Climate Governance Initiative Australia

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Gearing up for mandatory climate reporting

What directors need to know now (and why it is a step up from TCFD)

MARCH 2023

Every organisation will be impacted by climate change and the move to a decarbonised economy. Irrespective of whether an organisation is subject to mandatory climate reporting standards, these dynamics will influence business models, supply chains, financial and non-financial risks, customer perspectives and more. Australian directors need to understand climate and sustainability risks, not just to oversee the preparation of corporate reports, but more fundamentally as responsible stewards of the long term health and sustainability of their business.

This short primer provides directors with a high level snapshot of what they need to know about forthcoming regulatory obligations. It will be followed by a report due for release later in 2023, *'A director's guide to preparing for mandatory climate reporting in Australia'* that will provide more detailed guidance for directors on how to oversee high quality disclosure.

KEY TAKEAWAYS:

1. **Mandatory climate reporting is imminent:** The first tranche of international sustainability-related financial reporting standards promulgated by the International Sustainability Standards Board (ISSB) is imminent, with a general sustainability and a climate-specific standard expected in June 2023. The recent Commonwealth Treasury Consultation Paper on Climate Reporting suggests mandatory climate reporting will start in the 2024/2025 financial year. This may initially only be aimed at large listed entities and financial institutions (large banks, superannuation, and insurers), although the scope could be broader.
2. **Reporting will be subject to stakeholder scrutiny:** There will be significant scrutiny of organisations' climate reporting from regulators, investors and other stakeholders. Directors and senior management will likely need expert advice to navigate complex legal issues.
3. **Main elements of the reporting model are clear:** Key questions remain around who will initially be caught by the standards, what the timelines will be, how the standards will require reporting on scope 3 emissions and how these will be regulated, but the fundamental expectations are largely clear and go beyond the Taskforce for Climate-related Financial Disclosure (TCFD) framework.
4. **Early preparation is critical:** Significant preparation is required in readiness for the anticipated reporting obligations – starting early is key. The runway for implementation will likely be short, and will require significant focus from board members and management. Board members should see the opportunities, not just risks from heightened disclosure and market comparability.
5. **Key actions to prepare:** Boards can act now by reviewing existing governance structures to identify responsibility and accountability, setting a comprehensive and measurable sustainability and climate strategy and asking management what the gaps are between current and future resourcing, data and disclosure needs.

WHAT IS BEING PROPOSED? A CLEARER PATH TO MANDATORY CLIMATE REPORTING

The ISSB has proposed two international standards for sustainability reporting: IFRS® General Requirements for Disclosure of Sustainability-related Financial Information (**IFRS S1**) and IFRS® S2 Climate-related Disclosures (**IFRS S2**). These standards, which will set a global baseline in sustainability-related financial disclosures, have been developed in response to calls from primary users of general purpose financial reports for more information about the entity's material sustainability-related risks and opportunities that materially impact an entity's future cash flows, financial position and performance. The standards will bring about greater consistency and comparability in reporting as countries (particularly the majority of jurisdictions which currently apply IFRS standards as the base for domestic financial reporting purposes) adopt these standards or their jurisdictional equivalents.

The release of IFRS S1 and IFRS S2 seeks to harmonise the 'alphabet soup' of climate change and sustainability-related disclosure standards. They are built off the architecture of the TCFD recommendations and draw heavily from the concepts of connected and integrated thinking set out in Integrated Reporting. They also utilise the Sustainability Accounting Standards Board (SASB) standards, as guidance, to propose industry-specific quantitative disclosures that entities may choose to take into consideration (although not mandated, at least initially).

The standards are expected to be issued by the ISSB in June 2023[1] and will pave the way for mandatory reporting in Australia. Treasury has signalled the ISSB standards could become mandatory for Australian large listed companies and financial institutions starting in the 2024/2025 financial year. This is consistent with several other jurisdictions, which are either planning or have introduced mandatory disclosure requirements for large businesses. For example, both New Zealand and the United Kingdom (UK) recently passed legislation that made climate-related disclosures mandatory for a subset of businesses.

Directors are facing the need to oversee a change in organisational mindsets to embed climate and sustainability into strategic thinking and financial decision-making at all levels. The anticipated mandatory reporting obligations will see board members responsible for overseeing the implementation of appropriate systems to embed these new requirements into their existing risk and compliance frameworks. The new obligations also provide an opportunity to prompt deeper strategic thinking and consider ways to create commercial value in an economy committed to transitioning to net zero greenhouse gas emissions.

We are in a decisive decade to accelerate action to address climate change. As climate change has evolved to become a material financial issue for many, it is now uncontroversial that directors are duty-bound to diligently consider relevant foreseeable risks, and to integrate consideration of material climate impacts into strategy, risk oversight and disclosure functions[2]. The global shift in sustainability and climate reporting is being driven not only by rapidly-evolving policy and regulatory baselines, but by investors, customers, suppliers, financiers, employees and other stakeholders – all demanding greater transparency on the actions required to achieve climate and sustainability goals. Policymakers are responding to demands from business for greater guidance, and from investors for greater consistency and comparability in information.

1. **Minutes of meeting of the ISSB, 16 February 2023**
2. **World Economic Forum, Principles of Effective Climate Governance, 2019**; **CGI Australia Climate Risk Governance Guide**; **For Australian law authority refer to Hutley Opinions**.

STEP UP FROM TCFD

While the ISSB builds on the TCFD framework, the shift to ISSB-based mandatory reporting will be significant and will require companies to disclose climate information to a level of detail and granularity that is not found in current Australian, or indeed global, reporting practices. The depth of the challenge will differ from company to company, but there will likely be significant work to do irrespective of the current maturity of reporting. This adjustment will require significant upskilling for both those preparing the reports and for directors who are ultimately required to sign-off on the disclosures.

The ISSB reporting requirements are investor focussed and go above and beyond the TCFD in that they provide a detailed reporting framework and far more prescription than the TCFD's higher level guidelines, including a step up in the number of quantitative disclosures that are expected.

Some examples of where the ISSB standards are an uplift from the TCFD[3] are in respect of:

Disclosure of quantitative impacts on strategy for addressing climate-related risks and opportunities: Relating to organisation's transition plans, the proposals have explicit requirements around disclosure of emissions reduction targets and use of carbon offsets on the business's strategy.

Increased disclosure on industry-based metrics and greenhouse gasses: The ISSB standards require disclosure of industry-based metrics relevant to an organisation's industry and activities. The proposals also require a different disclosure treatment of greenhouse gases, including Scope 3 Greenhouse Gas (GHG) emissions (that is, those emissions in an organisation's value chain, but outside its business fence-lines).

Relevance of targets used by the organisation: Companies will need to explain how targets compare with the latest international agreement on climate change, whether this has been validated by a third party and whether the targets have been derived using a sectoral decarbonisation approach.

The ISSB standards are also wider than merely climate-related disclosures. As they are adopted, the application of detailed disclosure of qualitative and quantitative aspects will apply to a range of risks and opportunities across the sustainability spectrum (e.g., biodiversity, fresh water and human capital). This does not necessarily mean that Australia will adopt future ISSB standards though, as each implementation will be considered on its merits.

More recently, the ISSB has confirmed[4] that disclosure of Scope 3 emissions will form part of the climate-related disclosure standards, although this may be staged to apply later than the standard's other requirements. This presents both data availability and data quality challenges for companies required to report on these up or down the value chain, including those not directly within the reporting scope of the new standards.

3. **ISSB - Comparison of S2 Climate-related disclosures with the TCFD recommendations**
4. **ISSB unanimously confirms Scope 3 GHG emissions disclosure requirements**

RISKS AND OPPORTUNITIES FROM MANDATORY REPORTING

The imminent era of globally consistent climate and sustainability reporting introduced by the ISSB represents both a risk and an opportunity for directors. The risk of greenwashing[5] (overstating a company's climate or broader ESG credentials, or understating the relevant risks or valuation impacts) remains ever present, but this needs to be balanced with the risk of green-hushing (failure to disclose for fear of greenwashing). Board members can then balance these risks alongside the opportunities, including the competitive advantage that comes with showing stakeholders your commitment to balance environmental and social sustainability with profit[6].

LEGAL RISKS TO MANAGE

The move to ISSB-aligned mandatory climate reporting will require a significant uplift in capability for most Australian organisations and a major change in the nature and detail of climate information currently disclosed.

Directors will need to oversee the approach taken by management to balance the goals of fulsome market disclosure while appropriately managing legal liability risks. In particular, there will likely be significant scrutiny from regulators, investors and stakeholders of organisation's public statements and the need to be able to back them up with credible, reliable information (not just well-intentioned aspirations). Activist groups may be looking to commence 'strategic' litigation against organisations to trigger a shift in corporate strategy and potentially broader market behaviour.

Notably, the proposed ISSB climate standards require the disclosure of a significant amount of inherently uncertain forward-looking information to the market, and granular detail around transition plans.

Directors and senior management should look to what role external assurance can play in providing them with comfort to sign-off on reports and the confidence that their organisation is not unintentionally engaging in greenwashing. Treasury is currently consulting on what level of assurance would be mandated for climate disclosures in Australia, including by who that assurance should be provided and whether assurance providers should be subject to independence and quality management standards.

THE BOARD'S EVOLVING ROLE IN SUSTAINABILITY AND FINANCIAL REPORTING

To date, much of the focus on the role of directors in governing climate change has been in the context of internal discussions regarding corporate strategy and risk oversight. In many cases, external reporting has largely been confined to narrative disclosure relating to an organisation's material business risks affecting its future financial prospects[7]. However, investors and other external market stakeholders are continuing to demand more decision-useful information from sustainability-related corporate disclosures. Increasingly, they are seeking proof that companies have joined the dots between risk and consequence: that material sustainability-related variables and assumptions have been applied in the preparation of financial information.

Directors need to understand how climate- and sustainability-related risks impact their business to diligently discharge their duties in overseeing the preparation of their corporate reporting including sustainability and financial reporting. Of course, challenges remain – including in data quality. Accordingly, reporting entities may find themselves relying on proxy measures as reporting maturity evolves.

Now is the time for directors to consider the implications for their business and financial reporting of expected ISSB-based mandatory reporting. While directors are currently required to focus on material financial issues such as climate risk and other sustainability matters, the ISSB standards will require an evolution in thinking and disclosures across industries.

5. **Beware the risk of greenwashing**
6. **Directors "best interest" duty in practice**
7. Disclosure in the Operating and Financial Review (OFR) for listed entities in accordance with **ASIC Regulatory Guide (RG) 247.61 - .66**

AUSTRALIAN REGULATORY CHANGES

TIMELINE FOR LEGISLATIVE CHANGE

November 2021
ISSB announced at COP26. Climate prototype released

March 2022
ISSB publishes IFRS S1 and S2 exposure drafts

June 2022
AASB consultation and ASIC participation

July 2022
ISSB & AASB consultation period ends

November - December 2022
Cth. Treasury consulted on changes to the *ASIC Act 2001* to enable the AASB to deliver sustainability reporting standards

Dec 2022 onwards
Cth. Treasury consultation (Additional consultations likely)

June 2023
Anticipated release of final IFRS S1 and S2 Standards

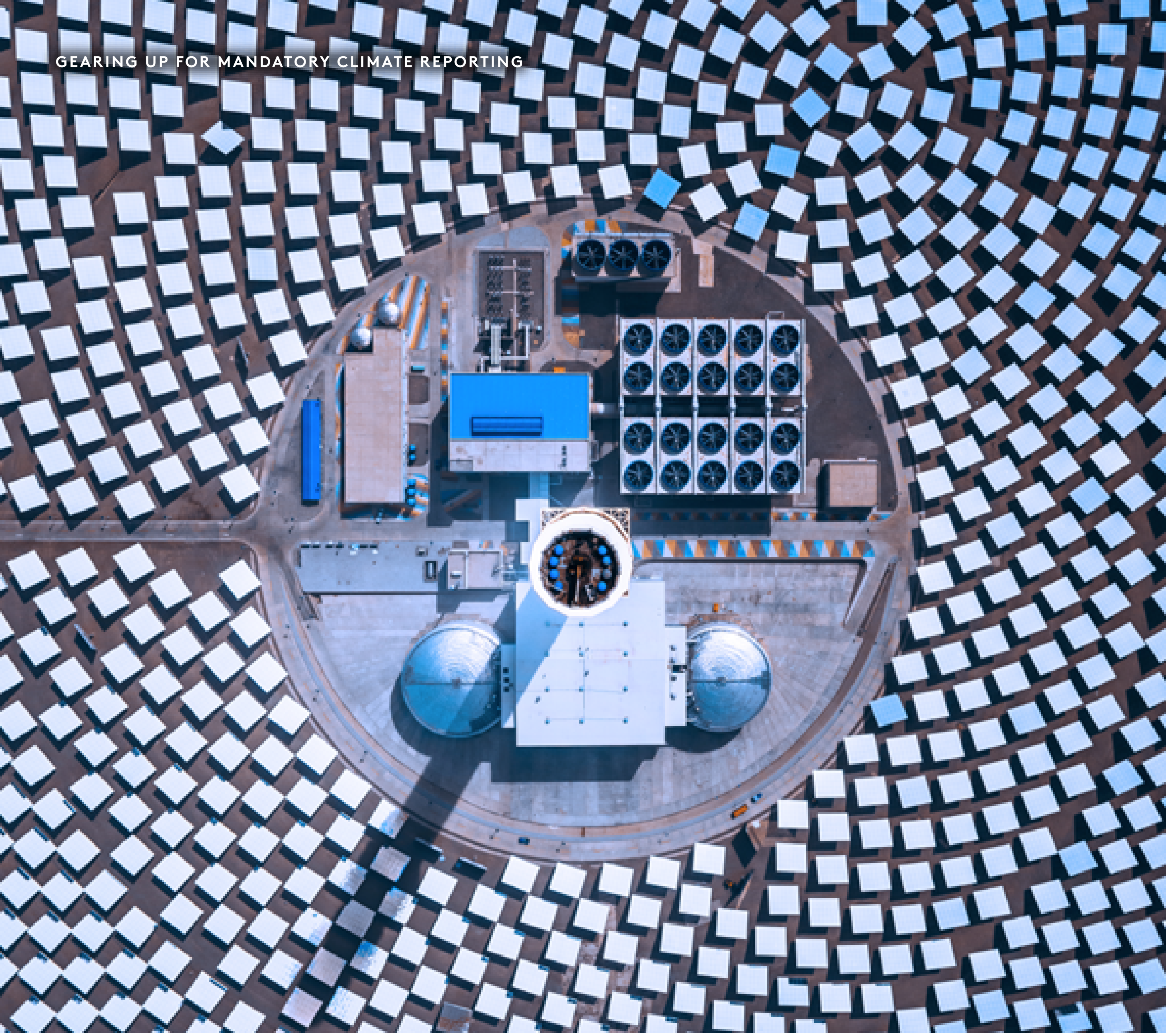
July 2024
Proposed mandatory disclosure in Australia

Treasury has given a strong indication of its intention to apply the ISSB standards in Australia (subject to considering domestic implementation issues). This means it is no longer a question of "if", but rather one of "who", "when" and "how". The key open questions that remain are:

Who
Which companies will be impacted first by legislation and what will the thresholds for reporting be?
Potentially large listed, heavy emitters and financial institutions in the first instance, but could be broader

When
From which date will disclosure and reporting be required?
First reports are likely for financial year 2024/2025

How
Will entities be required to report on scope 3 emissions in Australia? How will industry specific metrics be incorporated? Will they be mandated or recommended disclosures? How will these standards be regulated? Will independent third-party assurance over ESG disclosures be mandated and will this be limited or reasonable assurance?
All to be confirmed



THE CHALLENGE

So, how should directors approach the task?

> I wish [our organisation] had started this a couple of years earlier.
>
> — Chair of UK Listed Company subject to mandatory reporting.

A challenge directors face is getting ready for the ISSB standards within the current reporting and regulatory environment before the ISSB standards are finalised.

This challenge is also the biggest opportunity – getting ready now gives directors the chance to make sure their organisation is more resilient to the changing external landscape, can build stakeholder trust and create competitive advantage as the world transitions to a net zero economy.

ACTIONS BOARDS CAN TAKE NOW TO GET READY

Source: Final Report - Taskforce on Climate-related Financial Disclosures, June 2017, p v.

To help lead the way and make the most of this opportunity, boards can:

1. **Set a comprehensive and measurable climate and sustainability strategy:** This requires an ambitious, yet achievable, climate and sustainability ambition in the short, medium and long-term with tangible objectives and success measures. It will be important for this strategy to continually evolve and be revisited regularly to make sure it remains relevant and responsive to investor and stakeholder needs and any emerging regulations. Critically, in order to avoid the risk of greenwashing, public statements around those ambitions will need to be carefully framed drawing on expert advice.

   See CGI Australia's complimentary webinar on connecting climate change and strategy. Find out more in The Chairperson's Guide to Decarbonisation and The Chairperson's Guide to Climate Stakeholders;

2. **Set a robust governance structure that incorporates sustainability matters with clear and identified ownership and accountabilities:** The execution of the organisation's climate and sustainability strategy is the responsibility of senior management, with active oversight from directors. Boards should establish appropriate oversight structures and ensure climate issues are regularly brought on the board agenda commensurate with the materiality of the issues to their organisation.

   Find out more in Bringing together ESG: board structures and sustainability and the Climate risk governance guide; and

3. **Understand the gaps:** Directors should encourage senior management to assess the following and report back to the board:
   - **Capacity and capability:** Does the team have the capability and capacity to execute on an organisation's climate and sustainability strategy? This will require both sustainability and finance capability in a labour market experiencing skills shortages;
   - **Connectivity to the financial statements:** How the sustainability strategy connects through to the organisation's financial position and performance may require a change in approach to ensure that information and data is available at the right level to be able to do this effectively;
   - **Assess current disclosures against future requirements:** Understand how current disclosures measure up against future reporting requirements. This will enable the business to effectively plan ahead to address any gaps, and which stakeholders will need to be engaged; and
   - **Data:** The data challenge should not be underestimated. Data has continually proven to be one of the most significant challenges that come with new reporting requirements. We expect this challenge to amplify with the introduction of the sustainability standards. Data integrity, transparency, availability and verification are expected to be hurdles to implementing the new sustainability standards particularly when considering scope 3 emissions reporting. Conversely, **do not let perfection get in the way of progress** – set credible targets, take action based on the best available information, disclose any areas of material uncertainty and dependency and update where the data changes materially.

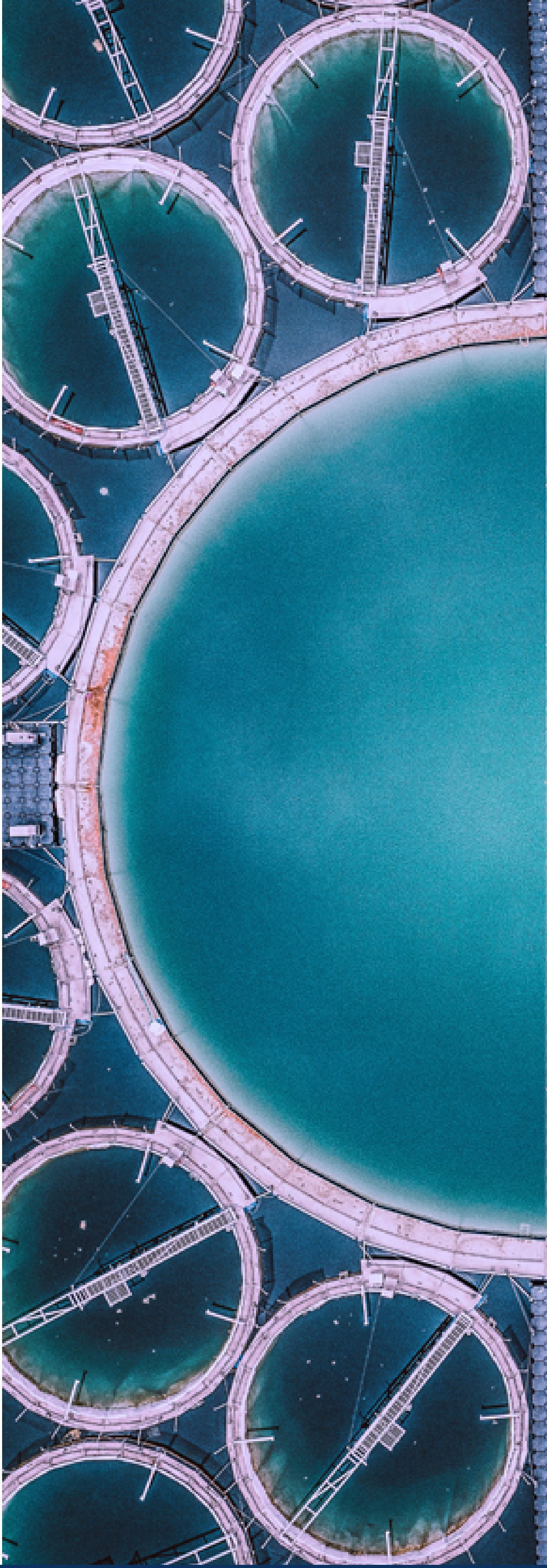
WHERE TO FROM HERE?

Many companies have already started preparations. Some will be able to draw on existing sustainability reporting (e.g., reporting on emissions, health & safety, modern slavery). The ISSB requirements and the anticipated Australian regulations are likely to be more extensive and pervasive. What is clear is that significant preparation will be required and starting early is key.

Key questions directors can ask to determine the level of preparedness:

- What is our readiness to comply with anticipated Australian regulations on sustainability reporting flowing from the ISSB standards?
- Does the board have the right competencies to govern sustainability-related risks and opportunities?
- What are the key sustainability-related risks and opportunities arising from requirements to report under local regulation?
- Will current systems, processes and training enable complete, accurate and timely reporting for ISSB sustainability-related financial information?
- What expert support do we need to draw on?

Look out for our next report due for release later in 2023, **a directors' guide to preparing for mandatory climate reporting in Australia**, providing more detailed insight into the climate and sustainability reporting landscape (starting with a focus on climate change).



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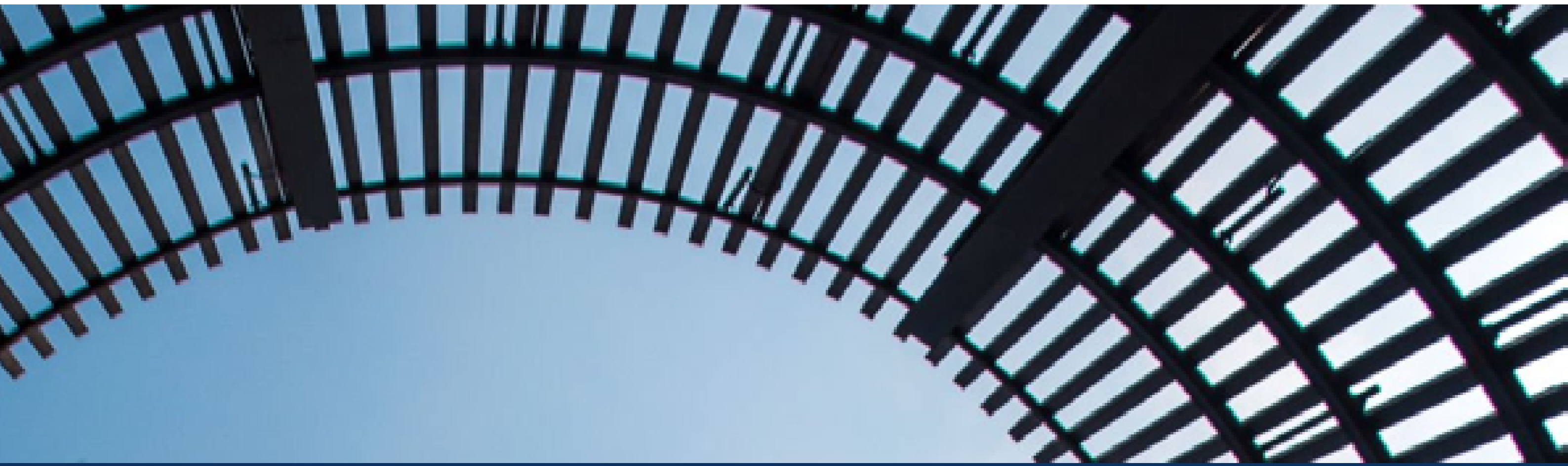

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