IFRS S2 STANDARDS ON CLIMATE CHANGE-RELATED FINANCIAL DISCLOSURES

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The International Sustainability Standards Board (ISSB) released the final version of its International Financial Reporting Standards (IFRS) Sustainability Disclosure Standards, S1 and S2, on June 26, 2023.*

The S1 standards apply to the disclosure of financial information regarding sustainability-related risks and opportunities which may impact a company’s enterprise value. Sustainability-related risks and opportunities arise from the relationships that an organisation has with the resources and people that it needs, and whether it chooses to manage those relationships in a way that preserves and develops societies, economies and the environment.

The S2 standards are more specific and apply to the disclosure of financial information regarding climate change-related risks and opportunities which may impact a company’s enterprise value. Climate change-related risks arise from the exposure of a company’s operations to event-driven hazards such as hurricanes and floods, as well as to longer term climate-related changes such as temperature increases, droughts and sea-level rise. In addition, organisations may face significant economic transition risks due to costs associated with decarbonisation, changing consumer sentiments and government regulations such as carbon taxes. Both natural and transition risks can potentially be highly disruptive to an organisation’s ability to operate, and research suggests that these risks will only increase in the future.

All affected publicly traded companies will be required to gather sustainability and climate change-related data in the 2024 financial year for reporting in 2025. However, the ISSB has agreed to delay reporting of S1-related sustainability risks and opportunities until 2026, though climate-related risks and opportunities still need to be reported in 2025.

What types of climate-related risks might affect my organisation?

The physical assets that an organisation owns or leases may be at direct risk from climate-related risks. The intensity of storms and rainfall are likely to increase with a warming atmosphere, and sea-level rise will add to the risk of coastal flooding. Buildings located in areas already prone to these events may be more severely impacted as the climate changes. In addition, heat waves could affect transportation networks and the supply of utilities to offices, factories and commercial centres, degrading a company’s ability to operate.

Global value chains are also susceptible to climate change-related events. Droughts, heatwaves and hail can damage crops and reduce agricultural output; extreme weather can damage road and rail networks, interfering with the movement of raw materials and people; high levels of heat and humidity can reduce employee productivity and significant climate-related disasters such as hurricanes can seriously degrade an enterprise’s ability to mobilise its workforce.

Aside from these physical impacts of climate change, companies should also meet the challenge of a rapidly changing commercial environment. Changes in government policies aimed at promoting decarbonisation can create significant financial costs for energy-intensive industries that rely on fossil fuels, while subsidies can spur the growth of new industries such as heat pumps. Similarly, new environmentally friendly technologies can be highly disruptive and lead to the displacement of former market leaders and the creation of entirely new industrial sectors. Organisations that fail to adapt to changes in the global economy that result from climate change are likely to face significant reputational risk and loss of earnings as customers turn away.

The consequences of climate change, both positive and negative, are likely to impact a company’s immediate finances and its short-, medium- and long-term outlook. Investors in publicly traded companies should understand not only what measures a company is taking to mitigate climate-related risks and ensure business continuity, but also the likely impact that climate change could have on the enterprise’s value.

Understanding climate-related risks

The first step in assessing your organisation’s exposure to climate-related risk is to understand the physical assets that your business relies on, including the factories, offices and commercial properties it needs to operate. These could be widely distributed both nationally and internationally and some may already be at risk from climate-related events such as flooding and storms. You will likely already have risk mitigation measures such as insurance in place to cover potential losses. However, assessing changes in the risk profile of an asset due to future climate change is a complex process that involves analysing the latest climate-change models and then calculating possible financial losses. Unfortunately, the complexity of combined climate and financial modelling puts it beyond the reach of all but a handful of organisations.

In addition to the direct risks from climate events, the business environment will be affected by the process of adjustment to a lower-carbon economy. Carbon taxes, new regulations and reporting requirements may impose new costs, while consumers may become more environmentally aware, potentially leading to reduced demand for services and products with the result that the organisation’s entire business model may have to change.

Understanding such transition risks requires the ability to model a range of different future scenarios, taking into account varying levels of policy response, technology and socioeconomic change, and assess the financial impacts on the company of each. The goal will be to model physical and transition risks together, since a rapid realignment of the economy to reduce emissions tends to reduce losses from climatic events, but the transition costs may be higher due to the changes in the business environment.

To assist enterprises with assessing their level of climate-related risk, specialised climate risk software has been developed. This software provides a platform for analysing and understanding a company’s level of risk under different future climate change scenarios. Using internationally accepted climate models as a starting point, climate-risk software aims to assess how a company’s assets might be impacted in the future, analysing whether each asset’s level of risk will increase or decrease. More advanced climate risk software can model, on an asset-by-asset basis, what the financial impacts of the risk are likely to be.

Combined climate and financial models offer a holistic framework for assessing the impact of climate change on an organisation’s assets, and providing management with important information regarding which sites require more investment in mitigation and adaptation measures to ensure business continuity. These combined climate and financial projections help to answer the question, “How will climate change affect the value of my enterprise in the short, medium and long-term?”, and so provide the basis for the information required for the IFRS S2 financial disclosures.
What actions does my company need to take now?

If you haven’t already begun the process of gathering sustainability and climate-related data on your organisation, you should start now. Putting the governance mechanisms in place, as well as the processes to identify and manage sustainability and climate-related risks and opportunities, can be time-consuming. People and processes should be in place during 2024 so that risk and opportunity assessments can be presented in financial statements produced in 2025.

There are four key areas that companies should focus on:

1. Governance

Key questions relating to governance are:

- Who is responsible for the oversight of sustainability and climate-related risks and opportunities?
- How often does the oversight committee meet?
- How are risks and opportunities presented to the board?
- How are sustainability and climate-related risks and opportunities considered when planning the organisation’s strategy and operations?
- How are relevant metrics identified, monitored and reported on?
- How is risk tracked from reporting period to reporting period?
- What data controls are in place to confirm that historical risk modelling is preserved, allowing it to be compared to current risk analyses?
- Is historic risk analysis data easily accessible and comparable to current projections?
- How can technology be used to support the governance of sustainability and climate-related risks and opportunities?

2. Strategy

Key questions relating to strategy are:

- What risks and opportunities have been identified that could affect the organisation’s:
  - strategy
  - business model
  - finances
  - cash flow
  - value chain
- How resilient is the organisation’s strategy to sustainability and climate-related risks?

3. Risk Management

Key questions relating to risk management are:

- How are sustainability and climate-related risks and opportunities identified in the short, medium and long term?
- How can risk modelling identify assets that are at risk from climate change in the short, medium and long term?
- How is the likelihood and potential impact of each risk and opportunity assessed?
- How can risk modelling support the prioritisation of risks and opportunities?
- What metrics are needed to support risk management decisions, and to evaluate progress towards targets?
- How are sustainability and climate-related risks incorporated into the organisation’s overall risk management process?
- How can technology be used to support the identification and management of sustainability and climate-related risks and opportunities?
4. Metrics and Targets

Key questions relating to metrics and targets are:

- What information do I need to measure, monitor, evaluate and manage sustainability and climate-related risks and opportunities?
- What specific metrics have been identified?
- How often will metrics be measured?
- What is the base period for the metrics from which progress can be measured and compared?
- What targets does the organisation have?
- What progress is the organisation making towards its targets?
- Are historic metrics easily accessible so that progress towards targets can be easily measured?
- How can technology be used to support business commitments around climate-related targets?

If your organisation is already complying with Taskforce for Climate Related Financial Disclosure (TCFD) guidelines, then you should focus on aligning your current activities with the new IFRS S1 and S2 standards to confirm that you are able to correctly report on sustainability and climate-related risks and opportunities.

FIS and Climate Risk

FIS and PwC have formed a strategic alliance to help companies assess their exposure to climate-related risks and to comply with the new IFRS standards. By leveraging FIS’ long experience in modelling financial risks, and PwC’s knowledge in climate analytics, FIS is working to offer companies the ability to both understand their exposure to climate change-related risks and to quantify the financial impact of those risks. Organisations will be able to understand which of their assets are most vulnerable to climate-related events, and the range of potential financial losses that may result. This information will be essential for planning future strategies, maintaining business continuity and complying with the new IFRS S2 reporting obligations.