Sustainability Reporting and Enterprise Value - Why it is relevant for industry and profession

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In recent years various governments, investors, lenders, corporates, and many public forums around the world are extensively discussing the responsible behavior of businesses.

This covers business activities having impacts on the environment, social and governance (ESG) aspects mainly the climate change, natural resources, pollution, waste, human capital, product safety and quality, access to finance, diversity, anti-corruption, anti-competitive, etc.

Since long entities provide information on their operations and business activities through the use of general-purpose financial reporting. This includes the provision of statements of financial position, performance, and cash flows of the entity together with its significant underlying policies and explanatory notes. The International Accounting Standards Board (IASB) formed by the International Financial Reporting Standards (IFRS) Foundation is the globally recognized forum that issues the relevant accounting standards to produce the general purpose financial statements. The primary users of such reporting comprise the investors, lenders, and other creditors who require information for their decision-making that is relevant, reliable, and faithfully represents but also that is comparable and verifiable. Such financial reporting is well entrenched around the world including Pakistan and is used extensively.

However, as stated, in recent years there has been a significant interest of the society toward responsible behavior of entities carrying out business activities having an impact on the ESG aspects. There is, accordingly, this advent of providing structured information on the responsible behavior of the entities. In practice, the presentation of such aspects of an entity is termed as ESG reporting or Sustainability reporting.

> **The ESG approach these days is being presumed as one of the foremost criteria used by the institutional investors and sponsors to screen out the prospects of making a long-term investment in any organization.**

For this reporting, various organizations and jurisdictions started developing and providing frameworks/ standards/guidelines. However, there was no internationally recognized forum, such as the IASB, whose ESG or sustainability reporting standards were followed in preparing or presenting the sustainability reports.

At the United Nations Climate Change Conference - COP26 in November 2021 there was the announcement of the establishment of the International Sustainability Standards Board (ISSB) by the IFRS Foundation. Under the IFRS Foundation structure, this was the birth of a sister organization to the IASB that issues the IFRS Accounting Standards. The ISSB has been formed to issue the IFRS Sustainability Disclosure Standards. It has recently proposed drafts of its two standards for public comments. These standards are expected to be adopted around the world by corporate regulators in the same standing as the IASB IFRS Accounting Standards.

The proposed standards build around the concept of providing 'Sustainability-related Financial Information' to the primary users of general purpose financial reporting at the same time and in the same place the financial statements are provided. Such 'Sustainability-related Financial Information' is required by the primary users when they assess the entity's enterprise value (meaning the total value of an entity. It is the sum of the value of the entity's equity [market capitalisation] and the value of the entity's net debt) and decide whether to provide resources to it.

The introduction to the proposed standard states that:

"An entity's ability to remain resilient will rely on a range of resources and relationships. Such resources and relationships include its workforce, any specialised knowledge it has developed and its relationships with local communities and natural resources. Investors, lenders and other creditors, therefore, seek information about the significant sustainability-related risks and opportunities facing an entity to inform their decisions about providing resources to the entity. Such information supplements and complements the information contained in the entity's financial statements.

Sustainability-related risks and opportunities arise from an entity's dependencies on resources and its impacts on resources, and the relationships the entity maintains that may be positively or negatively affected by those impacts and dependencies. When an entity's business model depends, for example, on a natural resource—like water—it is likely to be affected by changes in the quality, availability and pricing of that resource. When an entity's activities result in adverse, external impacts—on, for example, local communities—it could be subjected to stricter government regulation and consequences of reputational effects—for example, negative effects on the entity's brand and higher recruitment costs. Furthermore, when an entity's business partners face significant sustainability-related risks and opportunities, the entity could be exposed to related consequences of its own. When such impacts, dependencies and relationships create risks or opportunities, they can create or erode the value of the enterprise, the financial returns to providers of financial capital, and the assessment of enterprise value by primary users.

Enterprise value reflects expectations of the amount, timing and certainty of future cash flows over the short, medium and long term and the value of those cash flows in the light of the entity's risk profile, and its access to finance and cost of capital. The information contained in its financial statements and the information included in an entity's sustainability-related financial disclosures are essential inputs to a primary user's assessment of an entity's enterprise value. The proposals would require an entity to disclose material information about all of the significant sustainability-related risks and opportunities to which it is exposed."

The core content of the 'Sustainability related financial information' based on the proposed standard comprises of the following:

a) Governance — the governance processes, controls and procedures the entity uses to monitor and manage sustainability-related risks and opportunities;

b) Strategy — the approach for addressing sustainability-related risks and opportunities that could affect the entity's business model and strategy over the short, medium and long term;

c) Risk management — the processes the entity used to identify, assess and manage sustainability-related risks; and

d) Metrics and targets — information used to assess, manage and monitor the entity's performance in relation to sustainability-related risks and opportunities over time."

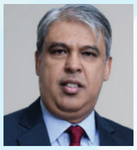
The establishment of the ISSB and global focus on sustainability reporting offers the accountancy profession an opportunity to lead on ESG and sustainability disclosures and their assurance. As chartered accountants, Institute's members are at the center of information flows and decision making. They are uniquely positioned to capture, analyze, report on, and assure sustainability information. Further, as a regulated profession, members are subject to an ethical code, public oversight, and charged with acting in the public interest. Their professional judgment and skepticism, independence, and competencies are unique.

However, in Pakistan, the awareness of the fast-paced development happening in the area of sustainability reporting is at a lower level. The understanding of the concepts related to sustainability requires significant nurturing. This requires focused attention and action of all stakeholders. The regulators and relevant government departments also have to play their role in this evolving landscape.

The Institute's members are though uniquely positioned to lead the role in the ESG and sustainability reporting and their assurance, however, to meet the requirements of this new subject and regime, knowledge and understanding of IFRS Sustainability Disclosure Standards are of fundamental importance for both industry and profession particularly for the members of the Institute. The members of the Institute are required to develop and update relevant skills and competencies. The skills to interconnect financial and sustainability information would be required by combining the understanding of a company's business model, risks/opportunities, systems/processes, and performance with knowledge of sustainability factors and the ability to collaborate with experts.

The industry also needs to keep itself aligned with global developments in sustainability reporting. The impact of climate change in Pakistan, social pressure, development of laws and regulations in other countries where our export market resides, and their consequential impact on our exporting entities, the highly likely involvement of multilateral organisations through linking provision of funding with sustainability-related compliances and measures from the IOSCO to endorse and implement sustainability reporting for the relevant corporate sector in Pakistan necessitate for the industry and profession to keep itself abreast of the developments. They need to start taking measures to not only create awareness but institute expert knowledge in their business processes. The ESG and sustainability reporting now requires the active attention of the company's board and management.

In Pakistan, the need of the hour is a proactive and collaborative approach, so that the industry, users of sustainability information, and accountancy profession are ready when sustainability reporting and its assurance are made mandatory or become obligatory as a business need.



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