Are ESG disclosures the new challenge for CFOs?

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In 2022, it's fair to say that organisations face a fragmented landscape of ESG disclosure options. Disclosures of all manner, can be the window into the soul of the company, but to be effective they must satisfy the following criteria:

(1) They must meaningfully explain the organisations' current and future performance, position, and intent

(2) They must describe the above items in a standard way that facilitates comparison to other companies

Financial measurement and reporting have enjoyed a long history of refinement, through the testing and changing of accounting standards. However, despite all the efforts towards accounting harmonisation, there are still well-established jurisdictional differences that need to be addressed by both preparers and users of financial statements.

This context is useful to try and envisage the journey ahead for ESG disclosures. ESG is a new and very important non-financial metric, and investors are rightfully demanding better and more standardised disclosure information.

There is no doubt that it will be a challenge for companies to develop a more standardised ESG disclosure framework but who in the organisation is accountable for doing so? To answer that question, it is important to understand how the world will align on ESG disclosures in the future.

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The harmonisation of ESG standards

The International Sustainability Standards Board (ISSB) was launched to drive harmonisation by delivering a comprehensive global baseline of sustainability-related disclosure standards. The ISSB was formed by the International Financial Reporting Standards (IFRS) Foundation, who are arguably the most qualified organisation to drive the development of global disclosure standards.

The ISSB think like accountants and the proposed sustainability standards read very much like accounting standards.

The formation of the ISSB is a welcome direction of travel in a confusing market. They have moved with speed and decisiveness to make some key progress. This includes:

- Gaining public endorsements (COP26, G7)
- Consolidating existing framework bodies under its governance/ownership (TCFD, CDSB, VRF, GRI, WEF)
- Publishing proposals quickly (they have already published two exposure drafts with the aim to publish a final version at end of 2022)
- Driving engagement to co-ordinate jurisdictions across the world (most reflected by the ongoing momentum of the jurisdictional working group)

Perhaps the biggest indicator though, is the impending endorsement of the International Organisation of Securities Commissions (IOSCO). Ashley Alder, who is the chairman of the IOSCO board, indicated at a recent IFRS foundation conference that IOSCO was close to endorsing the ISSB standards.

This endorsement will become a fundamental acceleration to the wide adoption of the ISSB standards. The IOSCO endorsement of the International Accounting Standards Board (IASB)'s standards over 20 years ago has arguably been the driving factor behind 140 countries adopting IFRS as a global baseline for accounting standards. We could reasonably expect the IOSCO endorsement to be a similar catalyst for the ISSB sustainability standards.

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What are the ISSB standards asking for?

The ISSB have published two exposure drafts to date:

- **IFRS S1**: A conceptual framework covering principles for disclosing all sustainability risks and opportunities
- **IFRS S2**: climate disclosures

The standards are designed following a building block approach, which allows for further inclusions (e.g. biodiversity, water, etc.) at a later stage.

Both exposure drafts ask companies to disclose sustainability-related risks and opportunities through four lenses:
(1) Strategy
(2) Governance
(3) Risk Management
(4) Metrics and Targets

This is a familiar format for anyone who has used the Task-force on Climate Related Financial Disclosures (TCFD) standards.

Companies also need to assess, quantify and disclose how the sustainability risks and opportunities impact their enterprise value (EV). This will require re-thinking materiality as well as the development of an EV impact assessment framework.

Companies must consider and disclose their sustainability impacts from activities that are not necessarily within their direct control. The best example of this is the requirement to disclose scope 3 emissions, which are carbon emissions that the organisation indirectly impacts through its value chain.

The climate standard also requires specific industry-based metrics in addition to cross-industry based metrics.

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One thing that is fundamentally clear, is that the disclosure requirements drive the need for constant consideration of how ESG/sustainability risks and opportunities have, and may materially affect, the financial statements.

There is an expectation that sustainability disclosures are intrinsically linked to general purpose financial statements, and there is even a requirement to produce them at the same time. Sustainability disclosures will act as another dimension that users of financial statements can utilise to complete the picture of a company's future.

CFOs will need to drive the coordination of the organisation's ESG disclosures

Given the very close linkage between sustainability disclosures and general-purpose financial statements, it is logical that organisations will look to the CFOs to drive sustainability reporting.

The effort will be substantial and require internal collaboration across finance, risk, compliance, sustainability, marketing and technology departments, as well as business lines and facilities management. There will also be input required from external data providers, technology providers and consultants.

When companies begin complying with ISSB standards, there will be a few barriers to implementation:

- **Data availability:** there is currently a lack of availability of key sustainability data (including scope 3 emissions, supply chain data and ESG ratings). There is also a factor of how quickly some of this data is sourced, as the ISSB propose publication of sustainability disclosures at the same time as general-purpose financial statements.

- **Jurisdictional alignment:** if jurisdictions adopt variations to the baseline, this could lead to a fragmentation of reporting across countries/regions. Too much flexibility also defeats the purpose of standardised disclosures and there will be a need for divergence guidelines.

- **Lack of subject matter expertise and capacity:** there is a scarcity of skilled resources with the knowledge and experience to measure, manage and articulate sustainability risks and opportunities. Companies will have to develop this capacity over time, and there will be fierce competition for talent in this area.

- **Proportionality of implementation and operation:** for many organisations, a new reporting process / operating model must be established, and considerations need to be given to how the organisation implements and operationalises risk management, assessment of materiality, impact to enterprise value, and impact on the financial statement. The link between strategy, governance, risk management and targets / metrics becomes tighter and therefore a stronger influence on the business and operating model of the organisation.

- **Assurance:** sustainability disclosures must be audited, and auditors, regulators and the assurance community need to align on a common assurance approach and conclusions that are meaningful to users of financial statements. Audit firms will have a huge task ahead to build the appropriate capability and capacity to provide assurance on companies' sustainability disclosures.

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What does the road ahead look like for CFOs?

Sustainability is already an important measure of a company's performance and future potential, and the world is rapidly aligning on developing a common language for companies to describe how they positively impact the world.

However, with a common language comes scrutiny and comparability. There is a risk that companies who have not proactively developed their disclosure strategy, and consequently recalibrated their business / operating / financial models, will be portrayed very unfavourably.

There is, however, a strategic opportunity for companies who understand what these disclosures will tell the world to take the required action and therefore increase their enterprise valuation. The responsibility for this will undoubtedly land with the CFO, which poses a great opportunity to provide the strategic leadership necessary to navigate their organisation to long-term success.

What are the immediate next steps that CFOs can take, that will prepare them for the long journey ahead?

1) Understand the delta: CFOs should seek to understand the gap between the proposed ISSB standards and what their organisation currently discloses, in order to determine the most material pieces of work to reach compliance.

2) Align the organisation: CFOs should engage all the parts of the organisation to describe the nature and extent of the combined effort required to operationalise sustainability disclosures. The organisation needs to plan and budget for the time, money and people required.

3) Understand data requirements: CFOs needs to understand the future sources and uses of data required for sustainability reporting. There will be a long lead time required to build these up, so they can be used in an industrialised way.

4) Develop a sustainability reporting operating model: CFOs should lead the charge in designing the target state of sustainability disclosures. The objective should be one set of disclosures that are fit for purpose to all stakeholders, utilising the ISSB building block and global baseline approach. All users of these disclosures should get the same information at the same time, albeit at the various levels of detail that they need.

5) Build the team and capability: CFO's should begin to hire, train and upscale a multi-disciplinary team that that can act as guardians of the firms' sustainability reporting.

Showing demonstratable impact toward the ESG and sustainability agenda is fast becoming a critical determinant of capital allocation to companies. Companies disclosing their ESG information in a meaningful, valuable and consistent way is an increasingly important strategic priority and CFOs will become the guardians of that responsibility.

It's a long road ahead, but ultimately a journey that CFOs need to begin now.

About us

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For more information on how we can help with your finance initiatives, please get in touch.

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Bash is responsible for **Be UK**'s Finance and CFO advisory practice. He drives change and innovation on behalf of CFOs and senior management across the financial services industry. As a qualified chartered accountant, half of his career has been spent working in the CFO / COO / financial control / product control space, which allows him to understand the unique challenges and opportunities facing the function.

The other half of Bash's career has been as a management consultant delivering large-scale strategic, regulatory and transformation programmes for multinational investment banks. He is passionate about embedding sustainable digital change that provides clients with immediate and continuous value.

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