paradigm shift.

Strategic Business Management Exam Room Notes 2025

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Contents

Agile Organisations

An agile organisation is one that responds quickly to changes in the marketplace and trends in the workplace – agile organisations react swiftly to competitor actions. They also review processes and working practices to encourage high levels of employee engagement and morale

In traditional organisations, hierarchical, functional teams carry out tasks as instructed by managers, whose role is to identify what needs to be done

In an agile organisation, this hierarchy of control is replaced with flexible, autonomous and cross-functional teams that focus on developing solutions to meet customer needs

Managers communicate the shared goals of the team and encourage team members to make their own decisions about what needs to be done and how

Agile organisations are often characterised by the following:

shared purpose and vision – teams are encouraged to seize opportunities that fulfil this purpose and vision – allocation of resources is flexible in order to support achievement of the vision

flat company structure – employees are empowered to fulfil their role and managers are hands-on

role mobility and entrepreneurial drive – agile businesses encourage employees to move roles to develop their cross-functional skills and knowledge – employees are encouraged to pursue opportunities to develop new initiatives and to innovate

effective, user-friendly technology – this facilitates communication, decision-making and feedback across teams

Artificial Intelligence and ABCD+ Technologies

Organisations today must adapt to a rapidly evolving technological landscape to meet customer demands and maintain competitiveness

A set of emerging technologies, referred to as ABCD+ technologies, is transforming industries and reshaping organisational strategies

These technologies encompass Artificial Intelligence, Blockchain, Cloud Computing, Cybersecurity, Data and Digital Transformation

Additionally, technology is fuelling the expansion of the platform economy

Artificial Intelligence and Automation (A)

Artificial Intelligence (AI) focuses on the development of advanced computer systems capable of performing tasks traditionally requiring human intelligence. These tasks include learning from data, reasoning, problem-solving, sensory interpretation, language processing, and pattern recognition. AI systems exhibit adaptability, autonomy in decision-making, and responsiveness to new information or changing environments

Machine Learning, a subset of AI, plays a significant role by enabling systems to learn and evolve from data without explicit programming

Automation, closely linked with AI, enhances efficiency by automating repetitive or manual processes, reducing error rates, and driving cost-saving measures. Through AI and automation, organisations can optimise their operations, improve customer experience, and support decision-making with data-driven insights

Blockchain (B)

Blockchain is a form of distributed ledger technology that records data securely and immutably across decentralised nodes. This structure eliminates single points of failure, enhances security, and ensures tamper-proof transactions. Public blockchains, accessible to anyone, enable transparency and decentralisation, prominently supporting applications such as cryptocurrencies. Private blockchains, available only to authorised users, offer bespoke solutions tailored to organisational needs

The potential applications of blockchain extend beyond cryptocurrencies. It facilitates supply chain transparency by tracking goods, ensures secure digital identity management, and enables reliable e-voting systems by preventing fraud. Blockchain will be explained in greater depth in subsequent discussions

Cloud Computing and Cybersecurity (C)

Cloud computing refers to the on-demand availability of computing resources—servers, storage, development tools, applications—hosted and managed by remote cloud service providers (CSPs). This technology enables organisations to scale their operations, reduce IT infrastructure costs, and increase operational efficiency. Hosted services are accessed via the internet, offering flexibility in managing workloads

Cybersecurity complements cloud computing by protecting assets against cyber threats. It encompasses a variety of tools, policies, practices, and technologies to safeguard organisational systems, networks, and data. In an increasingly digital environment, cybersecurity is critical to mitigating risks, ensuring compliance, and protecting sensitive data

Data and Digital Transformation (D)

Data technologies focus on the use of advanced software and machine learning algorithms to analyse large datasets and derive actionable insights. Through digital transformation, businesses leverage data to enhance strategic decision-making, optimise performance, and discover new market opportunities

Digital transformation involves integrating digital technology across all facets of an organisation, leading to fundamental changes in how businesses operate and deliver value. By utilising data and technology, organisations can automate processes, gauge customer needs more effectively, and pivot strategies in real-time

Platform Economy

Technological advancements have given rise to the platform economy, characterised by digital platforms that enable interactions between users and service providers. Examples include e-commerce platforms, ride-hailing apps, and financial technology (FinTech) hubs. This model leverages the scalability of technology, creating new opportunities for businesses to innovate and expand their reach. The platform economy has disrupted traditional industries, enabling faster and more cost-effective delivery of services, while embedding technology at the centre of business processes

In conclusion, the ABCD+ technologies represent a convergence of digitisation, innovative tools, and modern strategy in the business landscape. Effective integration and adoption of advances in Artificial Intelligence, Blockchain, Cloud Computing, Cybersecurity, and Data Transformation will be essential for organisations to navigate the challenges of the technological revolution and remain relevant in rapidly changing markets

Artificial Intelligence, Robotic Process Automation, and Transition Strategies

The integration of advanced technologies into business operations has become essential to maintain efficiency and competitiveness

Robotic Process Automation (RPA)

Robotic Process Automation refers to the use of software to replicate manual business processes, following specific "if this, then that" programming instructions. It does not replace existing applications but works alongside them to enhance efficiency in repetitive tasks. However, not all processes are suitable for automation, especially infrequent or non-repetitive tasks, which are often more effectively handled by people

Implementing RPA projects can involve significant costs, and organisations must carefully evaluate the benefit-to-cost ratio for each process to justify automation. While it initially required expensive software and lengthy implementation periods, modern RPA tools like Microsoft Power Automate enable finance staff to automate processes independently, with minimal IT support and no programming skills required. This has contributed to improving productivity and efficiency in organisations

The role of automation in finance has become increasingly prominent, as businesses demand greater operational efficiency while minimising non-value-adding activities. By automating routine tasks, finance professionals can focus on strategic, high-value contributions

Artificial Intelligence (AI)

Artificial Intelligence is the development and use of advanced computer systems capable of tasks traditionally performed by humans, such as data processing, reasoning, decision-making, language understanding, and sensory interpretation. AI systems are characterised by autonomy and adaptability,

leveraging new information to optimise performance. Machine learning, a subset of AI, focuses on enabling systems to learn from data and improve through experience while reducing the need for human intervention

Organisations that fail to integrate an AI strategy risk being outperformed by competitors who maximise AI's potential. Strategic deployment of AI enables rapid decision-making, personalised customer experiences, improved operational efficiency, and innovative problem-solving

Machine Learning

Machine learning allows computer systems to analyse large datasets and make predictions or decisions without explicit programming. It employs two primary methods:

- Supervised Learning: The model is trained using labelled data, where input data is paired with correct outcomes, enabling the system to make future predictions with accuracy
- Unsupervised Learning: The model processes unlabelled data and identifies patterns, correlations, or structures without predefined outcomes, supporting exploratory analysis and pattern detection

Machine learning improves capabilities across industries, including customer personalisation, fraud detection, forecasting, and operational optimisation

Generative AI

Generative AI involves creating entirely new content, such as text, images, audio, or video, based on patterns identified in training data. Unlike predictive AI, which focuses on making decisions, generative AI synthesises novel outputs that mimic characteristics of the input data. For example, generative AI can assist accountants by drafting reports, creating software code, or conducting research, enabling professionals to dedicate more time to value-adding activities such as strategy development and business advisory

While generative AI offers numerous benefits, it also presents certain risks:

- Bias: Outputs reflect biases inherent in the training data, potentially leading to discriminatory or skewed results
- Inconsistency: Responses may vary even when the same input is provided, creating reliability issues
- Inaccuracy: AI models may "hallucinate," generating false or misleading information to answer user queries
- Outdated Information: Outputs are limited to the scope and timeframe of the training data, potentially omitting the most up-to-date knowledge
- Fraud and Deepfakes: Cybercriminals can misuse generative AI to create deceptive phishing emails, videos, or online personas
- Data Privacy: Information input into public AI models, such as ChatGPT, may be shared or used for further training, raising concerns about confidentiality
- Intellectual Property Breaches: AI may inadvertently use copyrighted material to generate new content, posing legal challenges

Despite these risks, generative AI continues to grow rapidly, offering transformative support in knowledge work for professionals across industries

Chatbots

Chatbots are software applications designed to simulate human conversations using natural language processing. These tools can streamline customer interactions, reduce manual workloads, and improve user engagement through responsive, automated systems

Artificial Intelligence and Its Role in Marketing

Overview of AI in Marketing

Artificial Intelligence (AI) has become an essential tool in modern marketing, leveraging advanced algorithms to process and analyse large datasets. AI technology identifies patterns, predicts consumer behaviours, and personalises content, thereby transforming marketing strategies and campaigns. These capabilities not only enhance customer engagement but also increase the effectiveness of marketing efforts

Machine Learning and Customer Data Analysis

AI, particularly through machine learning algorithms, allows businesses to gain deep insights into customer behaviour. By examining vast quantities of customer data, AI can:

- Identify patterns that illuminate consumer preferences and trends
- Make accurate predictions about future customer actions

This data can be used by organisations to personalise their interactions with customers. Effective use of AI-enabled personalisation includes:

- Targeted Advertisements: Delivering ads that are specifically tailored to individual consumer interests and behaviours
- Product Recommendations: Suggesting products to customers based on their purchase history, browsing patterns, and preferences
- Personalised Messaging: Communicating with customers through messages that resonate with their unique preferences and interests

These strategies contribute to strengthening customer relationships, increasing customer loyalty, and helping organisations gain a competitive advantage in terms of market share

Generative AI Adoption in Marketing

Generative AI has seen exponential growth in adoption across different business functions. A 2024 report from McKinsey highlights that:

- Sixty-five per cent of surveyed organisations are regularly using generative AI in at least one business function, a significant increase from one-third in 2023
- The highest growth in adoption is observed in marketing and sales, where the usage rate has more than doubled since 2023

This growth demonstrates the increasing reliance on AI to create value through improved marketing strategies. Generative AI supports tasks such as developing creative content, automating customer communication, and refining campaign designs, which drive improved outcomes in marketing operations

Generative AI

Generative AI extends the capabilities of artificial intelligence by combining data from the internet with advanced machine learning techniques, such as deep learning, to produce content previously only possible for humans to create

This includes text, audio, video, and other forms of media. Tools like ChatGPT, Copilot, and Bard are examples of Generative AI already being widely used across industries

However, these tools often operate without understanding the ethical implications of how their outputs are used. For instance, deepfake technologies can manipulate video and audio to falsely attribute words or actions to individuals, often for political or malicious purposes

In light of these challenges, the rise of Generative AI has prompted the development of ethical guidelines to ensure responsible usage. Organisations like the ICAEW and UNESCO have provided frameworks to address ethical concerns and advise on best practices for AI implementation

ICAEW Guidance on Generative AI

In 2023, the ICAEW issued guidance for applying the five fundamental ethical principles to Generative AI use

- Integrity:

  Users must be transparent about employing Generative AI to create content for clients. It is also vital to scrutinise the sources of data used by Generative AI to ensure factual accuracy, avoiding the dissemination of incorrect or misleading information

- Objectivity

  Generative AI may source data from the internet that is biased or incomplete. It is important to avoid automation bias—the misplaced trust in machine-generated output—and critically assess the content produced

- Professional Competence and Due Care

  Content created by Generative AI may lack up-to-date technical knowledge and the creative insight of human problem-solving. Users need to apply professional scepticism to verify that the content meets appropriate standards and is fit for purpose

- Confidentiality

  Generative AI relies on extensive data, raising concerns about the handling of sensitive or personal information. Care must be taken to avoid breaching confidentiality restrictions, especially where protected or sensitive data is involved

- Professional Behaviour

  Users should avoid over-reliance on Generative AI, acknowledging that it remains an evolving technology with limitations—such as "hallucinations," where outputs are based on inaccurate assumptions or biased datasets. Compliance with legislation concerning intellectual property and data protection is also essential

The ICAEW advises vigilance when recommending Generative AI for non-audit client work, warning against the risk of assuming management responsibilities or placing undue trust in AI-generated outputs

Hallucination

In the context of AI, hallucination refers to the generation of incorrect or misleading content due to inaccurate knowledge, faulty assumptions, or biased data

UNESCO Recommendations on Ethical AI

UNESCO, the United Nations Educational, Scientific and Cultural Organisation, promotes a global ethical framework for AI underlined by governance principles referred to as "ethical guardrails."

In 2021, UNESCO's recommendations on the ethics of AI were adopted by all 193 UN member states, with a focus on ensuring that human rights and dignity remain central to AI implementation

- Core Values:

  The recommendations are anchored in four fundamental values:

  - Human rights and human dignity
  - Living in peaceful, just, and interconnected societies
  - Promoting diversity and inclusiveness
  - Ensuring environmental and ecosystem flourishing

- Core Principles:

  To address the ethical implications of AI use, UNESCO has outlined ten guiding principles:

  - Proportionality and do no harm: AI should only fulfil necessary roles and avoid extending beyond what is required
  - Safety and security: Risks and vulnerabilities linked to AI systems must be mitigated
  - Privacy and data protection: Robust frameworks are essential to safeguard individuals' data rights
  - Multi-stakeholder governance: Collaboration across diverse populations and countries is needed to avoid breaching international laws or compromising sovereignty
  - Responsibility and accountability: AI must be governed by structured accountability to prevent harm to people or the environment
  - Transparency and explainability: The operations and decisions of AI systems should be understandable while balancing security, privacy, and safety concerns
  - Human oversight: Humans should retain control and responsibility for AI systems
  - Sustainability: AI's influence on sustainability goals should be thoroughly assessed
  - Awareness and literacy: Public education and engagement are necessary to develop understanding and trust in AI

    - Fairness and non-discrimination: AI systems should benefit society equitably, avoiding bias and prejudice

- Addressing Challenges:

  UNESCO has identified the rapid pace of AI development as a challenge to ethical adoption, recommending the formulation of policies to ensure responsible usage. It advises governments and stakeholders to determine their readiness to adopt the framework and evaluate the ethical impacts of AI implementations

Ethical Dilemmas in AI Applications

UNESCO provides examples highlighting the ethical complexities associated with AI use, showcasing how well-intentioned applications can lead to unforeseen consequences:

- Gender Bias in AI: AI algorithms can perpetuate historical biases present in datasets, such as only generating male candidates for roles where no female representatives exist (e.g., US president). Ethical frameworks must tackle these biases by using diverse and representative data sources
- AI in Judicial Systems: While AI could assist judges by processing complex legal texts objectively, risks include biased outcomes and reduced transparency, as AI systems may rely on opaque algorithms
- AI-Created Art: AI systems have produced original works of art based on analysis of historical styles (e.g., AI creating a new "Rembrandt"). This raises questions about authorship and intellectual property rights, threatening traditional human creativity
- Autonomous Vehicles: AI-powered vehicles introduce moral dilemmas, such as how to prioritise lives during unavoidable accidents. The ethical programming of such systems remains highly contentious

Conclusion

Generative AI is a revolutionary and rapidly growing technology with far-reaching implications. While it brings valuable opportunities across industries, ethical challenges must remain at the forefront of its adoption

By applying and evolving frameworks from organisations like the ICAEW and UNESCO, stakeholders can ensure AI's development aligns with principles of fairness, inclusivity, and accountability

As AI continues to evolve, these frameworks will guide society in addressing emerging ethical dilemmas and safeguarding the humane use of AI technology

Artificial Intelligence and Workforce Adaptation

Impact of Technological Advancements on Employment

The rapid pace of technological development poses significant challenges for the global workforce, particularly as automation and Artificial Intelligence (AI) continue to advance

A 2019 forecast from the Organisation for Economic Co-operation and Development (OECD) projected that within 20 years:

- automation technologies could eliminate 14% of jobs worldwide
- a further 32% of jobs could undergo significant transformation

These estimates have gained further urgency with the rise of generative AI, which has accelerated job displacement

Tasks once handled by humans, particularly in knowledge-based roles such as research, coding, and writing, are increasingly being automated by AI systems that perform these functions with greater efficiency

This technological disruption highlights a critical challenge for businesses and governments alike: ensuring that millions of workers who lose their jobs to automation are adequately supported through upskilling or retraining programmes

The Importance of Workforce Upskilling

To address the impact of job displacement caused by automation and AI, organisations must prioritise upskilling and reskilling their workforce

Employees must be equipped with new skills that align with the demands of the evolving technological landscape. Key considerations for organisations include:

- Learning and Development Opportunities: Providing training and education programmes aimed at equipping employees with skills relevant to emerging roles and industries
- Goal-oriented Upskilling: Ensuring that the skills employees acquire are matched to specific job opportunities within the organisation or the wider job market. Upskilling should not be arbitrary but instead focused on preparing employees for future roles that require new competencies
- Redeployment Support: Facilitating the transition of employees into suitable positions where their newly acquired skills can be applied effectively. This may involve internal transfers or external career support

The Rise of Generative AI and Knowledge-based Roles

Knowledge-based work is particularly at risk of disruption due to generative AI. Tasks that require human skills, such as writing, research, and coding, are now being performed by AI systems with increasing sophistication

The implications for organisations are significant, as these roles, once considered safe from automation, are now subject to rapid change

Businesses must therefore adopt a proactive approach to reskilling their workforce in these areas to remain competitive and to ensure employees can adapt to changing job requirements

Supporting Employees Through Transition

The impact of automation on employment is not just a technological issue but also a human one

Organisations must take responsibility for supporting their workforce through this era of change. Offering structured programmes, fostering a culture of lifelong learning, and ensuring that employees are equipped to thrive in new roles are essential steps in navigating the challenges posed by rapid technological advancement

Failure to address these issues adequately risks long-term damage to employee morale, organisational performance, and economic stability. By investing in reskilling efforts, organisations can foster a workforce that is resilient, adaptable, and prepared to embrace the opportunities created by technological progress

Compilation Engagements

Involves the collection, classification, and compilation of financial information using accounting expertise, as per ISRS 4410. Outputs can include historical, pro forma, and prospective financial information, such as budgets and forecasts

Agreement on Engagement Terms

- Intended use and distribution of the financial information and any restrictions
- Identification of the applicable financial reporting framework
- Objective and scope of the engagement
- Practitioner's responsibilities, including adherence to ethical requirements
- Management's responsibilities for the accuracy and completeness of information
- Expected form and content of the practitioner’s report

Understanding the Entity

The practitioner aims to understand the entity's business, operations, accounting system, records, and the financial reporting framework. The work's nature varies with the engagement type

Incomplete or Unsatisfactory Information

If management provides incomplete or unsatisfactory information, the practitioner must notify management and request additional or corrected information. Withdrawal from the engagement is necessary if management fails to provide required information or refuses to make suggested amendments

Management's Acknowledgement

Management or those charged with governance must acknowledge their responsibility for the information's final form

Practitioner’s Report Elements

- Statement of information usage provided by management
- Description of management or governance responsibilities
- Identification of the applicable financial reporting framework
- Identification of the financial information and titles of each element
- Description of the practitioner’s compilation responsibilities
- Overview of what a compilation engagement entails
- Clarification that the engagement is not an assurance engagement, negating the need to verify information accuracy or completeness

- Disclaimer of any audit opinion or review conclusion on the financial information's compliance with the reporting framework
- Explanatory paragraph on the financial information's purpose, highlighting any limitations if a special purpose framework is used

Suspected Non-compliance with Laws and Regulations

Under ISRS 4410, the practitioner should consult internally, seek legal advice, and engage with regulators or professional bodies to navigate the implications of various actions

Enterprise Risk Management (ERM) and the COSO Framework

ERM can be defined as:

"The culture, capabilities, and practices that organisations integrate with strategy-setting and apply when they carry out that strategy, with the purpose of managing risk in creating, preserving and realising value" (COSO (2017))

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) is one of the global leaders in developing guidance on risk management and internal controls, designed to improve organisational performance and governance

In 2017, COSO published a revised guidance document *Enterprise Risk Management – Integrating with Strategy and Performance* which provides greater insight into the links between strategy, risk and performance

In particular, the revised guidance highlights the need for organisations to consider risk in the strategy setting process, as well as considering the ways risks could affect an organisation's ability to deliver a strategy successfully

Traditionally, organisations have viewed ERM as a way of identifying, assessing and managing risks and threats to their existing strategies – this approach focuses primarily on managing downside risk

However, COSO highlights that ERM potentially has greater value to organisations through the way it can enhance strategy selection

ERM can play a very important role in helping organisations deliver value to their stakeholders by ensuring that management evaluates alternative strategies properly before choosing a particular option

COSO's ERM Framework

The COSO ERM framework is a set of 20 principles which represent the things an organisation should do as part of its ERM practices – these principles are organised into 5 groups ("components"):

- Governance and culture
- Strategy and objective setting
- Performance
- Review and revision
- Information, communication and reporting

Governance and culture

Governance and culture together form the basis of all the other components of ERM

Governance sets the organisation's tone, including reinforcing the importance of ERM and establishing oversight responsibility for it

Culture encompasses an organisation's ethical values and desired behaviours as well as an organisation's understanding of risk – an organisation's culture is typically reflected in its decision-making

1	Exercises Board risk oversight – the Board of directors provides oversight of the strategy – for example, reviewing management's proposed strategies and risk appetite to ensure that they align with the organisation's mission and core values
2	Establishes operating structures – the organisation establishes appropriate operating structures in the pursuit of its strategy and business objectives
3	Defines desired culture – the organisation defines the desired behaviours that characterise its desired culture
4	Demonstrates commitment to core values – where the organisation demonstrates a commitment to its core values then this will generally pervade throughout all decision-making, improving ethical values and risk management
5	Attracts, develops and retains capable individuals – the organisation is committed to building human capital, in alignment with its strategy and business objectives

Strategy and objective setting

ERM is integrated into an organisation's strategic plans through the process of setting its strategy and business objectives

By gaining an understanding of business context, an organisation can gain insight into internal and external factors such as strengths, weaknesses, opportunities and threats, together with their impact on risk

An organisation sets its risk appetite in conjunction with setting its strategy – business objectives allow strategy to be put into practice, and to shape the organisation's day-to-day operations and priorities

6	Analyses business context – the organisation considers the potential effects of the internal and external environment on its risk profile
7	Defines risk appetite – the organisation defines risk appetite in the context of creating, preserving and realising value
8	Evaluates alternative strategies – the organisation evaluates alternative strategies and their potential impact on its risk profile – the suitability of potential strategies could be influenced by the organisation's risk appetite
9	Formulates business objectives – the organisation considers risk while establishing the business objectives, at various levels, that align and support strategy

Performance

An organisation needs to identify and assess the risks that may affect its ability to achieve its strategy and business objectives – risks should be prioritised according to their severity and considering the organisation's risk appetite

The organisation then needs to select appropriate risk responses

In this way, the organisation develops a portfolio view of the amount of risk it has assumed in the pursuit of its strategy and business objectives – the results of this process are reported to key risk stakeholders

10	Identifies risk – the organisation identifies risk that affects the performance of strategy and business objectives

11	Assesses severity of risk – an assessment of the severity of each risk will help define a suitable response to each risk
12	Prioritises risks – the organisation prioritises risks as a basis for selecting responses to risks
13	Implements risk responses – the organisation identifies and selects appropriate risk responses
14	Develops portfolio view – the organisation develops and maintains a comprehensive view of all risks and how they could collectively impact across the business

Review and revision

An organisation needs to review its performance in order to consider how well its ERM components are functioning over time and in the light of substantial changes – for example, changes in the business environment

The organisation also needs to consider what revisions may be needed to its strategy and business objectives as a result of the changes – for example, investing in new business areas or scaling back its operations in other areas

15	Assesses substantial change – the organisation identifies and assesses changes that may substantially affect its strategy and business objectives
16	Reviews risk and performance – the organisation understands the relationship between risk and future performance so it can take preventative steps to avoid specific scenarios
17	Pursues improvement in Enterprise Risk Management – an objective of continuous improvement to ERM improves the organisation's agility to respond to risk events

Information, communication and reporting

ERM requires a continual process of obtaining and sharing necessary information from internal and external sources which flows up, down and across the organisation

18	Leverages information and technology – the organisation leverages its information systems and technology to capture, process and manage data and information to support ERM
19	Communicates risk information – the organisation uses communication channels to support ERM by sharing information
20	Reports on risk, culture and performance – the organisation reports on risk, culture and performance at multiple levels and across the entity

Benefits of ERM

COSO's ERM Framework document (2017) highlights a number of benefits that organisations can gain from integrating ERM across their entities

These benefits highlight the fact that risk should not be viewed solely as a constraint or challenge to setting and carrying out a strategy – instead, the way an organisation responds to challenges could be a source of strategic opportunities and ways for it to differentiate itself from its competitors and achieve competitive advantage over them

1. Increase the range of opportunities – by considering all reasonable possibilities (both positive and negative aspects of risk) management can identify new opportunities, as well as challenges associated with current opportunities

2. Identify and manage risk entity-wide – every organisation faces a number of risks which can affect different parts of the organisation – sometimes, a risk can emanate from one part of an organisation but have an effect on another part but by looking across the organisation as a whole, management can identify and manage these risks to help sustain and improve performance

3. Increase positive outcomes and advantage while reducing negative surprises – ERM helps an organisation to improve its ability to identify risks and establish appropriate responses, thereby reducing negative surprises and their related costs or losses and allowing the organisation to benefit from advantageous developments

Having discussions about alternatives and possibilities does not mean that an organisation will not face challenges and threats but it should mean that the organisation is less surprised by them

4. Reduce performance variability – the challenge for some companies has less to do with surprises and more to do with variability in performance – performing significantly ahead of schedule beyond expectations can cause problems just as performing below expectations does – ERM allows organisations to anticipate risks of over- or underperformance and to take action to minimise disruption

5. Improve resource deployment – having information about risks (and which risks are most important) allows an organisation to assess resource needs and enhance resource allocation – having a greater focus on resources should mean an organisation uses its resources (money, people, time) more efficiently and in turn this should improve its ability to generate value for its stakeholders

6. Enhance resource resilience – an organisation's medium and long-term viability depends on its ability to anticipate and respond to change, not only to survive but also to evolve and thrive – this ability to respond effectively to change becomes increasingly important as the pace of change accelerates and business complexity increases

FinTech

Developing Technologies and the Financing Decision

Introduction

Emerging technologies are significantly reshaping the business landscape, particularly in how businesses approach financing decisions

Digital disruption has fostered the creation of innovative platforms that broaden access to finance

Key areas influenced by developing technologies include financial technology (FinTech), crowdfunding, initial coin offerings (ICOs), peer-to-peer (P2P) lending, revenue-based finance (RBF), and the application of artificial intelligence (AI) in financing decisions

Financial Technology (FinTech)

- Definition and Applications:

  Financial technology, or FinTech, is revolutionising the financial services sector. It combines technology and financial services to address consumer needs, making financial transactions more accessible, efficient, and affordable

    - Examples include:
        - Crowdfunding platforms
        - Peer-to-peer lending solutions
        - Cryptocurrency applications for digital transactions
        - Digital wallets (e.g., Apple Pay)
        - Algorithm-driven financial advice, which is more cost-effective than traditional advisory services
        - Digital-only banks that operate without legacy systems or physical branch networks

Crowdfunding

- Definition and Process:

  Crowdfunding enables businesses, particularly startups, to raise equity finance through online platforms by pitching to a large pool of potential investors

    - A successful crowdfunding campaign typically involves:
        - A strong, persuasive business plan
        - A management team with proven skills and experience
        - Additional media, such as videos, to summarise and market the proposal

    - The growth of internet technology has made crowdfunding an increasingly common way to secure funding, as it allows businesses to connect with millions of potential investors globally

- Advantages of Crowdfunding:
    - Accessible for startup companies with limited trading history
    - Helps attract customers and build brand awareness
    - Often quicker than traditional finance methods, with campaigns lasting as little as 30 days
    - Companies can select regulated crowdfunding platforms, such as those overseen by the Financial Conduct Authority (FCA), to provide confidence to investors
- Costs and Limitations:
    - Fees for platform usage
    - Legal and advisory costs
    - Administrative expenses related to handling investor inquiries
- Examples:
    - Platforms like Kickstarter, which focus on creative industries such as film, music, art, and design
    - Some platforms offer both equity and debt finance (covered later under P2P lending)

Initial Coin Offerings (ICOs)

- Definition and Mechanics:

  ICOs are blockchain-based versions of crowdfunding, raising equity finance in cryptocurrencies like Bitcoin or Ether
    - Investors receive tokens, which may represent shares or grant access to services (e.g., Filecoin's decentralised cloud storage system)
    - ICOs rely on a "white paper" to explain the project, the token system, and payment methods
- Advantages and Risks:
    - Initial Appeal: Simpler than Initial Public Offerings (IPOs) and relied on minimal documentation
    - Regulatory Changes: Increasingly, ICOs have been classified as securities by regulators, necessitating more complex compliance like producing full prospectuses
    - Risks:
        - Unregulated: With a lack of stringent oversight, ICOs are vulnerable to fraud (e.g., a 2018 study found 78% of ICO projects were scams)

- Price volatility: Prices can vary significantly, influenced by demand, sentiment, and external factors. For instance, Bitcoin's value fluctuated from £4,093 in 2019 to £56,404 in 2024
- Early-stage nature: Many ICO projects are in their infancy, posing significant risks of loss to investors

Peer-to-Peer Lending (P2P Lending)

- Definition and Process:

  P2P lending involves connecting businesses seeking loans with investors through online platforms. It is a form of debt finance but is generally unavailable to startups, as lenders typically require an established trading history

  - Borrowers must supply financial accounts and pass credit checks
  - Platforms may offer fixed interest rates or allow lenders to bid on loans by proposing rates they are willing to accept

- Advantages:
  - Lower interest rates compared to traditional banks due to competitive lending and reduced origination fees
  - Faster loan processing, as platforms operate outside conventional bank hours and use streamlined procedures
  - Greater accessibility for borrowers with lower credit ratings compared to conventional lending

- Examples:
  - Many P2P platforms regulated by the FCA provide detailed options for borrowers and lenders

Revenue-Based Finance (RBF)

RBF allows businesses to secure capital with repayments based on a percentage of ongoing revenues. It bridges the gap between debt and equity financing

- Repayment periods typically range from 1 to 5 years
- A repayment cap is agreed upon, calculated as the initial investment multiplied by a pre-set multiple, influenced by company performance, loan duration, and risks

- Advantages:
  - Payments fluctuate based on business revenues, easing cash flow strain during lean months
  - No personal guarantees or fixed interest obligations are required, reducing complexity compared to traditional loans

- Companies retain ownership as investors have no direct shareholding
- Particularly suited for startups, e-commerce businesses, and subscription-based models such as Netflix

- Considerations:
  - Risk: Sales fluctuations can still create financial strain
  - Cost: Over time, RBF may be more expensive than traditional loans due to variable repayments

The Role of Artificial Intelligence (AI) in Financing Decisions

- Key Applications:
  - Risk Assessment and Credit Scoring:
    - AI can rapidly analyse vast data inputs, including financial details, credit scores, and even behavioural factors, to assess borrowing eligibility
    - Reduces bias and enhances the accuracy of creditworthiness evaluations
  - Streamlining Loan Approvals:
    - Automation of tasks like financial document verification and credit analysis speeds up application processes and reduces errors
    - Helps ensure fair decisions and quicker access to funds
  - Matching Lenders and Borrowers:
    - AI algorithms optimise the pairing of lenders with borrowers based on financial profiles and preferences
    - Improves efficiency, reducing dependency on traditional intermediaries
  - Fraud Detection:
    - AI identifies anomalies in data patterns and flags fraudulent activities, enhancing security and reliability in financial transactions
  - Real-Time Analysis:
    - Offers instant data processing, enabling swift financing decisions and better risk management
  - Forecasting and Predictions:
    - AI's ability to recognise trends makes it invaluable in forecasting future financial scenarios and helping organisations strategise effectively

Flexible Workforce Management

Long-range, detailed people planning is a necessary form of risk management, preparing businesses for foreseeable contingencies

However, organisations also need to take action to reduce costs and increase productivity

Traditional staffing models based around full-time employees working a standard number of hours each week are proving inefficient in terms of matching demand and supply – at times, there is too much work while employees are underutilised in less busy periods

Flexible working can also be attractive to employees – for example, by helping them to manage their worklife balance or by combining responsibilities as a parent of young children with their careers

Elements of workforce flexibility: where, when, how much

Where: flexibility in where someone works

This could involve working from home for some or all of the time, working in several different offices or on several different sites within the same organisation or working remotely from a number of different sites

If data is stored in the cloud, employees can access it from anywhere there is an internet connection so cloud-based systems help to support the flexibility around where people can work

When: flexibility when someone works

This could involve flexible start or finish times, compressed work (e.g. working 4 days of 9 hours each and then having 3 days off rather than working 5 days of 7 hours each and then having 2 days off) or shift work

An important consideration here will be to flex when someone works to try to match availability with workload peaks and troughs – doing this could be more cost-effective than having to hire additional temporary staff or having to pay large amounts of overtime to meet workload demands in busy periods

How much: flexibility in how much someone works

This could involve working part-time or job sharing

Multi-skilling

If employees are multiskilled, the organisation has the flexibility to arrange them in the way which best fits its needs at any given time, helping to deal with capacity matters

This can also help reduce costs because the business may be able to operate with fewer employees than a business whose employees are not multiskilled – workers who are only skilled in a single area may have periods of idle time, waiting for work to become available – multiskilled workers may be able to move to different areas, reducing the amount of idle time, and meaning the overall level of work can be carried out by fewer people

Multi-skilling can also increase job satisfaction among employees by increasing the variety in their work and giving them the opportunity to learn and apply new skills

Perils of homeworking

Some research articles have indicated that homeworking can take a heavy psychological toll where workers are encouraged to adopt an "always on" mentality where the lines between work and home life are increasingly blurred

Working away from the office can isolate employees from social networks and career opportunities

Working away from the office can foster a "grazing" instinct that keeps dangerous stress hormones at persistently high levels – "grazing" is the term used to describe the compulsion to work outside of normal office hours, leading to ever longer days, increased stress and depression and poor diet and sleep among home workers

Work has, for some people, become more intense as new technology enables, and even forces, people to work faster, do more and multitask

This can in turn lead to "presenteeism" where people continue to work even when they are off ill

According to some reports, on average adults in the UK spend more time using technology than sleeping each day

Contract workers and freelancers

The increased use of freelance or contract workers in place of permanently employed staff can form part of an HRM strategy which ensures that the appropriate people are brought together to complete a specific project or task

Such a model fundamentally changes the nature of job vacancies, compared to a model in which organisations employ staff on a full-time basis

Advantages of the freelancing model for organisations

For organisations, particularly ones involved in project work, the use of short-term contracts enables particular skills to be brought in as and when required

This means that organisations only incur employee costs when work is required rather than having to pay regular salaries (and associated costs) for full-time members of staff

Advantages of the freelancing model for workers

Workers can be selective about the work they undertake, based on the opportunities they are most interested in (subject to there being sufficient work available to provide them with an income to live on)

The “gig economy”

They “gig economy” is a labour market characterised by the prevalence of short-term contracts or freelance work instead of permanent jobs

Workers get paid for the specific tasks or “gigs” that they perform

The gig economy offers flexibility to companies and workers – companies only pay when work is available and do not incur staff costs at times when there is no demand

Workers can benefit from flexible hours and can control how much time they work – they can also manage how they juggle work around other priorities in their lives

The gig economy has proved contentious because workers are classed as independent contractors, rather than employees – this means they have no right to receive the minimum wage, paid holiday, or sickness pay and they have no protection against unfair dismissal

A number of labour disputes have arisen regarding the economy with people who work for large companies fighting to have their status upgraded to that of a worker or employee

Forensic Audits

Defined as the process aimed at gathering, analysing, and reporting data to find facts and evidence within financial or legal disputes, offering both investigative and preventative advice. Forensic auditing is critical in situations involving financial or legal disagreements, spanning various applications from fraud detection to expert witness services

Applications of Forensic Auditing

- Fraud: Identifying and investigating fraudulent activities
- Negligence: Uncovering cases of carelessness that result in financial loss
- Insurance Claims: Investigating claims to confirm their validity
- Shareholder and Partnership Disputes: Resolving financial disagreements among business partners or stakeholders
- Contract Disputes: Clarifying and resolving disagreements over contract terms
- Business Sales and Purchase Disputes: Addressing financial discrepancies in transactions
- Matrimonial Disputes: Assessing financial assets in divorce proceedings
- Investigation of Terrorist Financing: Tracing and identifying funding sources for illegal activities
- Expert Witness Services: Providing impartial testimony in court cases, adhering to the Civil Procedure Rules (CPR), which dictate an expert's duty to the court and the necessity for independence and relevance

Planning a Forensic Audit

Similar to a statutory audit, the forensic audit process involves planning, evidence gathering, review, and reporting, but with distinct characteristics such as no materiality threshold, variable reporting timing, critical documentation review, potential interviews requiring advanced skills, sophisticated data mining, and often a conflict-driven environment

Example Procedures for a Fraud Investigation

- Developing a profile for the entity or individual under investigation
- Identifying internal control and record-keeping weaknesses
- Using trend analysis and analytical procedures to spot significant transactions and variances
- Detecting pattern changes in sales or purchases and unusual consumption of materials
- Spotting abnormal account balances and reviewing transaction documents for inconsistencies
- Tracing individuals responsible for fraudulent actions and reviewing their responsibilities and transaction history

- Examining the individual's broader business involvement and conducting further analytical reviews

Forensic audits require a high degree of precision, expertise, and integrity to uncover the truth in complex financial disputes, ensuring justice and resolution in legal conflicts

Organisational Structures

Challenges that inform organisational structure

Johnson, Scholes and Whittington identify 3 major groups of challenges for modern organisational structures:

1. flexibility of organisational design – the rapid pace of environmental change and increased levels of environmental uncertainty demand flexibility of organisational design
2. effective systems – the capture, organisation and exploitation of knowledge requires effective systems to link the people who have knowledge with the applications that are needed
3. internationalisation – internationalisation creates new types (and a new scale of) technological complexity in communication and Information Systems – at the same time, diversity of culture, practices and approaches to personal relationships bring their own new problems of organisational form

Of these 3 sets of issues, the need to capture, organise and exploit knowledge is probably the most pressing for most organisations

Types of basic organisational structure

Johnson, Scholes and Whittington review 7 basic structural types:

1. functional
2. multi-divisional
3. holding company
4. matrix
5. transnational
6. team
7. project

Detailed summary notes on the above 7 organisational structures are provided below (please note that we have followed the SBM Workbook in discussing the multidivisional and holding company structures within the same subsection)

You may also need notes on the meaning of the term "network structure" as this is discussed in the SBM Workbook – see the end of this section for relevant notes on this more general concept which potentially applies regardless of which of the above 7 basic structural types is the best specific formal description of the organisation's structure

Choosing a structure

An organisational structure must provide a means of exercising appropriate control

It must also respond to the challenges of rapid change, knowledge management and globalisation

In many cases, it is likely that there will not be a single model of organisational structure suitable for all purposes – managers must make choices as to which challenges they regard as most pressing

Goold and Campbell proposed 9 tests that may be used to assess proposed structures:

Tests relating to the organisation's objectives

Market advantage – where processes must be closely coordinated in order to achieve market advantage, they should be in the same structural element

Parenting advantage – the structure should support the parenting role played by the corporate centre – for example, a "portfolio manager" would need only a small, low-cost corporate centre

People test – the structure must be suited to the skills and experience of the people that have to function within it – for example, skilled professionals used to a team-working approach might be frustrated by a move to functional hierarchy

Feasibility test – this test sweeps up all other constraints, such as those imposed by law, stakeholder opinion and resource availability

Tests relating to matters of design principle

Specialised cultures – specialists should be able to collaborate closely

Difficult links – it is highly likely that some interdepartmental links will be subject to friction and strain e.g. the link between sales and production when there are frequent problems over quality and delivery – a sound structure will embody measures to strengthen communication and cooperation in such cases

Redundant hierarchy – the structure should be as flat as is reasonably attainable

Accountability – effective control requires clear lines of accountability

Flexibility – the structure must allow for requirements to change in the future so that unexpected opportunities can be seized

1. The functional structure

People are organised according to the type of work that they do

Departments are defined by their functions, based on the work that they do e.g. production department, sales department, finance department and so on

The functional structure is a traditional, common sense approach and many organisations are structured in this way

Advantages of a functional structure

Based on work specialism and therefore logical

The organisation can benefit from economies of scale

Offers a career structure

Disadvantages of a functional structure

Does not reflect the actual business processes by which value is created

Hard to identify where profits and losses are made on individual products

People do not have an understanding of how the whole business works

There are problems of coordinating the work of different specialisms

Hampers cross functional creativity and innovation i.e. sharing of knowledge between functions

2. and 3. The multidivisional and holding company structures

A multidivisional structure divides the organisation into semiautonomous divisions that may be differentiated by territory, product or market – each division will then have separate functions within it

A holding company structure is an extreme form of multidivisional structure in which the divisions are separate legal entities (subsidiaries) – the holding company can be a company with a permanent investment or one that buys and sells businesses or interests in businesses – the subsidiaries may have other shareholders

Each division has its own revenues, expenditures and profits

Communications between divisions and head offices are restricted, formal and related to performance standards – influence is maintained by headquarters' power to hire and fire the managers who are supposed to run each division

Divisionalisation is a function of organisation size, in numbers and in product-market activities

Advantages of a divisional structure

Focuses attention of subordinate management on business performance and results

Management by objectives is the natural control default

Gives more authority to junior managers and therefore provides them with work that grooms them for more senior positions in the future

Provides an organisational structure which reduces the number of levels of management – the top executives in each division should be able to report direct to the Chief Executive of the holding company

Disadvantages of a divisional structure

Each division is partly insulated by the holding company from shareholders and capital markets, which ultimately reward performance

The economic advantages it offers over independent organisations reflect fundamental inefficiencies in capital markets – in other words, different product-market divisions might function better as independent companies

The divisions are more bureaucratic than they would be as independent corporations, owing to the performance measures imposed by the strategic apex

Headquarters management have a tendency to usurp divisional profits by management charges, cross subsidies, head office bureaucracies and unfair transfer pricing systems

In some businesses it is impossible to identify completely independent products or markets for which divisions would be appropriate – one particular problem for divisional structures is that they struggle to cope with large customers who span the divisions

4. The matrix structure

A matrix structure attempts to ensure coordination across functional lines by the embodiment of dual authority in the organisational structure

Matrix structures provide for the formalisation of management control between different functions while at the same time maintaining functional departmentation

Matrix structures can be a mixture of a functional, product and territorial organisation

Matrix and project organisation may possibly be thought of as a reaction against the golden rule of classical management theory of unity of command: i.e. the principle that an individual should have only one boss – a matrix approach has a project management structure superimposed on top of the functional departmental structure

Under a matrix structure, an individual may be responsible to both a product manager and a manager in the finance department, for example

		Boss 1				
		Production Department	Sales Department	Finance Department	Distribution Department	Marketing Department
	Product Manager A					
Boss 2	Product Manager B					
	Product Manager C					

The key issue in a matrix structure is the need for the division of authority between product managers and functional managers to be carefully defined

A subordinate cannot easily take orders from 2 or more bosses and so an arrangement has to be established, perhaps on the following lines:

a subordinate takes orders from one boss (the functional department manager) and the second boss (the project manager) has to ask the first boss to give certain instructions to the subordinate, or

a subordinate takes orders from one boss about some specified matters and orders from the other boss about different specified matters – this would require the authority of each boss to have been carefully defined and good cooperation between the bosses would be necessary

Advantages of a matrix structure

Offers greater flexibility in relation both to people and to the task and structure itself as the matrix may be short-term (as with project teams) but with a longer term functional structure underneath

Should improve communication within the organisation

Dual authority gives the organisation multiple orientation so that functional specialists do not get wrapped up in their own concerns

Provides a structure for allocating responsibility to managers for end results – a product manager is responsible for product profitability and the project leader is responsible for ensuring that the task is completed

Provides for interdisciplinary cooperation and the mixing of skills and expertise

Disadvantages of a matrix organisation

Dual authority threatens a conflict between managers – subordinates must know to which boss they are responsible for each aspect of their duties

One individual with 2 or more bosses is more likely to suffer role stress at work

It is sometimes more costly – for example, product managers are additional jobs which would not be required in a simple structure of functional departmentation

It may be difficult for management to accept a matrix structure – it is possible that a manager may feel threatened that another manager will usurp his or her authority

Requires consensus and agreement which may slow down decision-making

Suitability of a matrix organisation

A matrix organisation is most suitable in the following situations:

- there is a fairly large number of different functions, each of great importance
- there could be communications problems between functional management of different functions at the present time so a matrix structure could improve matters here
- work is supposed to flow smoothly between functions but such communications problems might stop or hinder the workflow so a matrix structure could improve work flows
- there is a need to carry out uncertain, interdependent tasks – work can be structured so as to be task centred with a task manager who is appointed to look after each task and provide the communications (and cooperation) between different functions
- there is a need to achieve common functional tasks so as to achieve savings in the use of resources i.e. product divisions would be too wasteful because they would duplicate costly functional tasks

5. The transnational structure

A transnational structure attempts to reconcile global scope and scale with local responsiveness: some markets may require high volumes of a single low-cost product whilst others require a range of low-volume and therefore high cost products

The **global approach** leads to global divisions, each responsible for the worldwide production and marketing of a related group of standardised products

The **multi-domestic** approach leads to the setting up or acquisition of local subsidiaries, each with a great deal of autonomy in design, production and marketing

A transnational approach tends to have a high proportion of fixed responsibilities in the horizontal lines of management and has 3 specific operational characteristics:

- national units are independent operating entities but also provide capabilities (such as R&D) that are used by the rest of the organisation
- such shared capabilities allow national units to achieve global, or at least regional, economies of scale
- the global corporate parent adds value by establishing the basic role of each national unit and then supporting the systems, relationships and culture that enable them to work together as an effective network

To work effectively, the transnational structure must have very clearly defined managerial roles, relationships and boundaries:

managers of global products or businesses should have responsibilities for strategies, innovation, resources and transactions that transcend both national and functional boundaries

country managers must feed back local requirements and build unique local competencies

functional managers nurture innovation and spread best practice

managers at the corporate parent lead, facilitate and integrate all other managerial activities – they must also be talent spotters within the organisation

Disadvantages of the transnational structure

Makes great demands on its managers, both in their immediate responsibilities and in the complexity of their relationships within the organisation

Complexity of the organisation can lead to difficulties of control and complications introduced by internal political activity

(Please note that the SBM Workbook does not provide a specific sub heading on the advantages of the transnational structure.)

6. The team-based structure

Although the transnational and matrix structures use project teams, projects naturally come to an end so project teams disperse at this point under those organisational structures

A team-based structure therefore extends the matrix structures use of both vertical functional links and horizontal, activity-based ones by using cross functional teams

Business processes are often used as the basis of organisation with each team being responsible for the processes relating to an aspect of the business – a purchasing team might contain procurement specialists, design and production engineers and marketing specialists, for example

(Please note that the SBM Workbook does not provide a specific sub heading on either the advantages or the disadvantages of the team-based structure.)

7. The project-based structure

A project-based structure involves employees from different departments working together on a temporary basis to achieve a specific objective or to address a specific issue – employees within the team perform specific job functions

A project-based structure is similar to a team-based structure except that projects, by definition have a finite life and so, therefore, do the project teams dealing with them under the project-based structure approach

Advantages of a project-based structure

This structure is very flexible and easy-to-use as an adjunct to more traditional organisational forms

Management of projects is a well-established discipline with its own techniques

Disadvantages of the project-based structure

Requires clear project definition if control is to be effective and comprehensive project review if longer term learning is to take place

The network structure

The network structure is a very modern idea, applied both within and between organisations

Within an organisation, the term is used to mean something that resembles both the organic organisation and structure of informal relationships that exists in most organisations alongside the formal structure

Such a loose, fluid approach is often used to achieve innovative responses to changing circumstances

The network approach is visible in the growing use of outsourcing as a strategic method

Some writers such as Ghoshal and Bartlett point to the likelihood of network organisations becoming the corporations of the future, replacing formal organisational structures with innovations such as virtual teams

Virtual teams are interconnected groups of people who may not be in the same office (or even the same organisation) but who share information and tasks, make joint decisions and fulfil the collaborative function of a team

Organisations are now able to structure their activities very differently, allowing increased flexibility:

> Staffing – certain areas of organisational activity can be undertaken by freelance or contract workers such as in Charles Handy's "shamrock organisation" which is gaining recognition as a workable model for a leaner and more flexible workforce, within the control framework – the key question is: how can the necessary control be achieved?
>
> Leasing of facilities such as machinery, IT and accommodation is becoming more common
>
> Production itself might be outsourced, even to offshore countries where labour is cheaper

Interdependence of organisations is emphasised by the sharing of functions and services – databases and communication create genuine interactive sharing of, and access to, common data

Examples of network organisational structures

Johnson, Scholes and Whittington give 4 examples of network organisational structures:

Teleworking – this combines independent work with connection to corporate resources

Federations of experts who combine voluntarily – this is common in the entertainment industry

One-stop shops for professional services in which a package of services is made available by a coordinating entity – a point of access to such conglomerates may be a website

Service networks such as the various chains of franchised hotels that cooperate to provide centralised booking facilities

Cooperation on non-core competence matters can lead to several benefits such as cost reduction, increase market penetration and an experience curve effect

Typical areas for cooperation between competitors include R&D and distribution chains – for example, the spread of the Toyota system of manufacturing, with its emphasis on just-in-time, quality and the elimination of waste has led to a high degree of integration between the operations of industrial customers and their suppliers

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

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

- 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

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

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

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

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

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:

- 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

- 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

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)

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

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

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

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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

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

- 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

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

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:

- Greenhouse Gas Emissions (Scopes 1, 2, and 3): Measured in metric tonnes of CO2 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

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

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

- 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