Analysis

Sustainability disclosures will transform the investment scene

- *Firms will soon be obliged to disclose their exposure to climate change and related risks.*
- *The consequences for asset values will be important for companies and investors alike.*

Accounts do not tell the whole story

Better disclosures are needed

Corporate disclosures – the information that firms release alongside their financial accounts – are set to change fundamentally.

Accounting standards do not normally exercise investors or move markets. But from next year, firms in several key markets will begin to publish new types of sustainability disclosures alongside regular financial accounts. Investors will get a better understanding of how climate change and other sustainability risks affect the bottom line, and of how firms transition to the low-carbon economy. This represents a key development for capital markets.

Financial accounts, typically in the format of the International Financial Reporting Standards (IFRS), seek to provide a 'true and fair' picture of a company's finances. Yet, a company's accounts are rarely sufficient to reflect risks from climate change and the impact of other sustainability issues.

Fossil fuel assets in particular will need to be written down

Comprehensive disclosure of such risks is needed alongside the published accounts. Much of the likely physical damage from climate change to corporate assets and future earnings is yet to be seen in portfolio values. Fossil fuel assets will soon need to be written down more drastically, for example when proven oil reserves turn out to be 'un-burnable'. Yet financial markets are seemingly still oblivious to the potential consequences of the now-binding global carbon budget and national emission targets for the value of such soon-to-be-stranded assets.

New standards

Many new standards are set to emerge

In late June, the International Sustainability Standards Board (ISSB) released two long-awaited sustainability disclosure standards.[1] Barely one month later, the EU set out how its new Corporate Sustainability Reporting Directive (CSRD) will be implemented.[2] Unlike the international ISSB standards, which need to be adopted by individual governments and regulators, the EU standard will immediately apply to about 50,000 listed or large firms, including many outside the EU, beginning in 2024. The UK is set to publish its own standards shortly, but has already announced that it wants to align closely with the ISSB.[3] The US securities regulator (SEC) is also due to release its disclosure requirements before the end of the year, and these will of course be hugely influential.[4]

The simultaneous introduction of these multiple standards may well create some confusion, although the core requirements will likely be quite similar across the key markets, as they build on the standard that the G20 helped to define in the Task Force for Climate Related Disclosures (TCFD) in 2016. Under this earlier standard, any company (whether in the financial or 'real' sector) should report how it manages climate risks, what metrics and targets it uses in doing so, the strategy and financial planning to address climate risks, and how governance within the organisation supports this strategy.

Transition plans are set to become a central element in corporate climate strategies, and will be elevated by the recent regulation. Such plans set out how organisations will align with a given climate scenario (in the EU's case, one of global warming limited to 1.5 degrees), and possibly also a net-zero target. Because companies can in future be held to account on how well they deliver on their own net-zero targets and broader climate plans, the new disclosure rules could have important consequences in limiting transition risks – which arise when companies back a carbon-intensive input or process for too long – and could help define capital market instruments that are tied to companies' emission reductions.[5]

ISSB will represent a global baseline for how firms report on sustainability risks that are material for their financial performance. Apart from climate, nature risks from biodiversity loss and ecosystem degradation will also soon be covered. Clearly, the new standards will thrive on the basis of wide adoption. IFRS accounting standards will not necessarily need to be matched with the ISSB but, in addition to the UK, Japan, Korea, and a handful of emerging markets have already signalled early adoption.

Financial materiality and sustainability: two sides of the same coin

The EU concept is set to be the most ambitious

The international accounting standard (and likely the UK and US standards) are firmly rooted in the concept of 'financial materiality': investors need to understand how any future risks stand to impact the future financial health of a company. The EU goes much further, however: it will also require reporting on the firm's impact on the outside world (the so-called 'double materiality' perspective).

This has been somewhat controversial, not least because all international firms with a substantial presence in the EU will need to report on the basis of this standard. The EU approach, driven by a different philosophy of stakeholder capitalism, stands to yield important additional information. And this will have value for investors, given that a firm's sustainability impact on the outside world can quickly and significantly impact its financial performance.[6]

The bottom line is that firms will have little time to lose in preparing much more comprehensive disclosures, in the case of the EU beginning with the 2024 financial year. A number of empirical studies already document that this greater transparency may well be in the self interest of the corporate sector: what gets measured gets managed, and managed more efficenctly.

True worth will be much clearer

Auditors will discipline greenwashing

Talk is cheap, and many past sustainability disclosures, and the transition plans and net-zero targets they contained, turned out to be quite shallow.[7] Few of the over 2,600 global companies that had adopted the TCFD standard observed all aspects.[8] Past corporate net-zero commitments were often little more than aspirational.

Now standards are much more detailed, and auditing and regulatory scrutiny will exert much more discipline on firms that need to report. Disclosures could become public, and begin to steer corporate strategy and management.[9] Investors will have plenty of material with which to differentiate between climate laggards and leaders, and gauge risks in their portfolios.

Based on upcoming disclosures, markets may be spared an abrupt re-pricing once investors grasp the scale of the climate transition. Capital could be mobilised for those firms least exposed to risks, or for investment opportunities in which low-carbon technologies are deployed.

Watch for

- How closely the SEC standard, due out before end-2024, reflects global best practice on sustainability disclosures.
- How well the standard rises above the ESG 'culture wars' ahead of the 2024 election.
- Consistency between the UK's Transition Plan Taskforce and the ISSB standard.
- More emerging markets adopting the ISSB standard.
- Firms being challenged by investors on the quality of their disclosures and transition plans.
- Sustainability-linked bonds that tie financial terms, such as coupon rates, to achieving the outcomes set in transition plans.■

Endnotes

[1] https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/?utm_medium=social&utm_source=linkedin&utm_campaign=s1_s2.

[2] https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en.

[3] See the UK Transition Plan Taskforce: https://transitiontaskforce.net.

[4] See the proposal of April 2022: https://www.sec.gov/files/rules/proposed/2022/33-11042.pdf.

[5] In sustainability-linked bonds issuers define sustainability targets, such as emission reductions. Should these targets be missed, financial terms, such as the coupon rate, will impose a penalty.

[6] For example, in response to changing consumer trends, litigation or the ability to recruit the 'brightest and best', in addition to potential vulnerability to hostile legislation.

[7] For example, the Climate Disclosure project showed earlier this year that few firms with published transition plans and net zero targets backed these up with the key elements to make them credible and effective. See: https://www.cdp.net/en/guidance/guidance-for-companies/climate-transition-plans.

[8] https://assets.bbhub.io/company/sites/60/2022/10/2022-TCFD-Status-Report.pdf.

[9] Pressure is growing to clamp down on inevitable 'greenwashing', improve transparency, and establish credibility through plans based on science and third-party accountability. See: https://www.un.org/sites/un2.un.org/files/high-level_expert_group_n7b.pdf

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