EIANZ's response to Treasury's climate-related financial disclosure Discussion Paper

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The Environment Institute of Australia and New Zealand is the peak body of environmental professionals in Australia and New Zealand. Through its code of ethics, it sets a high standard for environmental professionals to work to. The specific interests and skills base of the EIANZ lies in facts-based and ethical environmental practice and environmental protection.

Through broad based evidence that is well summarised in the 2021 State of Environment Report and the 2020 Samuel Review of the Environment Protection and Biodiversity Conservation Act, EIANZ acknowledges:

- The poor and deteriorating nature of many aspects of Australia's environment;
- The role that climatic events and climate change is contributing to this; and
- The need for urgent stronger policy direction, regulatory reform and Government action to stabilise and reverse the negative trends.

Furthermore, industry and business are contributing to and are affected by the environmental (and climate) burden, but they can lead in moving to an environmentally sustainable future and benefit from emerging "green" opportunities. Understanding and disclosing climate related financial information is an important foundation activity for this.

Consequently, the EIANZ welcomes Treasury's Discussion Paper on climate related financial disclosure and the opportunity to contribute. EIANZ supports the introduction of mandatory reporting of climate-related financial risk. Numbers in [red square brackets] throughout this document refer to the key questions raised by Treasury in its paper (these questions are included in the back of this document.

The purpose and principles of financial disclosure need greater definition

EIANZ considers that the discussion paper inadequately explores the purpose and principles behind financial disclosure. Further elaboration of this is required before disclosure details are finalised.

Within the discussion paper, there are three purposes provided for climate related financial disclosures [3], [5]:

- *Risks to firms* - Climate change poses as a significant Australian business risk and opportunity needing to be monitored, acted upon and disclosed. Investors and host communities (eg the Pilbara region of WA hosts much of Australia's iron ore mining) need to be appraised of the risks and opportunities.
- *Risks to the economy* - National economic growth and financial stability[1] will be threatened with progressive unmitigated climate risks or the sudden onset of regional scale disasters.
- *Risks to the climate* - Climate disclosure by business and industry will assist with Australia's transition to net zero emissions before 2050.

Understanding the differences between these three purposes is important as different reporting metrics will be required for each. For example:

- When considering the risks to firms, use of internal annual discount rates of 7 – 10 per cent promotes a focus on the current decade and a diminished concern for business impacts over a longer period. Such discount rates relate to firm-level risks, opportunity cost on capital and relative returns from secure government bonds. Under these practices, much business activity can achieve commercially acceptable rates of financial return by consuming "free" environmental goods and services without disclosing the true impact or making sufficient payment. Such practices may disclose few climate risks to the firm over *its* planning horizon but set the scene for ongoing unacceptable climate change and environmental damage[2].
- In comparison the climate problem is with us now and will continue forever. It is far more than a financial problem. It is an imperative to stabilise global temperatures (this century), by achieving net zero emissions (before mid-century) through decisive action this decade (ie 43 per cent reduction in Australia's emissions by 2030). Unlike funds which can move nimbly from one entity to another to limit becoming stranded, climate and biodiversity loss can't be shifted on a finite planet. Nature and ecosystem services need to be rapidly included in financial accounting and financial regulations.

Depending upon the agreed purpose of the climate related financial disclosures there will be differences in the numbers and types of businesses required to report and the materiality of reporting.

- Where the purpose is climate related, reporting should be government-led and very broad (see next section).

[1] A stable financial system is one that can provide essential services to households and businesses in good times and bad. https://www.bankofengland.co.uk/knowledgebank/what-is-financial-stability

[2] An additional challenge for Treasury to climate disclosure is to develop and implement financial risk assessment tools that accommodate environmental externalities and multi-layered time scales and risk scenarios. Treasury should require environmental accounting methods and default valuations for common ecosystem services to help encourage businesses and other reporting entities to act in a sustainable manner.

- Where the purpose is one of financial stability and economic performance, then the listed and unlisted organisations that most influence financial stability should be the focus of the reporting (this includes the lenders and the wealth managers of all Australians), including Treasury and the Reserve Bank and other financial system regulators.
- Should the purpose of the disclosure be to protect the interest of investors in and lenders to individual firms, then predominately listed firms should be included, and disclosure requirements should be integrated with existing ASX, ASIC and APRA risk reporting requirements.

The discussion paper merges the three purposes. The disclosure mandate and methodology will be stronger if there is greater clarity on purpose and principles.

For the EIANZ the primary purpose of disclosure is to achieve climate protection targets, with financial stability and investor protection being important secondary purposes. Climate change targets must be based on achievement of a sustainable climate, with net zero before 2050 [5].

A whole of country approach is required on climate-related financial disclosure

In protecting the national interest the Australian Government has an accountability for promoting climate action internationally, maintaining the economy and financial stability, driving domestic mitigation, making the environment and society resilient to climate change and assisting in the recovery when the inevitable happens. This can only happen when a whole of nation perspective to climate related financial disclosure is available and small but important environmental values aren't ignored. This requires government and government-owned entities themselves to institute nation-wide climate related financial disclosures at a similar level of detail to that expected of business [3].

- Government and non-listed entity activity represent a significant component of the Australian economy. Governments must shoulder their accountabilities particularly as National and State governments are in the unique position of being policy setters, regulators, developers and operators.
- EIANZ notes that Australian governments are already committed to climate related disclosures eg State of Environment Report, National Determined Contribution (via the UNFCC), Australia's Long-Term Emissions Reduction Plan: A whole-of-economy Plan to achieve net zero emissions by 2050 (also via the UNFCCC); and annual ministerial statements under the Climate Change Act 2022.
- This reporting is not as thorough as expected of corporations via the TCFD. Australia through its fossil fuel exports has significant Scope 3 risks, which need to be collectively reported and addressed by government (as well as separately by resource companies). Also the full impact of and necessary response to national weather and climate related natural disaster risks won't be comprehensively considered by most private sector entities. These areas require Government led reporting.
- Excluding entities not subject to the Corporations Act, such as trusts, will also cause substantial gaps in data and knowledge of Australia's climate-related

risk, and can lead to perverse incentives related to entity structuring to avoid reporting obligations.

The reporting methodology needs to accommodate international practice, diverse climate risks and be adaptive

In specifying a reporting methodology there should be a single-minded focus on the primary purpose for the reporting and getting the methodology right the first time. "Nice to include" items should not be added. The desire to customise and "improve" established reporting protocols should be resisted. The cost of continual modification and bespoke requirements adds significantly to reporting costs and often without benefit. Only changes from established methods that improve the reporting and/or avoidance or mitigation of climate change and loss of natural capital should be considered.

Disclosure scheme detail should promote both national consistency in reporting and international alignment. Getting disclosure scheme detail right requires pragmatism and understanding of the: diverse nature of financial risk amongst reporting entities; inherent complexity in quantifying climate related financial risks; and reporting maturity of the reporting entities. Investment in education and training across the relevant professional environmental, accounting and auditing disciplines will be needed.

The total climate related risk of a reporting entity is the sum of risks across its whole supply chain. The modified **SIPOC** model is useful for conceptualising this:

Suppliers → Inputs → Internal processes → Outputs →Customers

↑ ↓

← Reuse and recycling ←

(Circular economy)

With the supply chain being nested within a broader **circular economy**, **regulatory** and **stakeholder perception** framework.

Climate related financial risks lie across the whole cycle. However, depending upon the business, the dominant contributors are likely to skewed to the left, right or predominantly towards the centre.

- Where the distribution of risks and opportunities are skewed or unreported by the suppliers or customers, it will be necessary that Scope 3 emission items are reported.
- Generally, EIANZ supports following the lead of the new International Sustainability Standards Board (ISSB) [4], [7], recognising that substantial effort has been invested by that organisation. Where possible (but also see next bullet point) consistent metrics enable aggregation and subsequent

development of a broader understanding of Australia's climate risk, as well as comparison between entities, and would limit greenwashing.

- Slavishly requiring standardisation of reporting to the level that all reporting fields can be numerically and parametrically aggregated should be resisted [10]. The nature of climate risk, the complexity of risks across the whole supply chain and differences in risk understanding and approaches by managers mitigates against disclosure being a mechanical box filling exercise. Complete standardisation will not be easy to proscribe.
- International standardisation will likely be important for continued Australian access to international markets [4].
- Approaches to maximise transparency, whilst avoiding double counting of emissions and greenwashing needs to be sought.
- The EIANZ is not persuaded that larger firms should take the lead on reporting. Climate related risks are complex and there is no guarantee that risks to a business and its size are correlated. Furthermore, all reporting entities will take time to establish a reporting rhythm and maturity – it is important that all climate exposed organisations start this journey as soon as possible and where necessary to have access to assistance from credible authorities [2].
- Development of a reporting framework that allows for future incorporation of other sustainability reporting should not hold back implementation of climate risk reporting. [17]

The EIANZ supports a progressive phase-in for reporting requirements, in order that reporting entities can ramp up both their skills and confidence of their disclosures. For example, in the first-year disclosure might be largely qualitative - highlighting the key risk and opportunity areas, the relative magnitude of the risks and the actions to be taken to remedy information gaps. The second year would then be expected to move to quantitative reporting, and the report in the third year to have addressed deficiencies that emerged when quantitative reporting was undertaken. This approach can allow for reporting obligation to be allocated on the basis of materiality rather than size of firm. In all subsequent years mitigation measures and their effectiveness should be included.[3] [12]

Disclosure without meaningful implementation and assurance is of little benefit and tends toward greenwashing

A total quality management approach (Plan, Do, Check and Act) to climate related financial reporting is required. Disclosure systems remain immature whilst they emphasise the current state of play and proposed work plans (Plan and Do), whilst failing to report on action plan implementation and carbon risk mitigation success (Check and Act). It is essential that disclosure tracks actions and success [11].

The basis of reported carbon risk mitigation success must also need to be transparent and substantiated. The methodologies employed for emissions accounting and claiming of credits and offsets must be credible and specified. The regulator could

[3] One option is for reporting entities to sign up to say a 5 year disclosure program with each year setting goals with a move towards more quantitative and comprehensive disclosure. Entities could be provided with incentives for signing up.

assist here by endorsing approved reporting, credits and offset schemes and methodologies [10].

Equally important is faith in the process. Auditing and assurance are integral. EIANZ supports high quality assurance as a requirement. Assurers need to be credible and independent. Assurance needs to be fit for purpose, and not unnecessarily onerous. Risk assessments and management strategies contain subjective components. Assurance protocols should not be simply lifted from financial accounting assurance. Equally qualitative disclosure parameters should not be ignored with the primary focus being on quantitative emissions data [8].

Assurance is an additional cost. Annual disclosures and risk profiles, once maturely established, may change slowly year to year. Consideration should be given to reducing the assurance burden for stable businesses with an already assured and unqualified disclosure (eg biennial or triennial assurance) [8], [12].

Climate related disclosures will be centred around disclosing known unknowns

Climate risk disclosure requires an assessment of the long term and hence includes much uncertainty. They are extremely valuable and important for the insights they bring, but they cannot accurately predict an uncertain future. Consequently, EIANZ does not endorse the mandated use of standardised scenarios. Such a mandate may encourage group think and discourage creative thinking about the future by a diverse set of business leaders.

However, what could help reporters would be a central bank of modelled scenarios (models). Reporters then would have opportunity to pick and choose consistent with their views of the emerging world. The modelled scenarios could be maintained by Treasury, CSIRO or possibly an academic institution [10], [13.1].

Reporting requirements should include evidence of resourcing for transition plans and verification of offsets. [11]

Oversight of climate related risks needs to be separate from conventional financial risks

Combining oversight and assurance of climate disclosures with that historically established for conventional accounting and financial disclosure practices is not supported. There remain key differences in methods, perceived importance, understanding and maturity between sustainability-related and financial focused reporting.

EIANZ supports Structure 2 Establish a separate sustainability standards board. Such a structure would also facilitate the future inclusion of other environmental and sustainability parameters – where the purpose of reporting extends past a health check on an individual enterprise and into the health of the financial system and the supporting natural environment [19].

Key consultation questions in the Treasury Discussion Paper

Question 1: What are the costs and benefits of Australia aligning with international practice on climate-related financial risk disclosure (including mandatory reporting for certain entities)? In particular:

> 1.1 What are the costs and benefits of meeting existing climate reporting expectations?
> 1.2 What are the costs and benefits of Australia not aligning with international practice and in particular global baseline standards for climate reporting?

Question 2: Should Australia adopt a phased approach to climate disclosure, with the first report for initially covered entities being financial year 2024-25?

> 2.1 What considerations should apply to determining the cohorts covered in subsequent phases of mandatory disclosure, and the timing of future phases?

Question 3: To which entities should mandatory climate disclosures apply initially?

> 3.1 What size thresholds would be appropriate to determine a large, listed entity and a large financial institution, respectively?
> 3.2 Are there any other types of entities (that is, apart from large, listed entities and financial institutions) that should be included in the initial phase?

Question 4: Should Australia seek to align our climate reporting requirements with the global baseline envisaged by the International Sustainability Boards?

> 4.1 Are there particular considerations that should apply in the Australian context regarding the ISSB implementation of disclosures relating to: governance, strategy, risk management and/or metrics and targets?
> 4.2 Are the climate disclosure standards being issued by the ISSB the most appropriate for entities in Australia, or should alternative standards be considered?

Question 5: What are the key considerations that should inform the design of a new regulatory framework, in particular when setting overarching climate disclosure obligations (strategy, governance, risk management and targets?

Question 6: Where should new climate reporting requirements be situated in relation to other periodic reporting requirements? For instance, should they continue to be included in an operating and financial review, or in an alternative separate report included as part of the annual report?

Question 7: What considerations should apply to materiality judgements when undertaking climate reporting, and what should be the reference point for materiality (for instance, should it align with ISSB guidance on materiality and is enterprise value a useful consideration)?

Question 8: What level of assurance should be required for climate disclosures, who should provide assurance (for instance, auditor of the financial report or other expert), and should assurance providers be subject to independence and quality management standards?

Question 9: What considerations should apply to requirements to report emissions (Scope 1, 2 and 3) including use of any relevant Australian emissions reporting frameworks

Question 10: Should a common baseline of metrics be defined so that there is a degree of consistency between disclosures, including industry-specific metrics

Question 11: What considerations should apply to ensure covered entities provide transparent information about how they are managing climate related risks, including what transition plans they have in place and any use of greenhouse gas emissions offsets to meet their published targets?

Question 12: Should particular disclosure requirements and/or assurance of those requirements commence in different phases, and why?

Question 13: Are there any specific capability or data challenges in the Australian context that should be considered when implementing new requirements?

> 13.1 How and by whom might any data gaps be addressed?
> 13.2 Are there any specific initiatives in comparable jurisdictions that may assist users and preparers of this information in addressing these challenges?

Question 14: Regarding any supporting information necessary to meet required disclosures (for instance, climate scenarios), is there a case for a particular entity or entities to provide that information and the governance of such information?

Question 15: How suitable are the 'reasonable grounds' requirements and disclosures of uncertainties or assumptions in the context of climate reporting? Are there other tests or measures that could be considered to ensure liability is proportionate to inherent uncertainty within some required climate disclosures?

Question 16: Are there particular considerations for how other reporting obligations (including continuous disclosure and fundraising documents) would interact with new climate reporting requirements, and how should these interactions be addressed?

Question 17: While the focus of this reform is on climate reporting, how much should flexibility to incorporate the growth of other sustainability reporting be considered in the practical design of these reforms?

Question 18: Should digital reporting be mandated for sustainability risk reporting? What are the barriers and costs for implementing digital reporting?

Question 19: Which of the potential structures presented (or any other) would best improve the effectiveness and efficiency of the financial reporting system, including to support introduction of climate related risk reporting? Why?

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https://www.eianz.org/about/climate-change/climate-change-special-interest-section

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