CFOs and ESG: A growing role

A high level overview of why ESG should be a top priority for CFOs

pwc

pwc.com.au/assurance

CFOs and ESG: A growing role

It's happening to CFOs more often: An investor asks about the firm's exposure to climate risk on an earnings call. Or the Board or Audit Risk Committee is asking about governance matters like board diversity, board performance, and ethics. Boards and the C-Suite are increasingly nervous after reading article after article on climate litigation risk resulting from greenwashing, and want to understand more about the company's measurable targets and KPIs for net zero.

Interest continues to pique globally from customers, employees, investors and regulators regarding ESG, with thanks to COP conferences and evolving regulatory announcements such as the SEC's Statement on Proposed Mandatory Climate Risk Disclosures and the establishment of the International Sustainability Standards Board (ISSB).

So, what does this mean for the CFO and the role they should be playing in an organisation's response to, and reporting of, climate risks and opportunities?

Managing climate risks and opportunities and reporting on such, has typically been the job of the Chief Sustainability Officer (CSO) or the General Counsel. However, the level of scrutiny over 'non-financial' and 'financial' reporting is increasingly being questioned, with transparency of reporting (i.e. reporting the good and the bad, and how this information was derived) being key to investor confidence. This fact necessitates a **clear role for CFOs – to explain the ESG impact on enterprise value, and to be able to validate the framework and methodology applied**. Given the growing interest from investors, robust and accurate ESG reporting can both differentiate a company and elevate the role of the CFO.

Greenwashing

The process of conveying a false impression or providing misleading information about how a company's products, approach and performance are more environmentally or socially sound or otherwise sustainable than they actually are.

What is 'Net Zero'?

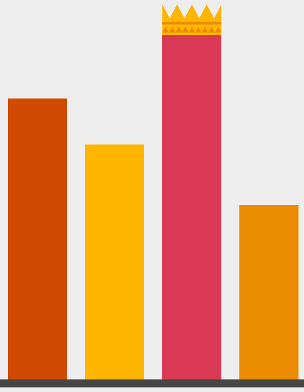
'Net zero emissions' refers to achieving an overall balance between greenhouse gas emissions produced and greenhouse gas emissions taken out of the atmosphere.[1]

Regulatory changes aplenty

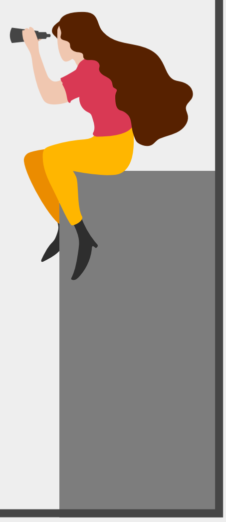
Changes locally and abroad will continue to keep CFOs on their toes.

Data (continues to) reign king

Auditable and regulatory-grade ESG data will be key for investors and shareholders going forward.



Why CFOs play a key role in ESG



View from the top

The link between enterprise value and financial value stands with CFOs.

A driving force

CFOs can drive better business outcomes and better capital allocation by bringing ESG into their decision making process.

A genuine and purposeful ESG story

A credible ESG story is essential for capital raising and engaging with the market; CFOs are critical to ensuring this.

A skill set like no-other

CFOs in-depth knowledge of ESG strategies are critical to balance the interrelationships between financial and sustainability measures.

Why do CFOs have the right capabilities and skills to manage ESG data across the board?

The right hand speaking to the left

While other parts of the organisation may hold the pen when it comes to targets and goals, **CFOs are required to report on those impacts, be it through managing financial commitments and budgets, the impacts on enterprise value in financial statements, or by ensuring the right hand is speaking to the left for all disclosures made in the annual report**. The interconnectedness of financial information released to the market and enterprise value is imperative for companies to consider and articulate – as was acknowledged by the IFRS Foundation in the decision to form the International Sustainability Standards Board (ISSB). With growing numbers of climate litigation in Australia, and investors being more cognisant of greenwashing, information reported throughout the broader annual report needs to reconcile with financial statements in a meaningful and transparent manner.

Ownership of auditable data and methodology

There's no denying the volume of relevant ESG data being captured by companies is increasing, as is the expectation the data is "investor grade". Currently, much of the ESG data being captured is done so manually, retained in pockets and sub-departments, and housed in unstructured folders and spreadsheets. In many cases, information is not in any kind of auditable environment – something that should give any publicly traded company pause. With finance teams being well versed in reporting infrastructure, design and implementation of integrated sustainability dashboards for real-time data tracking and reporting is a logical next step, **given their in-depth understanding of an organisation's data, processes, and reports, as well as their broad cross-divisional network.**

Many of the skills required to set, measure and report on ESG targets, such as risk management and cost optimisation and control, are already found within finance teams.[2] These teams are uniquely positioned to support the overall execution and delivery of an organisation's sustainability strategy, while also ensuring metrics being reported (both internally and externally) are accurate and compliant with the rapidly evolving framework and methodology landscape.

CFOs possess the skills needed to track and measure an organisation's non-financial metrics and achievements and link those to financial information. They have expertise in risk analysis as well as measurement, prevention and mitigation, governance, internal monitoring, and third-party assurance. **CFOs in-depth knowledge of ESG strategies are critical to be able to balance the interrelationships between financial and sustainability measures.**

CFOs play a key role in management reporting frameworks within an organisation, including the decision making process that goes alongside business partnering. As part of this, Finance needs to be able to align the organisation's ESG strategy, for example Net Zero commitments and KPIs, to metrics within those performance management frameworks, including being able to understand the progress towards achieving those commitments and KPIs. By bringing ESG and Net Zero into the broader decision making process, CFOs can drive better decisions and better capital allocation across the business, as well as hold business teams and the organisation as a whole to account, critical for stakeholders and investors.

What should be top of the CFOs ESG agenda right now?

Announcement of the International Sustainability Standards Board (ISSB)

Alongside the announcement of the formation of the ISSB, the IFRS Foundation Trustees also announced the publication of prototype climate and general disclosure requirements developed by the Technical Readiness Working Group for consideration by the ISSB. In contrast to GRI standards, which focus on a company's impact on society, the new IFRS will outline enterprise value focussed disclosures that influence investor decisions.

The new IFRS Sustainability Disclosure Standards will form part of the general purpose financial report. There is an expectation these disclosures, which will include forward-looking metrics, will be required to be audited in the not too distant future.

The mandating of these standards globally is inevitable and approaching, with global standards body International Organization of Securities Commission (IOSCO) accounting for 95% of the world's securities market, indicating the time for voluntary disclosures is up.[3] Should IOSCO formally endorse these standards, global markets, including Australia, would be forced to mandate them. Therefore, early action from CFOs is vital to ensure policies, processes and frameworks are in place for their efficient and effective implementation.

Impact of climate on enterprise value and reporting

Investors are expecting climate-related risks to be considered within the financial statements whether they pose a significant impact on a company or not[4], if there is an expectation of an impact, this needs to be disclosed. That is, for any climate-related risks which an investor may expect to have a significant impact on an entity, and will qualitatively influence investors, this should be disclosed in the financial statements, regardless of the quantitative impact. Given the current environment, companies will be hard pressed to argue that investors would not be influenced by climate risk. In fact, in a recent PwC Global survey, 50% of investors expressed willingness to divest from companies that didn't take sufficient action on ESG issues while only 34% were prepared to accept a lower rate of return in exchange for ESG.[5] What this indicates is that **CFOs are facing pressure to find the right balance around how and when to implement ESG, ensuring the right focus is put on value creation.**

The way in which climate risk and opportunity are reflected within the financial statements will depend largely on the transition pathway planned by the organisation the climate scenario modeling. It will no longer be sufficient for asset valuations to consider generic and scenario-unspecified assumptions around forecast future cash flows. **Both transition risk and physical risk should be understood to an extent that they can be validated and estimated within the thresholds required for reporting under IFRS.** These disclosures may take the form of 'estimation uncertainty' disclosures that highlight the evolving physical, political or economic landscape the entity operates in and the uncertainty surrounding the future climate-related implications on the recognition and measurement of assets and liabilities at this stage.

Additionally, they should all be underpinned by the climate scenario ‘base-case’ being applied by the company and assumptions should be able to be cross-referenced to both publicly available industry consensus data and the sustainability report. **CFOs know better than anyone else in the organisation (particularly after the implementation of the new revenue recognition Accounting Standard, AASB 15 Revenue from Contracts with Customers), it’s not enough to claim there is no impact, these assumptions must be validated.**

Add to this the complexity to consider with the i**ncreasing demand for Paris Agreement aligned financial reporting**, which has grown ever stronger off the back of annual UNFCCC COP meetings, and CFOs are sitting right in the driving seat, navigating the alignment of company strategy and financial statement reporting obligations.

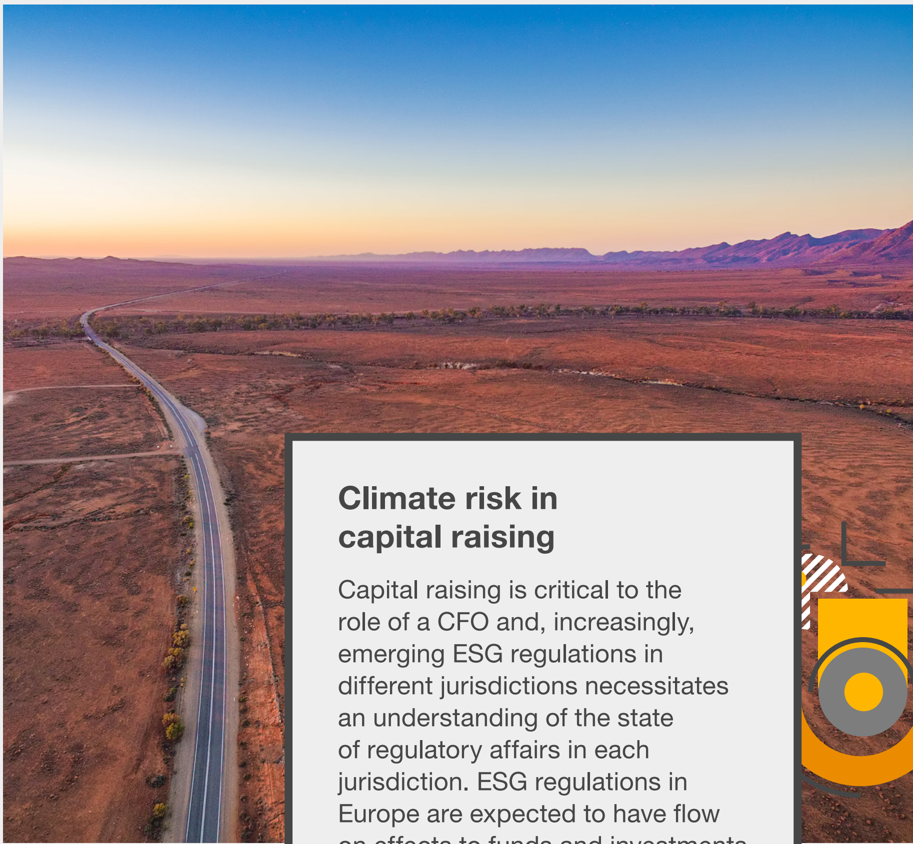
In practice, we are seeing:

Impairments: Impairments recognised in the market linked to changes in assumptions due to changes in business models.

Exposure: In financial services, investors looking at their exposure to other organisations that may be directly impacted by transitional climate risk, with the banking sector considering this in determining provisions for the estimated impact of potential future credit losses.

Disclosure: Increased calls for disclosure based on a Paris Agreement aligned scenario.

Valuation: Valuers including ‘ESG premium’ adjustments to discount rates.



Climate risk in capital raising

Capital raising is critical to the role of a CFO and, increasingly, emerging ESG regulations in different jurisdictions necessitates an understanding of the state of regulatory affairs in each jurisdiction. ESG regulations in Europe are expected to have flow on effects to funds and investments across the globe.[6] Any company with debt or equity investors in Europe will need to consider the implications.

Countries including China, the UK, Canada and Singapore (just to name a few) are also exploring similar models. **A credible ESG story is essential for capital raising – whether that be for regulatory reasons, market position, or even to pass the ‘due diligence’ phase of asset managers. Not just to access capital, but also for the cost of said capital.** MSCI have noted that “companies with high ESG scores, on average, experienced lower cost of capital compared to companies with poor ESG scores”[7]. And while achieving a good ESG rating may be challenging, it’s going to become non-negotiable as investors need to meet their own ESG disclosure obligations. The availability of relevant and reliable ESG data is critical do all of this.

What's holding CFOs back?

Despite the increasing focus on ESG, **many CFOs have yet to recognise the value that can be created from corporate sustainability.** In recent PwC analysis, less than half of Australia's top 200 companies (by revenue), identified ESG opportunities[8] (versus 68% who identified ESG risks). Indeed, no longer are a company's value and risks driven purely by financial performance, but a much broader set of KPIs.

In practice, we're seeing increasing pressure from a variety of key stakeholders for sustainability reporting, including:

- government regulators for compliance with a broad range of non-financial requirements, including those focused on ESG;
- investors and analysts that demand sustainability reporting and disclosures;
- suppliers that need detailed emissions information to manage their supply chain and meet their own ESG-related targets;
- customers changing their buying preferences towards 'green' or sustainable products; and
- talent, where the embracing of a strong ESG strategy may be a critical way to combat the great resignation by keeping the employees you have.

Climate change and other ESG topics are rightly known to be complex and require a very unique qualification and capability, one that is not always aligned to the study undertaken by CFOs.

However, who better to take on the opportunity to invest in upskilling to enable a broader perspective be given to risks and opportunities. Sustainability teams and Finance teams need to meet in the middle and start to speak each other's language to be able to clearly articulate the impact on enterprise value and society.

An ESG-savvy CFO: What's needed?

The expansion of the role of the CFO to include sustainability is vital if companies want to continue to meet the needs of their internal and external stakeholders, as well as ensure the creation of long-term enterprise value.

To meet the ongoing challenges associated with increasing stakeholder demands, CFOs need the following to take the lead on sustainability and drive meaningful change:

- an understanding of the core ESG concepts, e.g. net zero commitments, asset decommissioning obligations, carbon regulation, financing;
- recognition from key internal stakeholders, including risk managers, that ESG risks are material to the organisation;
- the incorporation of data on sustainability metrics and measures into the organisations ERP and operating systems, which will also provide a clear audit trail for internal and external verification;
- cross-divisional, scenario-based consideration of ESG-related factors, e.g., the risks that climate pose to core operations and supply chain;
- the integration of ESG-related metrics and link to performance management frameworks into KPIs, providing a clear internal incentive to drive change; and
- an ability to monetise non-financial sustainability data, creating a competitive advantage relative to peers and giving internal and external stakeholders the information needed to make operational and investment decisions.

Proactive measures are needed for companies to address the knowledge and skills that CFOs are lacking and ensure that strong sustainability credentials are achieved and maintained.

Our Assurance ESG team helps organisations understand the risks, controls, governance and reporting capabilities of the organisation, underpinned with a comprehensive understanding of a fast-paced changing regulatory landscape, with a view to drive positive change and meet growing stakeholder expectations.

For a more in-depth discussion on how to address ESG within your organisation, please reach out to one of our experts below.

Sam Lobley
CFO Advisory Leader
sam.lobley@pwc.com

Katelyn Bonato
Director, ESG CFO Advisory
katelyn.bonato@pwc.com

Sam King-Jayawardana
ESG Trust & Risk Director
sam.a.king-jayawardana@pwc.com

Endnotes

1 https://www.climatecouncil.org.au/resources/what-does-net-zero-emissions-mean/
2 World Economic Forum, Sustainability is the CFOs new best friend. Here's why, August 2021
3 https://www.reuters.com/business/cop/global-standards-body-takes-aim-company-greenwashing-claims-2021-11-03/
4 Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AUASB) Joint Bulletin on Climate-related and other emerging risks disclosures Practice Statement
5 PwC, Global Investor Survey - The economic realities of ESG, November 2021
6 https://www.pwc.com.au/assurance/eu-green-deal.html
7 MSCI, 'ESG and the cost of capital', February 2020,
8 PwC, 'ESG Reporting in Australia - the full story or just the good story?', November 2021

pwc.com.au/assurance

P0157916