Climate disclosures: Corporations underprepared for tighter new standards, study reveals

January 12 2024, by Diogenis Baboukardos, Evangelos Seretis, Fanis Tsoligkas, Ioannis Tsalavoutas and Richard Slack

Credit: Pixabay/CC0 Public Domain

Companies and the carbon emissions that they generate are one of the key drivers of anthropogenic climate change. Because of this, however, they also hold precious potential of curbing its severity. The 2021 Glasgow Pact stated that rigorous sustainability reporting standards that will push companies to disclose information about their impact on the environment as well as climate change's impact on their operations are essential. For this reason, it supported the creation of the International Sustainability Standards Board (ISSB), a new branch of the International Financial Reporting Standards (IFRS) Foundation, which aims to develop a robust set of financial-related sustainability-reporting criteria.

In June 2023, the ISSB issued its first two standards, IFRS S1, General Requirements for Disclosure of Sustainability-Related Financial Information and IFRS S2, Climate-Related Disclosures. The second focuses solely on climate change-related issues, requiring companies to disclose information around four aspects of their activities: governance, strategy, risk management, and metrics and targets. The standard requires information about the company's governance body responsible for oversight of climate-related risks and opportunities, as well as quantitative disclosures (in particular, greenhouse-gas emissions).

The standards have gained support from many global bodies, including the G7, the G20, the International Organization of Securities Commissions, and the Financial Stability Board. Although no country has yet adopted them, many are expected to endorse or require them in the near future. Countries such as the UK and Brazil are moving toward this direction. Also, the European Commission confirmed that climate-related disclosures of the European Sustainability Reporting Standards exhibit a high degree of alignment with second IFRS standard, and EU-based companies will have to adopt them in 2024.

Are companies ready for this transition?

At the end of March 2022, the ISSB issued drafts of the two standards. Our study explored the *ex ante* level of firms' adherence with climate-related disclosures by capturing disclosure levels against those proposed as to be required by the draft IFRS S2 (known as ED IFRS S2). Our year of analysis was the financial year 2021, i.e., the year immediately prior to the publication of the draft. We purposely focused on 100 large international companies in sectors with high carbon emissions, comprising 50 from the chemicals and 50 from the construction materials sectors.

Due to their size, such companies are under increasing pressure from consumers, shareholders, regulators and NGOs to report on their climate-related risks and opportunities. To carry out our analysis, we built a research instrument based on the ED IFRS S2 and scored the firms' publicly available reports, ranging from annual, sustainability to integrated reports.

Variations in reporting

Our findings indicate that, on average, the companies analyzed disclose around 39% of the items they would be required to reveal under the ED IFRS S2. When we zoom into the four categories of the ED IFRS S2 "core content," we find that companies engage much more with climate-related disclosures about their governance processes (around 60%) but much less with strategy and risk management disclosures (around 36% and 35%, respectively).

For metrics and targets, companies disclosed more of their climate-related targets than reporting their metrics (i.e., outcomes) with average levels around 67% and 35%, respectively. In other words, companies are found to be more vocal about their future plans (i.e., their future targets) than they are about their actual achievements so far (i.e., metrics). The moderate overall level of companies' forecasted adherence with the draft standard does not allow us to draw a direct conclusion. Nevertheless, a closer look to the findings reveals some additional insights with important implications about the application of IFRS S2:

- It draws heavily from the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) recommendations. When we focus specifically on the "new" items (those not included in the 2017 TCFD recommendations), we find that the related average disclosure score drops to about 25%.
- Many "new" items relate to the effects of climate-related risks and opportunities on financial statements. Our evidence indicates that climate-related disclosures appear disconnected from the financial statements. This is consistent with our previous studies on companies from the extractives sector that report very low levels of engagement with climate-related financial disclosures in their financial statements. For example, whether climate change affects companies' accounting policies, their financial performance, and their cash flows.
- Companies use various locations to disclose their climate-related information with limited cross-referencing between their various reports. On average, 50% of the items disclosed are found in the annual reports, about 25% are found in sustainability reports only, and around 15% in other reports only (e.g., CDP response). The absence of cross-referencing potentially hinders the connectivity (and hence the usefulness) of the disclosures scattered among different reports.
- About 50% of the companies have, at least, some parts of their climate-related disclosures assured by a third party. The assurance refers primarily to the metrics disclosed and to a much lower extent to the narratives.

More challenges ahead

This fast-changing corporate reporting landscape brings new challenges for companies, regulators, standard setters, and users:

- Having contrasted the suggested requirements in the ED IFRS S2 and in the final version of IFRS S2, we note few differences that, however, do not alter the requirements in substance. If anything, IFRS S2 is more prescriptive and thus more "demanding" for companies.
- Future disclosure. Based on forecasted disclosure levels, companies face considerable changes to their reporting when the two standards are adopted, or made mandatory, at a country level.
- New standards on the horizon. The ISSB is considering a number of other sustainability-related topics such as biodiversity, ecosystems and ecosystem services; human capital; and human rights for its future standards. There is still a long way ahead for the ISSB to cover such a multidimensional topic satisfactorily. At the same time, companies may find it particularly challenging to collect all the necessary information for adequately disclosing their sustainability-related activities/impact when the full set of IFRS sustainability standards is completed.
- Materiality. According to IFRS S1, companies shall disclose sustainability disclosures that have financial implications for them and their financial capital providers. Nevertheless, the magnitude of various climate-related risks (especially the physical ones) companies, potentially, face inherently cannot easily be reliably measured. Hence, the reliability of these disclosures may be questioned.
- Audit and assurance. Neither IFRS S1 nor S2 requires assurance of disclosures, although they recommend verification for some items (such as the volume of direct and indirect greenhouse gas emissions). Nevertheless, companies are required to disclose material sustainability-related financial information which is

likely to be subject to the audit process. It is unclear how the audit of this extra financially material information will be performed.
- Integrated reporting. The intention of ISSB is to integrate financial and sustainability reporting, following the Integrated Reporting Framework. However, very few companies engage with disclosures directly connected to their financial statements. Without change in reporting, the ISSB's purpose to provide integrated sustainability-related financial reporting standards may be undermined.
- Standards competition. Although the ISSB has received support from many jurisdictions, other countries (namely the EU block and the US) are working on separate projects (e.g., European Sustainability Reporting Standards). While the current "polyphony" helps to improve the quality of sustainability reporting standards, companies may find themselves being subject to multiple reporting requirements. Moreover, users may find it difficult to compare companies' performance that report against different Standards. Without global comparability, sustainability reporting may fail its very purpose.

Provided by The Conversation

Citation: Climate disclosures: Corporations underprepared for tighter new standards, study reveals (2024, January 12) retrieved 27 April 2024 from https://phys.org/news/2024-01-climate-disclosures-corporations-underprepared-tighter.html