANK YOU MOST PROFOUNDLY,

PROF. Y. M. DAMAGUM





## Selected References

Barry Elliot and Jamie Elliot (2008), Financial Accounting and Reporting, *FT Prentice Hall , Financial Times*, London.

Belkouih A. R (2015) Accounting Theory, *Eagle Wood Publishers*, New York.

Damagum Y. M (2023), Introduction to Financial Accounting, *Ogive Press Limited*, Kaduna.

Deloitte & Touche (2002), Accounting for Carbon under the UK Emissions Trading Scheme- Discussion Paper, *Deloitte & Touche* London.

European Union, Directive No. 95 (2014) @ [www.eu.org](http://www.eu.org) Visited 3<sup>rd</sup> January 2024.

IFAC, International Accounting Standards Board (2024), IFRs S1 S2 @ [www.ifrs.org](http://www.ifrs.org) visited 3<sup>rd</sup> January 2024.

O'Dwyer, B (2001), The State of Corporate Environmental Reporting in Ireland, *Certified Accountants Educational Trust for the Association of Chartered Certified Accountants (Research Report 69)*.

R. W. Perks and R. H. Gray (1978), Corporate Social Reporting- an analysis of objectives, *British Accounting Review*, Vol. 10(2), pp 43-59.