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**Response to the Climate-related financial disclosure: exposure draft legislation and accompanying explanatory materials**

We write in response to your consultation at https://treasury.gov.au/consultation/c2024-466491 concerning the Exposure Draft legislation which seeks to amend parts of the *Australian Securities and Investment Commission Act 2001* and the *Corporations Act 2001 (Cth)* to introduce mandatory requirements for Australian entities to disclose their climate-related risks and opportunities.

We are a collective of Australian scholars, based in Australia, dedicated to advancing research in the fields of sustainability and climate change accounting and reporting. As signatories, we are affiliated with the Social and Environmental Sustainability in Organisations (SESIO) Research Group at Swinburne University of Technology, Australia. Our mission within SESIO is to generate insights that enable organizations to avoid unethical, socially, and environmentally harmful business practices, while also providing actionable intelligence to policymakers to foster sustainable business environments. The SESIO research group serves as a nexus, bringing together academic and industry researchers along with practitioners from the business, government, and civil society sectors, both within Australia and on a global scale. The Consultation Paper addresses issues that are of great significance to the society and environment and, therefore, to the stakeholders of the SESIO research group.

We support the mandatory climate risk disclosures and the assurance of disclosures. Reliance on ED SR 1 *Australian Sustainability Reporting Standards – Disclosure of Climate-related Financial Information*, once it becomes finalised gives a workable framework for climate-related reporting that can evolve with other Standards to encompass sustainability issues more broadly. A mandate is needed because disclosure of risks associated with climate change can be pejorative for companies, their shareholders, and key personnel such as CEOs, if not forced on all companies as the experience with the Task Force on Climate-related Financial Disclosure Recommendations has shown.

We advocate for a robust sustainability reporting framework which not only facilitates organisations in recognising and reporting on financially material climate-related risks but also organisations' impacts on the society and environment that do not have any consequences on the financial position, performance or cashflows of the organisation (i.e., impact material sustainability-related disclosures). Investors and other stakeholders are increasingly concerned about businesses’ impacts on the environment and society regardless of the direct financial effects of those impacts on the business. Therefore, our position is that the sustainability reporting framework adopted in Australia should be based on the principle of double materiality, similar to the approach taken in Europe. While we commend the government's objective to harmonise Australian sustainability reporting with the International Sustainability Standards Board's (ISSB) standards, we advocate for an approach that does not discourage the use of other frameworks, such as the GRI Standards, which emphasise impact materiality. It is crucial that entities retain the flexibility to report on the full scope of their sustainability impacts.

<u>Overall approach</u>

1. Alignment between the policy intent and approach adopted in the Exposure Draft Legislation.

To assert that sustainability reporting solely serves to help investors navigate risks and identify financial prospects is to overlook the profound societal and environmental transformations that climate change and the journey to net zero entail. Such a narrow focus fails to consider the broader implications for Australian life, work, and global interactions. We posit that this perspective does not align with the best interests of the Australian economy nor, more significantly, with the Government's responsibilities in accordance with the Public Trust Principle whereby public officers (e.g., public servants, MPs, Minister) must put the public interest ahead of all other interests (i.e., ahead of the interests of investors, asset-holders, etc.). The public interest in regulation prioritising effective climate action must prevail.

Notwithstanding, the Treasury's proposal does not facilitate the government to adequately meet the objective of enabling regulators to effectively identify and manage systemic financial risks that arise from climate change and efforts to mitigate its effects. This is because it overlooks the broader spectrum of systemic risks originating from businesses’ impacts on the climate. The Exposure Draft's reliance on the IFRS S2 *Climate-related Disclosures* restricts the scope of reporting to direct business impacts (i.e., financially material climate-related impacts on the business), sidelining indirect yet significant systemic risks originating from businesses’ impact on the climate. This limitation undermines the regulators' capacity to fully assess and mitigate climate-related systemic risks to the financial system. A more comprehensive approach, capturing both financially and impact material sustainability-related information, would better align with the overarching goal of enhancing financial system resilience against climate-related risks. The GRI Standards already guide the reporting of materially impactful information, and the European Union, through its Corporate Sustainability Reporting Directive, mandates the concept of double materiality for comprehensive sustainability-related disclosures. We strongly recommend that the Treasury adopts this double materiality approach for sustainability reporting to align with the policy intent of the proposed legislation. Implementing such a framework would ensure that both the financial impacts of climate change on businesses and the impacts of businesses on the climate are thoroughly reported and assessed.

To this affect, we recommend an inclusion of a directive that requires entities to report on the true and fair view of the quantitative and qualitative impacts arising out of double materiality, outside-in-perspective (how sustainability issues affect the entity's business) and inside-out perspective (how the entity's operations impact society and environment).

<u>Entities subjected to the new regulation.</u>

2. Exclusion of asset owners from Group 1

The exclusion of asset owners from Group 1 lacks justification, given the urgent need for these entities to begin disclosing their climate-related risks. Prompt and comprehensive reporting on such risks is critical, as it equips asset owners to meet the escalating demand from investors for transparency in this area. Moreover, as the market increasingly favours sustainable investments, the ability of asset owners to provide detailed information on climate risks is not only a matter of regulatory foresight but also a strategic imperative that aligns with investor priorities and market trends.

3. Determining materiality

Only those Group 3 companies with material climate-related risks or opportunities are subject to the mandatory climate-related financial disclosure requirements.

- Materiality Criteria: The legislation does not specify the criteria for assessing whether climate-related risks or opportunities are deemed 'material'. A defined framework for materiality assessment is essential for consistency and comparability across reports.

- Opportunities vs. Risks: The legislation does not expressly state if entities that encounter material climate-related opportunities, in the absence of material risks, are still obliged to disclose this information. This distinction is important for entities primarily experiencing positive sustainability impacts, as their reporting obligations may differ.

- Reporting Period Clarification: It remains unclear whether 'materiality' pertains to the period for which the sustainability report is being prepared, or if it anticipates the forthcoming reporting period. This distinction is crucial for entities as they assess and report on climate-related issues.

<u>Reporting content of the disclosure</u>

4. The absence in the legislation of any mention of 'greenwashing' by sustainability report preparers or a definition of greenwashing.

It will be very difficult for auditors or assurance providers, however labelled, to prevent or deter greenwashing, which much academic research reveals as evident in current sustainability reporting, climate-related or otherwise. Similarly, without clear legislative guidance on what greenwashing is and the penalties to be applied for engaging in it, regulators such as the

Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) find it difficult, although not impossible judging from existing regulatory actions, to identify and prosecute greenwashing. Greenwashing in non-financial information is synonymous with manipulating accounting numbers in financial information, but much harder to achieve accountability for. Could more attention be given in the Bill to this issue?

5. Preparing consolidated sustainability reports by groups

The draft legislation mandates that a parent entity is to compile a consolidated sustainability report for the entire group, incorporating the environmental data from its subsidiaries in a manner analogous to the preparation of consolidated financial statements. This approach ensures a comprehensive overview of the group's sustainability performance, including Scope 1, 2, and 3 greenhouse gas emissions, by aggregating data across all subsidiaries to reflect the group's total carbon footprint. In the consolidation process, to remove the impact of intra-group transactions, Scope 1 and 2 emissions from entities down the supply chain must be reclassified as Scope 3 emissions for the entity acquiring outputs within the group. This approach has two implications. Firstly, it alters the emission profile presented in the consolidated report, diverging from what would be depicted if each entity reported its emissions independently. Secondly, with the legislation providing a grace period for reporting Scope 3 emissions, the comprehensive carbon impact of subsidiaries—particularly where their outputs serve as inputs for other group entities—might be underreported initially. This could delay a full understanding of the group’s climate impact, underscoring the importance of strategic planning for Scope 3 emission reporting to capture the entire value chain's environmental footprint.

As per AASB 10 'Consolidated Financial Statements', if the ultimate parent is not an Australian entity but there exists an Australian intermediate parent with control over Australian entities, then the Australian entity may be required to prepare consolidated financial statements, including all subsidiaries, both foreign and domestic, unless certain exemptions apply. We propose that this principle should extend to the preparation of consolidated sustainability reports. In the absence of the Australian equivalent to ISSB’s Sustainability Disclosure Standards, which does not include this requirement, it would be prudent for the *Corporations Act* to explicitly mandate such reporting.

6. Other statements relating to environmental sustainability-related financial matters

As per the Exposure Draft Legislation the Minister may make rules to require other statements relating to matters concerning environmental sustainability to be included as part of the sustainability report. This statement limits the ability of the Minister to require other sustainability-related disclosures to be part of the sustainability report as it only pertains to ‘environmental’ matters. Sustainability reporting extending to risks associated with social aspects and societal impacts of companies should also be part of a sustainability report as it is traditionally conceived. Therefore, we recommend the following amendment to paragraph s296A (c) “the Minister may, by legislative instrument, require a sustainability report to include statements relating to matters concerning social or environmental sustainability.”

7. Measuring Scope 3 emissions by banking and insurance industry

Financial institutions play a pivotal role in realising Australia's commitment to achieving net zero emissions by 2050, as they oversee capital flows necessary for financing a transition to a decarbonised economy. Scope 3 emissions represent the most pertinent climate impact of financial institutions. The insurance industry plays a pivotal role in driving the transition to net-zero through its functions as risk managers, reinsurers, and investors. Approximately 95% of emissions in the insurance industry fall within scope 3, presenting challenges in tracking, categorising, and reducing them. The task of quantifying the carbon footprint of financial institutions is fraught with complexity, especially when accounting for Scope 3 emissions, which include those emissions indirectly financed by the institutions' lending and investment activities (financed emissions), as well as those associated with underwriting (insured emissions). To surmount these methodological hurdles, we advocate for the development and enforcement of a robust set of industry-wide standards and measurement methodologies. Such uniformity would ensure that the carbon accounting practices of each financial entity are both consistent and comparable, thereby enhancing the credibility and utility of the reported data. This would also facilitate a transparent benchmarking of environmental impact across the industry and contribute to the global efforts to mitigate climate change.

While the report acknowledges the importance of utilising well-established industry-based metrics where feasible, we recommend placing greater emphasis, in collaboration with the Australian Prudential Regulation Authority (APRA), on developing standardised measurement techniques for Scope 3 emissions. Such an approach would foster increased transparency and comparability across industries, thereby facilitating informed decision-making and alignment with climate goals.

<u>The reporting Framework</u>

8. Scope of the proposed sustainability report

Traditionally, a sustainability report refers to a separate report prepared by companies (in addition to an annual report) to communicate sustainability related information. These reports have typically included information about the company's impacts on the environment and society, as well as social and environmental risks and impacts on the business. However, the Exposure Draft Legislation requires companies to include the sustainability report in their annual reports. This has the potential to create confusion among report users. Moreover, the content in the proposed sustainability report cannot include disclosures relating to impacts of the business on the society and environment. This is because the ISSB standards, which dictate the information that must be disclosed in these reports, do not require such disclosures. If the legislation is not changed to give effect to double materiality, then we urge the Treasury to use a different term to refer to the report containing sustainability-related disclosure in the annual report, recognising that the content therein is limited to financially material sustainability-related disclosure. However, the most suitable course of action would be to expand the scope of the sustainability report to include impact material information, as stated in our previous comment, thus retaining the phrase ‘sustainability report’.

The assurance framework

9. Use of terminology

The use of the term ‘audit’ and ‘auditor’ when ‘assurance’ is used more generally in the profession in respect of assuring the credibility of non-financial disclosures is potentially confusing.

10. Requirement for the financial auditor to conduct assurance of the sustainability report

The concern for auditor independence intensifies when financial auditors are also tasked with the assurance of sustainability reports. This dual role may lead to a perceived or actual conflict of interest, undermining the fearless independence required for auditor opinions. Furthermore, the legislative proposal to limit the eligibility for providing sustainability report assurance to registered auditors only, precluding other consultancy firms currently offering these services, risks intensifying auditor-client dependency. This issue is further aggravated by the predominance of the Big 4 audit firms within the Australian market, which could potentially lead to a concentration of influence and a reduction in the diversity of independent perspectives in the assurance space.

The level of interlocking directorates in Australia and lack of restriction on the number of directorships held compound the problem even more, because there is much academic research that shows common directors across companies tend to engage common audit firms across those networked companies. Auditing is a credence good, the quality of which needs to be experienced to be evaluated. Networks of directors create trusted sources of information, and it is not surprising that interlocked directors tend to be associated with the same audit firms, but the proposed legislation risks compounding this problem.

The scarcity of auditors in Australia possessing the necessary expertise for the assurance of climate-related and broader sustainability reporting has led to a market where services are predominantly provided by the Big 4 accounting firms. These larger firms have the capacity to invest in specialised training and technology, allowing them to develop the required skill sets more effectively than their smaller counterparts. The proposed legislation, excluding other assurance providers, intensifies the existing skills gap and clients’ dependence on their financial auditor. Without a corresponding strategy to widen the pool of qualified auditors, this situation risks creating a bottleneck in the assurance services market, hindering the legislation's effective implementation and the timely adoption of these crucial reporting practices.

In summary, while this joint provision can bring knowledge spillovers, the combination of unlimited multiple directorships and restricted numbers of competent audit and assurance providers mean that ‘independence’, the cornerstone of audit along with competence, potentially will be threatened more than ever.

Amendments to the Corporations Act

11. Proposed s296A is equivalent to current S295. We suggest S296A be part of S295 (we note proposed s296B has no current equivalent. Nonetheless, as proposed s296A and B are interrelated, together they should be placed with current s295.

12. s295A mandates a declaration in relation to listed entity's financial statements by chief executive officer and chief financial officer. To support better quality reporting, we suggest the incorporation of an equivalent requirement of declaration for sustainability reports.

13. For the sake of clarity and uniformity, we recommend the introduction of a section analogous to the current s296, which requires a statement indicating compliance with accounting standards and regulations. This new section would specifically require adherence to sustainability standards and regulations.

14. In mirroring existing s297 concerning financial reports providing a true and fair view, we propose the introduction of a parallel provision. This provision would necessitate that climate statements and accompanying notes for a financial year reflect a true and fair view.

<u>Terminology</u>

15. Sustainability Standards

The term 'sustainability standards' is misleading when used to denote the standards used for sustainability reporting. The Australian Accounting Standards board uses the label 'Australian Sustainability Reporting Standards' and the ISSB 'Sustainability Disclosure Standards'. This proposed phrasing in the Exposure Draft Legislation suggests a broader remit beyond reporting, implying it encompasses the actual sustainability practices and initiatives within organisations. To avoid ambiguity, it is critical to differentiate between standards that guide reporting and those that dictate operational conduct regarding sustainability. A more precise term such as 'sustainability reporting standards' would better confine the scope to the disclosure of sustainability information, ensuring clarity in legislative and regulatory language.

<u>Policy Impact Analysis (2023)</u>

There are several features of the design of the Treasury Policy Impact Analysis (2023) that cause concern, and these are briefly discussed[1]. Through these discussions, our submission

[1] More than 25 years have passed since the Howard government introduced its Corporate Law Economic Reform Program (CLERP) Policy Reforms (1988) to "improve Australia's business and company regulation as part of the Coalition Government's drive to promote business, economic development and employment" (page iii). The included CLERP Accounting Standards Reforms were designed to:

1. Lower costs of capital.
2. Maintain investor confidence.
3. Not impose excessive and unnecessary costs on business.
4. Produce high quality accounting standards.
5. Enable Australian companies to compete on an equal footing overseas through harmonisation of accounting standards with (the antecedent) International Financial Reporting Standards.

https://treasury.gov.au/sites/default/files/2019-03/clerp.pdf
The Treasury Policy Impact Analysis (2023) design emphasises factors 1-3.

shows how the Treasury recommendation for the Australian Government to adopt Option 1b is founded on a weak analysis and is incongruent with the objective of the Government's commitment to introducing standardised, internationally aligned requirements for mandatory disclosure of climate-related financial risks and opportunities in Australia for large business.

- Costs and benefits of digital technology adoption: The 2023 Intergenerational Report observes the expanded use of digital and data technology and climate change and the net zero transformation as two of five factors that will influence the future path and structure of our economy and change how Australians live, work, and engage with the world. By ignoring the expanded use of digital and data technology including current and proposed developments in the use of AI (see for example "Meet ChatPwC, the custom-built AI tool" AFR 6 February 2024), we suggest Treasury's assessments of the costs to business is flawed.

- Costs and benefits of digital reporting: The ISSB and the Global Sustainability Standards Board (GSSB) of the GRI are developing digital taxonomies to facilitate structured digital reporting of sustainability-related information prepared applying the ISSB Standards or GSSB Standards. The Treasury analysis ignores costs and benefits arising from these developments to improve the global accessibility and comparability of sustainability information for stakeholders.

- Cost of disclosing business impacts: The Treasury's analysis of the business impact costs appears predicated on a narrow view of materiality—a stance we believe is fundamentally flawed and inadequate in capturing the full spectrum of sustainability impacts. In contrast and consistent with the Intergenerational Report, it is for the AASB and not Treasury to decide whether sustainability reporting should serve as a deeper indicator of corporate responsibility, ensuring companies act in the broader, long-term interests of society. The resulting assessment of the costs to business would be both different and holistic if the double-materiality concept was applied.

- Assurance: Currently, the Auditing and Assurance Standards Board (AUASB) Standard on *Assurance Engagements ASAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information* applies to a reasonable assurance engagement or a limited assurance engagement when the subject matter information is a sustainability report. Finalisation of an international standard on sustainability assurance currently underway would result in a subject-matter specific ASAE that applies when the subject matter information is a sustainability report in addition to ASAE 3000. With ASAE 3000 first issued in June 2014, we think the Treasury analysis overstates the problems of capability uplift required in the assurance and audit industry and the uncertainty in determining how long this could take.

<u>Exposure Draft Explanatory Material</u>

The Exposure Draft Explanatory Material document exhibits notable discrepancies in its use of terms, leading to potential confusion. For instance, the document uses 'sustainability disclosure report' and 'sustainability report' interchangeably, though they may carry different connotations. Additionally, section 296A(c) employs the term “environmental sustainability-related financial matters”, diverging from the Exposure Draft Legislation's language of “matters concerning environmental sustainability”. The insertion of 'financial' unduly narrows the scope of mandatory sustainability information, potentially restricting the breadth of environmental data required for comprehensive sustainability reporting.

Adherence with the principles of open government

Australia is a member of the Open Government Partnership (OGP) and has committed to its principles, set out in the Open Government Declaration. Accordingly, each decision and action of Government should reflect those commitments, where and as relevant. The Treasury Laws Amendment Bill generally reflects those OGP commitments, except as otherwise indicated. However, there is scope to further strengthen Australia’s OGP commitments through amendments suggested below.

- Small and medium entities should be progressively required to provide climate related financial disclosures, consistent with zero emissions by 2050, with all required to disclose not later than 2050.
- Where the Minister makes “rules to require other statements relating to matters concerning environmental sustainability to be included as part of the sustainability report” civil society must be engaged, the rules must be published, and must be disallowable by either House.
- The business of an AGM must (rather than may) include the consideration of a sustainability report.
- The proposed maximum penalties under the current framework appear notably insufficient. With ‘one penalty unit’ valued at $192.31 for the fiscal year 1 July 2023 to 30 June 2024, a fine amounting to 50 penalty units totals merely $9,615.50. When juxtaposed with the penalties under the EPBC Act, where breaches can attract up to 5,000 penalty units for individuals and up to 50,000 units for corporations, the discrepancy becomes stark. Having regard to the existential implications of the offences, it is reasonable to argue for a significant increase. A tenfold increase of the penalties, resulting in a new ceiling of 500 penalty units equivalent to $96,155.00, would provide a more appropriate deterrent commensurate with the severity of the infractions.
- The stipulated period of ‘15 sitting days of that House’ for tabling a report in Parliament, after it has been presented to the Minister, could result in an excessively protracted interval. For instance, a report submitted on the 9th of February 2024 might not be tabled until as late as the 16th of May 2024. This duration could hinder timely dissemination and review of the report's contents. A reduction of this interval to five (5) sitting days would ensure a more prompt and efficient handling of these critical reports,

facilitating swifter legislative or regulatory action and maintaining the momentum of transparency and accountability.
- Where the Minister makes a legislative instrument, civil society must be engaged, the legislative instrument must be published, and must be disallowable by either House.

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