The important role accountants have to play in sustainable finance and a greener future – how they can guide their companies

by Sarah Moran and Paddy Molony

The IMF Global Financial Stability Report of April 2020[1] states that "Disasters as a result of climate change are projected to be more frequent and more severe, which could threaten financial stability." The report finds that investors do not pay enough attention to climate risks and argues that better disclosures and stress testing by organisations can both help to preserve financial stability and should complement policy measures to mitigate and adapt to climate change.

Moreover, the consideration of broader Environmental, Social and Governance ESG (ESGEnvironmental, Social and Governance) factors has become critical to the success of organisations across all sectors. Customers, employees, shareholders, lenders, rating agencies and regulators are demanding that organisations consider how their business impacts the world, their contribution to society and how they conduct themselves.

Whilst historically the role of accountants focussed exclusively on retrospective financial performance, recent regulatory shifts mandate an extension of this horizon to include forward-looking, non-financial aspects, with climate at the core. Consequently, the accounting function has evolved from a hygiene factor to a performance nucleus, placed at the top of the CEO's agenda. In order to adapt to the evolving landscape ahead, further skills development is required at multiple levels throughout most organisations with a recent KPMG survey[1] revealing 78% of executives believe that managing climate-related risks is "likely" or "highly likely" to be an important factor in keeping their jobs over the next five years[2].

So, what role will accountants need to play in the transition to a sustainable future?

The Financial Stability Board established the Task Force on Climate-related Financial Disclosures ("TCFD") framework to develop recommendations for more effective climate-related disclosures that could promote better-informed investment, credit, and insurance underwriting decisions. The disclosure recommendations are structured around four thematic areas that represent the core elements of an organisation's infrastructure i.e. governance, strategy, risk management, and metrics and targets[3].

In addition, EU regulation is leading the way to channel capital to sustainable outcomes with far reaching effects. The EU Taxonomy is a common classification of economic activities deemed to significantly contribute to environmental objectives using science-based criteria. The EU Taxonomy Regulation has created a direct regulatory link between corporate reporting requirements and wider ESG financial services regulation.

It is envisaged that companies can reliably use the EU Taxonomy to plan their climate and environmental transition and raise finance for this transition, whilst conversely, financial institutions can use the EU Taxonomy to design credible green financial products to accelerate capital allocation to green initiatives[4].

To successfully deliver on TCFD and EU Taxonomy requirements, organisations will need to facilitate cross-functional collaboration between disciplines, transcending the language barrier between scientific and financial acumen. Accountants will need to draw from their technical competence, constructing robust processes with veritable datasets, in order to attach credibility to the information that is presented to internal and external stakeholders.

Critically, accountants will be positioned at the helm when formulating an organisation's response to the following key questions from internal and external stakeholders:

1 https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020#Chapter5
2 https://home.kpmg/xx/en/home/insights/2020/11/climate-change-and-corporate-value-what-companies-really-think.html
3 https://www.fsb-tcfd.org/about/
4 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-faq_en.pdf

How resilient is our organisation to climate change?

The TCFD recommends that organisations perform scenario analysis to understand how climate-related risks and opportunities might impact the business and to plan appropriate responses. Impacts of both physical risks (for example, due to extreme weather events and/or chronic weather patterns) and transition risks (for example, policy change, carbon price, technology disruption and shifting customer sentiment) need to be considered. The scenario analysis process helps organisations to surmise how risks might evolve under different climate, economic and regulatory conditions.

Traditional backward-looking risk assessment models are not fit for purpose when faced with the non-linear trajectory of climate-related risks. It is therefore important for organisations to report on potential climate risks under a range of possible global warming scenarios, for example, 1.5°C, 2°C (considered low warming scenarios and are targets of the Paris Climate Agreement), 3°C (considered a moderate warming scenario) and 4°C (considered a high warning scenario). In order to provide investors and other stakeholders with a forward-looking view on the organisation's potential vulnerability or resilience to climate-related risks, accountants will need to use forward-looking risk modelling methodologies that are re-calibrated to a longer-term horizon.

It's worth noting that climate scenarios are hypothetical constructs, not forecasts, predictions or sensitivity analyses[5]. Financial stakeholders need to know that the scenarios used by organisations for climate-related risk assessment are robust and reliable – examples include the Intergovernmental Panel on Climate Change (IPCC), the International Energy Agency (IEA) or the International Renewable Energy Association (IRENA), appreciating that using a combination of different scenarios from reputable sources adds depth to analysis. Accountants will be required to provide this level of comfort.

What is our ESG impact?

How well an organisation performs on ESG issues is becoming an increasingly critical performance metric for investors, consumers, and management. Investors and rating agencies are demanding ESG reports. Investors believe that companies with a strong ESG programme perform better and are more stable[6].

Organisations are often challenged when measuring ESG outcomes and reporting metrics on ESG priorities and performance to key stakeholders. Accountants are ideally positioned to help organisations carry out ESG reporting efficiently and to weave ESG considerations into strategy and operations.

When measuring ESG impact, positive or negative, accountants must often incorporate non-financial and unstructured datasets from internal and external sources – as seen in the case of GHG emissions for example. The process extends beyond monetising social and environmental factors or "externalities" to determine their impact on the financial performance of the organisation.

Reciprocal outward impact of the organisation on society and the environment must also be considered, a concept referred to as "double materiality". The concept of double materiality is also expanded beyond exclusively financial considerations to include the wider non-financial facets of impact relating to environment, social and governance.

Identifying and harnessing the relevant data sources within a trusted and efficient reporting infrastructure is often a seemingly insurmountable challenge. Accountants are conversant with navigating complexity within their organisations and by facilitating a convergence of technologies—IoT, cloud, machine learning, and blockchain, can enable organisations to capture, measure, and verify data that all stakeholders can trust.

How will the EU Taxonomy affect our organisation?

Regardless of your sector, it is important to recognise that the implications of the EU Taxonomy are not exclusive to the financial sector and will have broad impacts across various sectors.

By providing appropriate definitions to companies, investors and policymakers on which economic activities can be considered environmentally sustainable, the EU Taxonomy is expected to create security for investors, protect private investors from greenwashing, help companies to plan the transition, mitigate market fragmentation and eventually help shift investments to where they are most needed[7].

5 https://www.tcfdhub.org/scenario-analysis/

6 https://www.nasdaq.com/articles/strong-esg-practices-can-benefit-companies-and-investors-2019-03-13

7 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en

The EU Taxonomy comprises six environmental objectives, namely, climate change mitigation, climate change adaption, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems. To be included in the proposed EU Taxonomy, an economic activity must contribute substantially to at least one environmental objective and do no significant harm (DNSH) to the other five environmental objectives, whilst also complying with minimum safeguards such as the Organisation for Economic Co-operation and Development (OECD) guidelines on multinational enterprises and the United Nation's Guiding Principles on Business and Human Rights[8].

The EU Taxonomy further operates as a transparency tool which supplements both the Non-Financial Reporting Directive (NFRD) and the Sustainable Finance Disclosure Regulation (SFDR) by laying down additional disclosure obligations for economic activities which contribute to the environmental objectives[9].

In April 2021, the European Commission adopted a proposal for the Corporate Sustainability Reporting Directive (CSRD) to amend the existing requirements of the NFRD[10].

Large financial and non-financial companies that fall under the scope of the CSRD will need to disclose the extent to which the activities that they carry out are aligned to the EU Taxonomy, calculated with reference to the proportion of revenue and expenditure allocated to achieving environmental objectives. Likewise, Financial Market Participants (FMPs) including asset managers, insurance companies and pension funds will need to report on the extent to which the activities funded by their financial products are aligned to the EU-Taxonomy under the SFDR[11].

8 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf
9 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-faq_en.pdf
10 https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_1806
11 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-factsheet_en.pdf

Economic activities are classified against the EU Taxonomy with reference to technical screening criteria. Methodology and guidance material were recently published by the European Commission for climate change mitigation and adaption environmental objectives with criteria for the remaining four environmental objectives to follow[12].

The first taxonomy-related disclosures for FMPs will apply from 1 January 2022 in respect of climate change mitigation and adaption environmental objectives. Disclosures in relation to the remaining four environmental objectives apply from 1 Jan 2023.

Consequently, FMPs will need to look more closely at the activities they are financing and investing in, whilst companies will need determine whether their business supports the environmental objectives of the EU Taxonomy and understand what additional information will be required from them, by financiers and investors to finance the green transition.

How reliable is our information?

A recent KPMG survey[13] revealed that of the top 100 companies (by revenue) across 52 countries, 80% report on ESG, with up to 61% of those reporting also obtaining assurance. The significant numbers of entities obtaining ESG assurance underscores the increasing relevance and importance of the ESG disclosures to an organisation's stakeholders.

Any information reported externally which is material to understanding an organisation's development, performance or position – including the impact of its activities on environmental and social matters – needs to be consistent, accurate and reliable. Stakeholders are increasingly looking for more comprehensive ESG information from organisations – not just around climate risk, but on governance and social issues, such as culture and diversity.

Assurance over non-financial information disclosed by an entity enables organisations to build trust in the accuracy and veracity of what they disclose. The nature and extent of assurance obtained can vary, and will be determined with reference to factors such as: who the organisation's stakeholders are; whether the organisation has specific ESG-related financing mandates; whether the organisation is public or private; what industry the organisation is in; and, how evolved the organisation is in their ESG reporting.

The most widely used external assurance standard for non-financial information is ISAE 3000 and, to a lesser extent, ISAE 3410 for GHG Key Performance Indicators (KPIs). The scope of independent assurance obtained is either limited assurance (for example, the opinion provided on a half-year review of financial statements) or reasonable assurance (for example, the opinion provided for an audit of financial statements).

Concluding remarks

As the sustainable finance landscape rapidly evolves to accommodate our accelerated transition to a greener future, an abrupt pivot of skills and technologies is required throughout organisations. Supported by Skillnet Ireland, the Sustainable Finance Skillnet is a national network working to develop skills and leadership capacity to advance sustainable finance best practice across Ireland's financial services sector. In 2020, the Sustainable Finance Skillnet supported 1,400 Irish located professionals to engage with the sustainable finance agenda. In 2021, the Sustainable Finance Skillnet aims to continue to support Irish located professionals to raise their awareness and sustainable finance skill levels throughout the year.

Through these developments, accountants are uniquely positioned as torchbearers for this journey and will need to extend the boundaries of their discipline into unprecedented terrain to meet these new challenges. In the face of future uncertainties, one thing is clear- the usual rules no longer apply.

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12 https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2021-2800_en.pdf
Annex 1 https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2021-2800-annex-1_en.pdf
Annex 2 https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2021-2800-annex-2_en.pdf
13 https://home.kpmg/uk/en/home/insights/2020/12/kpmg-survey-of-sustainability-reporting-2020.html