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Corporate Reporting Exam Room Notes 2025

Additional PDF content 2025

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Sustainability

New content on sustainability from 2024 edition of SBM Workbook

Evaluating Strategy with Sustainability and Dependencies

- Organisations must consider the impact of their strategies on sustainability and assess how environmental, social, and governance (ESG) issues, known as 'dependencies', affect their value creation and maintenance
- Dependencies can include climatic conditions, resource availability, regulatory environments, worker health, workplace diversity, consumer expectations, other stakeholder expectations, and risks to organisational reputation, requiring a broad assessment beyond just sustainability impacts

Definitions

Sustainability

- Defined broadly to focus on environmental and social aspects aimed at improving life and the planet long-term, sustainability is about meeting present needs without compromising future generations' ability to meet theirs, as outlined in the Bruntland Report 1987

Impacts

- Relates to how an organisation’s decisions and actions positively or negatively influence environmental, societal, and governance issues

Dependencies

- Focuses on how current and future ESG issues impact an organisation's capacity for value creation and maintenance

Sustainable Development

- Targets the continuation of economic activity without causing permanent societal or planetary harm, aiming for thriving economies and just societies within nature's limits

Environmental, Social, and Governance (ESG)

- ESG offers a corporate perspective on sustainability, assessing business and enterprise value impacts from environmental, social, and governance issues. It is a common term in corporate and investment contexts, serving as a framework for considering sustainability through the lenses of environmental impact, social responsibility, and corporate governance

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Key Areas of Consideration

Governance

- Involves board accountability, shareholder engagement, compensation practices, and anti-bribery and corruption measures

Environmental

- Encompasses climate change, resource use, biodiversity and land use, waste management, and air quality

Social

- Includes labour standards, human rights, health & safety, diversity & inclusion, and product responsibility
- These areas highlight the multifaceted approach organisations must take to align their strategies with sustainability principles and manage dependencies effectively

Business Strategy, Sustainability, and ESG

Business Strategy and ESG Issues

- Business strategy considerations must account for both the impact on environmental and social issues and the strategy's implementation
- This category encompasses the reciprocal effects between business strategies and sustainability, including how strategies can influence and be influenced by environmental and social concerns

Sustainability vs ESG

- While the terms sustainability and ESG are often used interchangeably, they have distinct meanings
- Sustainability focuses on creating thriving economies and just societies within the boundaries of what nature can sustain. It encompasses the broader impact and dependencies of an organisation on both the organisation itself and society at large
- ESG, on the other hand, views environmental, social, and governance issues through a corporate lens, concentrating on how these factors affect a business and its value. Unlike sustainability, ESG does not account for the concept of operating within environmental and social limits

Risk Management

- Climate change and sustainability issues present significant risks and opportunities for organisations
- Effective ESG risk management can reduce costs and attract investors, highlighting the important role of accountants in guiding organisations through risk management and opportunity identification

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- The role of accountants extends to evaluating the external environment and understanding how current and future ESG issues can impact the organisation, its strategies, and its value creation capabilities

Strategy and Environmental Impact

- Organisations must consider their own impact on the environment and social issues as part of their strategic planning
- This includes understanding the activities of suppliers and customers and assessing how an organisation's operations affect broader societal and environmental goals
- Accountants play a crucial role in analysing these dynamics, aiding organisations in aligning their strategies with sustainable development goals and managing dependencies effectively

Metrics and measures for sustainability

- Materiality analysis is a crucial step in identifying key sustainability issues for an organisation's focus
- This analysis involves graphically plotting sustainability-related issues based on two dimensions:
    - The significance of the issue's impact on the organisation (plotted on the vertical axis, ranging from high to low)
    - The significance of the organisation's impact on the issue (plotted on the horizontal axis)
- After identifying the key focus areas through this process, the next step for organisations is to integrate these areas into their performance management systems
- This involves:
    - Identifying relevant aspects of performance related to the key sustainability issues
    - Selecting appropriate Key Performance Indicators (KPIs) to measure these aspects

Climate Change Transition and Change Management

The shift towards net zero and climate change transition presents a significant challenge for organisations, requiring a comprehensive change management approach. Drawing on established change management models can provide a valuable framework for planning and implementing climate change strategies

Key Concepts for Climate Change Planning

Shared Vision and Understanding

- According to Balogun & Hope Hailey's Change Process (Step 3), identifying a shared vision or common understanding of the net zero goal is crucial. This involves clarifying what the organisation aims to achieve in its transition towards a more sustainable future

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Designing the Transition Process

- Organisations must design a transition process tailored to achieving their sustainability goals and objectives. This involves outlining the steps necessary to move from current practices to more sustainable ones

Leveraging Lewin's Forcefield Analysis

- Strengthening driving forces that promote the transition to net zero while weakening restraining forces that resist change is essential. This approach can help overcome obstacles and accelerate progress towards sustainability targets

Practical Planning for Change

Organisations must focus on the tangible aspects of planning for climate change transition, which includes:

- Responding to potential shifts in supply and demand, navigating new regulations, and integrating new technologies
- Translating high-level commitments to net zero into specific, actionable objectives and measures that effectively reduce greenhouse gas emissions
- Preparing for climate change transition risks associated with policy, legal, market, and technological changes. These risks include the potential for assets to become stranded due to unanticipated write-downs or devaluations as decarbonisation progresses

Managing Transition Risks

- Awareness and proactive management of climate change transition risks are essential. Organisations must anticipate and plan for the impacts of transitioning to a low-carbon economy on their operations, financials, and strategic positioning
- Addressing the risk of stranded assets requires careful assessment and planning to mitigate financial impacts and align with the broader transition towards sustainability

ESG-linked remuneration

- **Integration with Traditional KPIs**: Sustainability targets and metrics are now being measured alongside traditional Key Performance Indicators (KPIs), indicating a broader definition of corporate performance that includes ESG achievements
- **Influence on Executive Remuneration**: There is a noticeable trend among listed companies to incorporate ESG targets into executive remuneration packages. This move is based on the understanding that effective ESG management significantly contributes to a company's financial performance and long-term viability
- **Motivation for ESG Performance**: The inclusion of ESG criteria in compensation schemes follows the principle that what gets measured gets managed. By tying a portion of executive pay to ESG performance, companies are incentivising sustainable practices and governance improvements at the highest levels of management

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Corporate social responsibility and ESG

The growing importance of Environmental, Social, and Governance (ESG) factors in the corporate world has profound implications for finance professionals. Beyond the traditional scope of finance, the inclusion of ESG considerations represents an evolution in how finance roles are perceived and executed. Here are the key areas where ESG factors intersect with the responsibilities of finance professionals:

Promotion of Sustainable Business Practices

- Finance professionals are pivotal in directing capital towards sustainable and responsible projects, ensuring that ESG factors are integrated into investment and funding decisions

Investing

- Investors are increasingly focused on supporting companies that demonstrate environmental and social responsibility. Finance professionals must therefore incorporate ESG considerations into investment analyses, evaluating how companies address climate change, worker treatment, health and safety policies, and supply chain management

Performance Management

- Research indicates that companies with robust ESG practices often have lower risk profiles and yield better long-term financial returns. Finance professionals play a critical role in identifying key sustainability issues, selecting measures to monitor ESG performance, and integrating these into the broader performance management framework

Risk Mitigation

- While not directly responsible for measuring ESG KPIs, finance professionals are essential in identifying potential ESG risks that could impact company performance. They assist in developing strategies to mitigate these risks, such as adapting business models to meet changing consumer demands (e.g., the shift towards electric vehicles)

Performance Reporting

- With ESG metrics gaining prominence in public reporting, finance professionals are expected to apply the same level of rigour to ESG reporting as to financial reporting. This involves organising data collection, ensuring accurate metric calculations, and preparing documentation for auditing
- Familiarity with ESG reporting standards (e.g., IFRS S1 and IFRS S2) is crucial for finance professionals to ensure compliance and effective presentation of relevant ESG data in public reports

Finance professionals are thus at the forefront of integrating ESG considerations into corporate strategies, investment decisions, risk management, and reporting. This expanded role underscores the importance of ESG knowledge and skills in modern finance, reflecting a broader commitment to sustainability and responsible governance within the corporate sector

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Governance and sustainability

ESG disclosures in annual reports are increasingly guided by IFRS Sustainability Disclosures Standards

IFRS S1 focuses on sustainability-related financial information

IFRS S2 targets climate-related disclosures

This methodology ensures comprehensive reporting on sustainability and climate impacts

Assurance for ESG content

Under UK listing rules, quoted and large unquoted companies must disclose ESG information in the Directors' Report using the TCFD framework

Since 2023, disclosures must also align with the IFRS Sustainability Disclosure Standards, which follow a similar approach to TCFD, focusing on governance, strategy, risks, metrics, and targets

ESG disclosures are not audited but must be reviewed by external auditors for consistency with the audited financial statements

External auditors check for material inconsistencies between the ESG disclosures and financial information, reporting any findings in a separate auditor's report section

This review process helps prevent misleading or inaccurate disclosures about a company's ESG credentials in the annual report

Activist Stewardship

Activist Stewardship Explained

Stewardship refers to the strategic practice by institutional investors to use their influence for maximising overall long-term value. This encompasses the enhancement of economic, social, and environmental assets that underpin client and beneficiary returns

Institutional Investors' Fiduciary Duty

Institutional investors, including hedge funds and pension funds, manage funds on behalf of others, adhering to a fiduciary duty to prioritise their beneficiaries' interests. With the rise of ESG concerns, integrating ESG factors into investment decisions has become a critical aspect of this duty. Effective stewardship, therefore, involves both addressing potential sustainability risks within investment portfolios and advocating for enhanced ESG policies and practices within investee companies. This could entail advocating for strategy shifts focusing more on ESG, implementing new ESG measurement and reporting metrics, and linking executive compensation to ESG performance

Stewardship Tools and Activities

Stewardship can be divided into two main categories: investee stewardship and broader stewardship, each with its own set of tools and activities

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Investee Stewardship Tools and Activities

- Engagement: Direct interaction with companies already within the investment portfolio or those under consideration for investment
- Voting: Participation in shareholder meetings to influence company direction
- Shareholder Resolutions: Proposing resolutions for votes at shareholder meetings
- Board Nominations: Suggesting candidates for company boards to ensure alignment with stewardship goals
- Board Roles and Committees: Utilising positions on boards or committees to oversee company practices and strategy
- Direct Oversight: Exercising direct oversight over portfolio companies to ensure alignment with long-term value creation strategies

Broader Stewardship Tools and Activities

- Policy Engagement: Involvement in policy discussions relevant to stewardship goals
- Standard Setter Engagement: Collaborating with organisations that set industry standards to promote sustainability
- Industry Group Engagement: Working with industry groups to advance collective action on ESG issues
- Stakeholder Engagement: Interacting with NGOs, workers, communities, and other stakeholders to support broader stewardship objectives
- Public Debate: Contributing to public discourse through media and other channels to advocate for stewardship principles

The Role of Lenders in Activist Stewardship

In addition to equity investments, companies often rely on debt capital. This capital comes with its own set of conditions or covenants set by lenders, which can include specific financial performance metrics. In the context of evolving green finance, lenders may impose conditions that link the provision of capital to sustainability performance or practices, such as the inclusion of ESG covenants or the appointment of non-executive directors with a focus on sustainability to the board. This approach not only ensures the financial health of the borrowing company but also aligns debt financing with broader sustainability goals

Sustainability and climate change

In 2023, the IFRS Sustainability Disclosure Standards were introduced, mandating the disclosure of sustainability and climate change-related risks and opportunities relevant to investors. These disclosures are integrated into the annual report alongside audited financial statements and other regulatory compliance information

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The IFRS Sustainability Disclosure Standards provide a methodology for presenting sustainability and climate change-related information, ensuring investors have access to comprehensive data on environmental risks and opportunities that could impact an organisation's financial performance and strategic direction

Despite the new standards focusing specifically on sustainability and climate risks, there's an acknowledged overlap with traditional risk disclosures, indicating the interconnected nature of financial and environmental risk factors

Nature of ESG risks

Environmental risks, especially climate and nature-related, dominate the long-term global risks landscape according to the Global Risks Perception Survey (GRPS)

"Failure to mitigate climate change" and "Failure of climate change adaptation" are identified as the top global risks, followed by "Natural disasters and extreme weather events" and "Biodiversity loss and ecosystem collapse."

2023 experienced diverse climate-induced weather events, from unusual snow in Los Angeles to devastating floods in Pakistan, Brazil, and Turkey

Consumer confidence in the global banking system has weakened due to failures of major banks like Silicon Valley Bank in the US and Credit Suisse in Switzerland, paralleling the 2008 financial crisis and contributing to social unrest

Corporate failures due to fraud or poor leadership, exemplified by the collapse of FTX in the US and Thames Water in the UK, highlight governance challenges

Current ESG reporting emphasises the reciprocal relationship between organisations and environmental, social, and governance issues, often framed in terms of impacts and dependencies

Impacts

- Organisations are required to assess how their operations and business decisions positively or negatively influence ESG issues. This involves understanding the direct and indirect effects of their actions on environmental sustainability, social welfare, and governance standards

Dependencies

- Conversely, organisations must also recognise how ESG factors influence their capacity to generate and sustain value. This means acknowledging how environmental conditions, social dynamics, and governance frameworks can impact an organisation's performance and risk profile

Interrelationship with ESG Issues

- To comprehensively evaluate risks and opportunities, an organisation needs to view itself within the broader ESG context, examining both how it depends on and impacts these issues. For instance:

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    - **Energy Companies**: Extracting fossil fuels implicates dependencies on natural resources and impacts through GHG emissions
    - **Drinks Companies**: Their production processes depend on water usage, impacting ecosystems through plastic pollution
    - **Fast Food Companies**: Depend on cattle for meat products, which contribute to GHG emissions, land use changes, and food resource allocations

This dual perspective on impacts and dependencies underscores the need for organisations to integrate ESG considerations into their strategic planning and risk management processes, aligning operational practices with broader environmental and social goals

A crucial aspect of the IFRS Sustainability Disclosure Standards involves organisations employing scenario analysis to gauge their resilience against sustainability and climate change-related risks

Scenario Analysis Defined

- Scenario analysis serves as a methodology for exploring and evaluating the potential outcomes of future events, particularly in situations marked by uncertainty. This process allows organisations to assess various future scenarios and understand the potential impacts on their operations, strategies, and risk management approaches related to sustainability and climate change challenges

Strategic and operational risks related to climate change

Within the framework of the IFRS Sustainability Disclosure Standards, understanding the specific lexicon related to climate risks is essential. These risks are categorised into climate-related physical risks and climate-related transition risks

Climate-related Physical Risks

- **Acute Physical Risks**: These arise from specific weather-related events like storms, floods, droughts, or heatwaves, noted for their increasing severity and frequency
- **Chronic Physical Risks**: Result from gradual changes in climate patterns, such as alterations in precipitation and temperature. This category encompasses long-term environmental shifts like sea-level rise, reduced water availability, biodiversity loss, and changes in soil productivity

Climate-related Transition Risks

- Encompass risks associated with the shift towards a lower-carbon economy. This category includes:
    - Policy and legal risks: New or changing regulations related to climate change that may affect operational costs or necessitate asset revaluations
    - Technological risks: Developments and deployment of new technology affecting current business models

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- Market and reputational risks: Changes in consumer demand and market dynamics due to climate consciousness, potentially impacting financial performance

Acute physical risks are often viewed as operational due to their immediate impact, whereas chronic physical and transition risks are considered more strategic, reflecting their longer-term implications and broader scale

ISSB Risk and Opportunities

The International Sustainability Standards Board (ISSB), established in 2022, has significantly evolved the ESG reporting and disclosure landscape. In 2023, the ISSB released two standards:

- IFRS S1: Covers General Requirements for Disclosure of Sustainability-related Financial Information, mandating entities disclose sustainability-related risks and opportunities relevant to financial report users

- IFRS S2: Focuses on Climate-related Disclosures, requiring entities to report on climate-related risks and opportunities pertinent to financial decision-making

These standards aim to inform investors and other financial report users about how sustainability and climate-related issues could affect an entity’s future prospects. They highlight the necessity for entities to integrate ESG risk and opportunity assessments into their broader risk management practices, ensuring that stakeholders have a clear understanding of the entity’s sustainability posture and climate-related resilience

Additional considerations

A well-crafted sustainability report is pivotal for understanding an organisation's commitment and progress towards environmental, social, and governance (ESG) objectives. Essential elements of a comprehensive sustainability report include:

- Overview of ESG Strategy: This section should articulate how the ESG strategy aligns with the organisation's overarching purpose and strategic goals, providing a clear link between sustainability initiatives and the broader business strategy

- Description of ESG Priorities, Goals, and Metrics: Detailed insights into the organisation's key ESG priorities, the objectives it aims to achieve, and the metrics used to measure progress are crucial. This component ensures transparency and allows stakeholders to gauge the seriousness and specificity of the organisation's sustainability efforts

- Evaluation of Progress: A critical assessment of how far the organisation has come in achieving its ESG goals, including both successes and areas requiring improvement, offers a transparent picture of sustainability performance

Such information can be presented in a dedicated sustainability report or integrated within the annual report and investor presentations, depending on the organisation's reporting approach

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Challenges associated with ESG information

Challenges associated with ESG information primarily stem from its comparative lack of robustness and standardisation relative to financial data. Despite advancements in reporting standards, such as those developed by the ISSB, including IFRS S1 and S2 for climate-related disclosures, ESG information still faces issues of measurement uncertainty and comparability. Key challenges include:

- Less Rigorous Reporting Processes: ESG data often does not undergo the same stringent reporting and verification processes as financial information, leading to concerns about its accuracy and reliability
- Measurement Uncertainty: There is a greater degree of uncertainty in ESG measurement processes compared to financial data, partly due to the evolving nature of ESG metrics and standards
- Data Collection Challenges: Accountants tasked with gathering ESG data may encounter difficulties in determining the appropriate internal sources for the required information, unlike more established financial data collection processes
- Lack of Standardisation: Although ISSB standards aim to improve consistency, ESG reporting still lacks the level of standardisation seen in financial reporting, complicating cross-organisation comparisons
- Recording and Continuity Issues: The processes for documenting ESG data sources and ensuring continuity of information year over year are often not as clearly defined as for financial data. This can pose challenges, especially if personnel changes occur

Addressing these challenges requires concerted efforts to enhance the rigour, transparency, and standardisation of ESG reporting processes, along with developing clear guidelines for data collection and documentation within organisations

Information on sustainability

Organisations are increasingly required to report on sustainability, underscored by ISSB's climate-related standards (IFRS S1 and IFRS S2)

Strategic level reporting is essential for boards to understand and communicate the organisation's sustainability performance to stakeholders

Tactical and operational levels focus on setting targets and measuring performance in areas such as GHG emissions, energy use, and diversity metrics

A major challenge in sustainability reporting is that many organisational information systems fail to capture relevant ESG data adequately

Tracking GHG emissions is complex, requiring data on direct emissions (Scope 1), indirect emissions (Scope 2), and supply chain emissions (Scope 3)

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Scope 3 emissions, related to the supply chain, are particularly challenging to track and validate due to reliance on data from third parties

HR and ESG

The significance of ESG considerations extends into human resource management, particularly focusing on the 'Social' aspect, which encompasses an organisation's impact on and relationship with its workforce. HR practices play a critical role in enhancing an organisation's ESG credentials through various areas:

Executive Remuneration

- Executive bonus schemes increasingly incorporate ESG criteria, linking leadership incentives directly to ESG performance outcomes

Fair and Living Wages

- Beyond executive pay, ensuring fair remuneration across the workforce addresses the social dimension of ESG. This includes commitments to paying employees not just the legal minimum wage but a living wage that covers everyday needs

Diversity and Inclusion

- Promoting a diverse and inclusive work environment is recognised as crucial for employee engagement and retention. Measuring and monitoring diversity metrics helps address inclusion and equity within the organisation, including efforts to eliminate pay disparities based on gender or race

Pay Ratio Disclosure

- The ratio of CEO pay to the median employee salary is increasingly scrutinised by investors and potential employees as an indicator of an organisation's equity and fairness in pay structures. This metric serves as a benchmark against industry standards and competitors, highlighting disparities in executive compensation versus overall workforce remuneration and the organisation's performance

Modern Slavery Prevention

- Vigilance against modern slavery and human trafficking is essential. Implementing strict measures to detect and rectify such issues, especially within complex supply chains, underscores a commitment to ethical labour practices

Health and Safety Standards

- Prioritising the physical and mental well-being of employees through comprehensive health and safety protocols not only safeguards staff but also mitigates financial and reputational risks associated with workplace accidents

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Employee Training and Development

- Investing in employee training signifies an organisation's dedication to enhancing skills and knowledge, fostering engagement, and bolstering loyalty. This commitment, often measured by training expenditure per employee, reflects the organisation's investment in its human capital, contributing positively to the 'social' element of ESG

The role of finance in achieving sustainability goals

The UK Companies Act mandates directors to consider their company's impact on the community and the environment, highlighting the importance of sustainability

The role of accountants in addressing sustainability is becoming increasingly crucial due to new regulations and stakeholder demands

Finance professionals are tasked with not only reporting on but also understanding and integrating the effects of environmental and social issues into financial management

ACA Professionals play a key role in integrating sustainability into strategic and operational decisions, encompassing risk management, compliance, and control systems design

They are also involved in measuring ESG-related liabilities, reporting, and advising on financial strategies influenced by environmental regulations

The preparation and issuance of ESG information have become a significant part of ACA Professionals' responsibilities

Their roles include identifying ESG risks and opportunities, advising on ESG impacts, and developing metrics and reporting methods

ACA Professionals also develop verification processes for ESG information and ensure compliance with ESG reporting requirements

They provide assurance over ESG disclosures and contribute valuable insights for strategic decision-making regarding sustainability

ACA Professionals influence decision-makers to enhance the organisation's ESG performance, demonstrating the critical link between finance and sustainability goals

Measuring ESG performance

Stakeholders demand that organisations monitor and report on ESG metrics, seeking companies that balance financial returns with sustainability and positive societal and environmental impacts

Post-COP 26, the focus on climate-related reporting has intensified, with major UK companies required to disclose climate-related financial information from April 2022

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ESG performance can be measured using various indicators, such as energy and water consumption, GHG emissions, waste generation, employee turnover, training hours, health and safety statistics, board diversity, and risk management policies

Challenges in ESG reporting include lack of comparability, difficulty in measuring non-financial data, insufficient assurance processes, and the risk of greenwashing

Despite challenges, progress is evident where data is robust, finance teams are engaged, and specific KPIs are set. ESG rating agencies play a crucial role in assessing a company's sustainability performance

The ESG ratings industry, though nascent, is growing rapidly, with ratings impacting companies' ability to secure finance and influence investment decisions. Agencies like MSCI grade companies on ESG performance, affecting their market reputation and financial conditions

Sustainability covers environmental, social, ethical factors, and governance

Accountants are not expected to be experts in sustainability upon qualification

The goal is to provide them with enough knowledge to apply professional scepticism

Accountants should be able to collaborate with experts on complex sustainability issues

Sustainability issues are categorised into Social, Environmental, and Economic (or Governance) types

This categorisation aligns with the United Nations Sustainable Development Goals

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Sustainability reporting standards

In June 2023, the ISSB published its first climate-related disclosure standards, IFRS S1 and IFRS S2, building on the TCFD framework

These standards mark a significant milestone in business reporting, aiming for uniform and reliable sustainability reporting across companies

They introduce a common framework for reporting the impact of climate-related risks and opportunities on company prospects, enhancing trust in sustainability disclosures for investment decisions

The necessity of these standards underscores the growing importance of sustainability in the business world, as recognised by leaders like the Chairman of the World Economic Forum

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IFRS S1 outlines general disclosure requirements for conveying sustainability-related risks and opportunities, covering governance, strategy, risk management processes, and performance against sustainability targets

IFRS S2 focuses on specific climate-related disclosures, complementing IFRS S1 by detailing the reporting on climate risks, opportunities, and related financial implications

Prescribed metrics in IFRS S2 include greenhouse gas emissions (Scopes 1, 2, and 3), climate-related transition and physical risks, opportunities, capital allocation towards climate initiatives, internal carbon pricing, and the integration of climate considerations into executive remuneration

Implementing sustainability policies in the SMEs

Environmental, social, and governance (ESG) considerations are becoming crucial for strategic decision-making in companies, moving beyond being optional to a core element of strategy

Customer interest in sustainability is growing, suggesting that SMEs adopting transparent and core environmental values can attract a larger customer base

Sustainability efforts can also enhance SMEs' attractiveness to investors by improving reputation, reducing risks, and potentially cutting costs through initiatives like energy efficiency and waste reduction

However, the transition to sustainable practices often involves upfront costs and investments that might yield longer-term savings, posing a challenge for SMEs with limited resources

Key challenges for SMEs in adopting sustainability policies include limited financial resources and a lack of knowledge and skills

SMEs often prioritise immediate financial and expansion needs over developing long-term ESG strategies due to their smaller size and resource constraints

This creates a dilemma where investing in sustainability could benefit SMEs in the long run, but immediate financial concerns limit their ability to undertake such investments

Externalities and social responsibilities

Investment appraisals should include the environmental and societal impacts of new ventures

Businesses should anticipate potential future costs related to their environmental impacts

Providing information on social impacts resulting from business activities is advised

Definitions:

- Environmental cost: Costs related to preventing or correcting environmental damage caused by a company’s activities
- Social cost: The total cost to society from a new venture or project

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- **Environmental management accounting:** Analysing financial and non-financial information to support internal environmental management

UNDSD's definition of environmental management accounting emphasises identifying, collecting, analysing, and using physical and monetary information for decision-making

When appraising investments, businesses must consider their projects' environmental and social impacts and dependencies

Financial implications can arise from environmental impacts (e.g. carbon taxes) and dependencies (e.g. energy consumption)

Businesses face challenges in defining, identifying, and managing environmental and social costs not easily tracked by cost management systems

Environmental costs can include:

- Consumables and raw materials
- Transport and travel
- Waste and effluent disposal
- Water consumption
- Energy usage
- Environmental taxes
- Compliance costs

Environmental cost classification:

- **Conventional costs:** Raw materials, utilities, capital goods, and supplies
- **Potentially hidden costs:** Costs lost in 'general overheads,' like regulatory compliance
- **Contingent costs:** Future costs, such as environmental damage remediation
- **Image and relationship costs:** Intangible costs related to environmental reporting and corporate image

Social costing involves considering the impacts of an organisation on social issues and how these dependencies affect value creation

Social cost-benefit analysis evaluates projects' social value and cost, crucial for public projects with significant social implications

Measuring environmental and social costs is essential for compliance, correct pricing, avoiding fines, regulatory compliance, and achieving cost savings

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Greenwashing

Firms must genuinely adhere to ethical principles, especially regarding their environmental claims, to avoid greenwashing accusations

Greenwashing involves companies making false or misleading claims about their environmental efforts to appeal to eco-conscious consumers

Not all greenwashing is intentional; companies may unknowingly make unverifiable statements due to incomplete data, such as CO2 emissions

The risk of greenwashing highlights the necessity for stricter scrutiny and transparency in companies’ ESG (environmental, social, and governance) practices

Trade-offs between ethics and sustainability

Transitioning to sustainable business models often involves ethical dilemmas and compromises, as sustainability efforts can sometimes result in unintended negative impacts

Mining for rare earth metals, essential for clean technology, and cobalt, used in electric vehicle batteries, exemplifies the ethical trade-offs due to the environmental damage and labour rights concerns in sourcing regions

Such sustainability-related challenges highlight the need for accountants to navigate complex ethical decisions, balancing the environmental impacts of business activities with stakeholder demands

Acknowledging these trade-offs is crucial to avoid greenwashing while striving to reconcile shareholder interests with sustainability goals, understanding that there may not always be a clear 'right' approach that satisfies all parties

Tangible assets

Asset carrying amounts may be overstated if climate-related matters are not considered in impairment calculations

Climate-related risks can indicate potential asset impairment and affect future cash flow estimates for recoverable amount calculations

Such risks may also shorten asset useful lives due to government regulations or shifts in consumer preferences, impacting residual values and recognised depreciation or amortisation

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New content on sustainability from 2025 edition of SBM Workbook

Net-Zero Transition Strategies

The movement towards sustainability has led many organisations to adopt net-zero transition strategies to reduce their environmental footprint. One such initiative in the UK is the Transition Plan Taskforce (TPT)

The TPT, established in April 2022, aims to support organisations in creating credible transition strategies to secure financing for net-zero goals. In November 2022, the TPT released its draft Implementation Guidance, structured into three main chapters:

1. Preparing a Credible Transition Plan
    - Establishing a baseline by assessing current climate risks and opportunities based on the Taskforce on Climate-related Financial Disclosures (TCFD) framework
    - Identifying decarbonisation levers, such as energy-efficient infrastructure or renewable energy adoption
    - Considering interdependencies between resources, supply chains, and natural ecosystems
    - Conducting emissions footprinting, particularly adhering to guidelines under the UK's Streamlined Energy and Carbon Reporting (SECR) framework
2. Disclosing Transition Plans Transition plans should address three key principles:
    - Ambition: Objectives aligned with net-zero strategies, embedded into the entity's business model
    - Action: Operational roadmaps and strategies showcasing short-, medium-, and long-term objectives, supported by sensitivity analyses
    - Accountability: Governance oversight, progress metrics, and reporting mechanisms to ensure consistent monitoring
3. External Use of Transition Plans Stakeholders, including investors, regulators, and governments, utilise transition plans to understand an organisation's net-zero progress. These disclosures also provide benchmarks for industry alignment, impact assessments, and audit assurance

Examples include ITV's comprehensive Climate Transition Plan, which aligns with TPT methodologies, and includes detailed metrics for greenhouse gas (GHG) emissions, renewable energy targets, and employee training programmes. Similarly, Decathlon has created an Organisation Environmental Footprint (OEF)-focused plan, concentrating on sustainability across various operational dimensions

Both companies incorporate Science-Based Targets initiatives (SBTi) for validated emissions reduction. Through robust strategies, organisations can ensure they meet global climate commitments while fostering competitiveness and stakeholder trust

Sustainability Metrics

Environmental – Taking Actions to Protect the Environment

Organisations must monitor and report on their environmental impact to promote sustainability. Key areas to focus on include:

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- Greenhouse Gas Emissions (Scopes 1, 2, and 3): Measured in metric tonnes of CO_2 equivalent, these emissions indicate the organisation's contribution to climate change
- Land Use and Ecological Sensitivity: This metric tracks the number and area (in hectares) of company sites located in or near protected or key biodiversity areas
- Water Consumption and Withdrawal in Water-Stressed Areas: Quantified in megalitres of water withdrawn and consumed, this highlights the organisation's impact on water resources in areas facing scarcity
- Single-Use Plastic: Measured in metric tonnes, this metric assesses the organisation's consumption of single-use plastics across the full value chain

Social – Building and Maintaining Relationships with Stakeholders

Social metrics focus on an organisation's impact on people and communities, emphasising inclusivity, safety, and well-being. Key indicators include:

- Employment Rates: The absolute number and rate of employment, including total new hires and employee turnover rates
- Innovation in Better Products and Services: The percentage of revenue generated from products and services that deliver social or sustainability benefits
- Diversity and Inclusion: The percentage of employees categorised by age group, gender, ethnicity, and other diversity indicators
- Freedom of Association and Collective Bargaining: The percentage of the active workforce covered under collective bargaining agreements
- Pay Equality: The ratio of remuneration between women and men, minority and majority ethnic groups, and other relevant demographic categories
- Health and Safety: The number and rate of workplace fatalities and injuries

Governance – Ensuring Transparent and Accountable Leadership

Governance metrics ensure that the organisation's leadership adheres to principles of transparency and accountability. Essential metrics include:

- Governing Body Composition: The percentage of individuals on the board of directors broken down by gender, age group, and minority status
- Board Expertise: The number of different disciplines (e.g., finance, engineering) represented on the board of directors
- Anti-Corruption Initiatives: The number of reported incidents involving corruption within the organisation
- Directors' Remuneration: Policies and performance criteria related to the compensation of board members

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By monitoring and reporting on these sustainability metrics, organisations can ensure alignment with environmental, social, and governance (ESG) principles. This creates value for stakeholders and reinforces ethical business practices

Accountants and Sustainability

The International Federation of Accountants (IFAC) emphasises the vital role professional accountants play in delivering high-quality sustainability-related reporting and assurance services. A 2024 report by IFAC, entitled Equipping Professional Accountants for Sustainability, highlights several key points:

- Professional accountants must adopt a systems-thinking approach, recognising the connectivity between finance and sustainability
- Sustainability should never be viewed in isolation; it is a fundamental component of business models, value chains, and strategies
- Developing an understanding of sustainability impacts is crucial for governance, identifying risks and opportunities, and providing strategic insights
- At all stages of their career development, professional accountants should maintain a focus on sustainability and actively incorporate it into their professional practices

By integrating sustainability into their work, accountants can help organisations adapt to evolving environmental, economic, and social challenges, ensuring long-term resilience and success

Corporate Sustainability Reporting Directive (CSRD) and European Sustainability Reporting Standards (ESRS)

The European Union (EU) has introduced a structured framework for organisations to disclose sustainability and climate-related information through the Corporate Sustainability Reporting Directive (CSRD). This directive became effective in December 2023 and mandates the use of the European Sustainability Reporting Standards (ESRS) for reporting. Key aspects of this framework are:

- Implementation and Timeline:
    - The largest EU companies are required to report under the CSRD framework starting in 2025
    - The rollout for smaller entities begins from 2026 onwards
    - Non-EU organisations engaging in significant trade within the EU will likely also be required to comply
- Assurance Requirements for CSRD Disclosures:
    - External assurance will become mandatory for these disclosures. Limited assurance, which involves verifying that “nothing has come to our attention,” will be required from October 2025
    - Reasonable assurance, offering a more definitive statement such as “in our opinion,” will be required from October 2028
    - Assurance providers must adhere to international standards, including the IAASB’s International Standard on Sustainability Assurance (ISSA) 5000. It is anticipated that

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assurance providers will need to possess the necessary expertise to execute this work effectively

- Key Features of the ESRS:
    - The ESRS framework is organised into four categories:
        - Cross-cutting General Disclosure Standards (ESRS 1 and ESRS 2): These address general requirements and disclosures
        - Environmental Standards (ESRS E1–E5): These cover specific topics such as climate, pollution, water and marine resources, biodiversity and ecosystems, and resource use and circular economy
        - Social Standards (ESRS S1–S4): These include the workforce, workers in the value chain, affected communities, and consumers and end-users
        - Governance Standard (ESRS G1): This focuses on business conduct
- Double Materiality:
    - A key difference between the CSRD and the IFRS Sustainability Disclosure Standards (IFRS S1 and S2) is the use of the double materiality concept under the CSRD
    - This concept requires organisations to assess both the impacts they have on people and the environment as well as the dependencies they have on those factors
    - The use of the ESRS involves evaluating material sustainability issues relevant to the organisation and reporting only on those surpassing a materiality threshold
- Intended Audience:
    - The CSRD is aimed at a broader audience, extending beyond users of financial statements, such as stakeholders interested in the organisation's sustainability efforts
- Alignment with International Standards:
    - Although there are differences in approach, the ESRS and IFRS Standards strive for complementarity to reduce administrative burdens on entities. Both methodologies place an emphasis on governance, strategy, impact/risk/opportunity management, and metrics and targets

Organisations are advised to remain observant as this reporting framework continues to evolve, particularly given the limited real-world application of the CSRD and ESRS so far

International Standard on Sustainability Assurance (ISSA) 5000

The IAASB introduced the International Standard on Sustainability Assurance (ISSA) 5000 in August 2023 to address the growing demand for a dedicated standard for sustainability disclosures. This new standard is pivotal in providing guidance for assurance engagements related to sustainability

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- Need for ISSA 5000:
  - Prior to ISSA 5000, there was no specific standard for providing assurance on sustainability-related disclosures. Instead, other frameworks, such as the FRC's ISAE (UK) 3000 for non-financial engagements or ISAE 3410 for greenhouse gas statements, were used
  - With the advent of major disclosure frameworks like the Taskforce on Climate-related Financial Disclosures (TCFD), the ISSB Sustainability Disclosure Standards, and the EU's CSRD, the need for a flexible and comprehensive framework for sustainability assurance became clear
- Scope of ISSA 5000:
  - The standard is intended for assurance engagements involving both qualitative and quantitative sustainability disclosures, whether voluntary or mandatory
  - It is designed to accommodate different reporters, practitioners, and stakeholders, making it applicable beyond purely financial considerations related to sustainability
  - ISSA 5000 incorporates the concept of double materiality, requiring assessment of both a company's impacts on sustainability factors and its dependencies
- Assurance Practitioners:
  - ISSA 5000 extends beyond accountants and allows various professionals to conduct assurance work. It provides a framework for delivering both limited and reasonable assurance on sustainability information
- Key Features of ISSA 5000:
  - The standard will cover essential elements of assurance engagements, such as quality management, ethical considerations, evidence collection, use of experts, and detailed reporting practices
  - These provisions are tailored specifically to sustainability engagements to enhance the credibility of disclosures made by organisations
- Alignment with Established Practices:
  - ISSA 5000 will build on the traditional stages of environmental audits, which involve setting metrics, measuring actual versus planned performance, and reporting the results

The adoption of ISSA 5000 is expected to provide a robust framework for ensuring the reliability and credibility of sustainability information, offering significant support to organisations navigating the growing expectations for transparency in this area

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