

Melbourne Climate Futures



THE UNIVERSITY OF
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Submission to the Treasury's Consultation on Climate-related Financial Disclosure

The Australian Treasury is seeking public input into a potential framework for climate-related financial risks, and it has issued a Consultation Paper which includes several issues related to the design and implementation of such a framework.

This submission is based on consultation with academics and experts from the University of Melbourne, as part of the Melbourne Climate Futures (MCF) initiative. MCF brings together academics from across all disciplines at the University, to develop evidence-based and practical solutions to climate related challenges. In 2023, MCF will launch a Sustainable Finance Hub which, among other areas, will work on issues related to climate-related financial risks.

The submission responds briefly and directly to each of the questions included in the Consultation Paper (Part A) and includes some matters for consideration for future policy development related to climate-related risks (Part B).

The authors of this submission would welcome the opportunity to provide the government with further details or commentary in relation to any of the questions below.

Part A: Responses to questions raised in Consultation Paper

Process

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?

There are a variety of stakeholders to whom costs and benefits accrue as a consequence of climate-related financial risk reporting regimes. These include, among others: firms subject to such reporting requirements and their investors, firms who provide climate-related reporting services, governments and regulators who oversee disclosure regimes and members of the public now and in the future. In this submission, we focus on the costs/benefits for reporting firms, their investors, and the public sector.

Given the measurement and conceptual complexities involved (Christensen et al, 2021), it is important to have a rigorous and informed debate about the costs and benefits of climate reporting. Firms potentially face direct costs if significant changes are made to the reporting requirements that apply to them. Where these costs do occur, they are likely to be visible in dollar terms and be immediate (short term) in nature. However, while benefits from this additional reporting may flow to the firms, they are unlikely to be immediately evident in dollar terms. Such benefits are likely to be derived within firms where improved reporting leads to better information and

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systems and an enhanced ability to understand and manage their exposures related to climate change and other sustainability issues. Additionally, firms and their directors, who are facing increasing legal liability related to their management of climate-related risks may also benefit from clearer reporting guidance.

A greater benefit will likely be for report users and society more generally. Research has provided evidence of benefits from providing information to investors, with concomitant effects on market valuations.

Governments and financial regulators may also benefit from climate-related reporting. If done in a consistent and comparable way, disclosure can support financial system stability by providing investors with information to manage climate-related risks and opportunities. However, inconsistent climate disclosures across the economy may have the opposite effect, creating instability due to sudden capital flight from voluntarily disclosing and climate-risk affected firms (Griffin and Jaffe, 2022). Ultimately, the financial stability benefits that governments and regulators enjoy from better climate-related financial information will rely on them having the skills and resources to be able to interpret and analyse disclosures and supervise firms; this will involve some costs for government on an ongoing basis.

In sum, the costs of climate-related financial reporting mostly fall on firms in the short term and the benefits are most likely to accrue to investors, the public, and governments. Benefits to firms will be indirect and over a long time horizon. Despite this imbalance in costs and benefits, the Government should continue to consider introducing a climate-related financial risk reporting regime to address the current deficit of standardised and comparable climate-related information, and to help internalise the costs of greenhouse gas emissions.

Failing to align with international practice on climate-related financial disclosure will put Australian firms at a global competitive disadvantage and could constrain the flow and/or increase the costs of capital into the country. This will likely result in direct and indirect costs for firms, their investors and the economy.

References

- Christensen, H.B., Hail, L. & Leuz, C. Mandatory CSR and sustainability reporting: economic analysis and literature review. *Rev Account Stud* 26, 1176–1248 (2021). <https://doi.org/10.1007/s11142-021-09609-5>.
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- Hutley, N and Hartford-Davis, S. Climate Change and Directors' Duties: Further Supplementary Memorandum of Opinion (2021), available at: <https://cpd.org.au/wp-content/uploads/2021/04/Further-Supplementary-Opinion-2021-3.pdf>

Covered entities and timing

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?

In relation to the timing of new climate disclosure obligations, it is important to balance between urgency and practical considerations. On the one hand, climate-related financial risks may already be impacting firms in Australia and thus there is a need for better information on these risks. On the other hand, many firms will need to build or bolster existing capabilities to make meaningful disclosure effectively, despite Australia's relatively high levels of engagement with voluntary reporting regimes. Therefore, a phased approach with reporting in the 2024-25 financial year would be beneficial.

Regarding the coverage of the requirements, the legal structure or size of firm is not the best concept for determining/driving implementation. For instance, it may not be appropriate to limit reporting requirements to listed firms only. Recent analysis has shown that there are presently low levels of climate-related risk reporting among Australian public authorities at the State and Commonwealth level, and that these non-listed firms may face considerable and material financial risks from climate change (Dibley et al, 2022). A better concept to drive rollout and implementation of the climate risk reporting requirements should be the materiality of climate impacts. Focusing on firms which have the highest climate-related financial risk exposures first, will ensure that the market has the most salient information to manage risks as soon as possible.

References

- Debelle, G, Climate Change and the Economy, Reserve Bank of Australia (2019).
- Dibley, A, Young, N and Phillips, T. Raising the Bar: Managing climate change risk in public authorities, Centre for Policy Development (2022), available at <https://cpd.org.au/2022/09/raising-the-bar/>

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?

Companies that are already mandated to disclose carbon emissions and other climate-related disclosures should be included in the first phase.

Sovereign entities, including government-owned companies and financial institutions, such as the Future Fund, should also be required to make disclosure as part of the initial round of obligations. While sovereigns have not historically reported their climate risk exposure to investors (Dibley et al, 2021), Australian governments are increasingly analysing and understanding their climate risk exposure. As public institutions, they have an important role to play in being at the forefront of climate risk management practices. Among other reasons, this is because the climate risks that these firms face are ultimately borne by the public.

Companies should be asked to “disclose or explain why not” because this helps distinguish no disclosure from non-disclosure.

References

- Dibley, A, Wetzler, T, Hepburn, C. National COVID debts: climate change imperils countries’ ability to repay, *Nature* Vol 592 (2021), available at: <https://www.nature.com/articles/d41586-021-00871-w>
- Arup, T. Investing for Australia – Clarifying climate risk expectations for the Future Fund. Centre for Policy Development (2022), available at: <https://cpd.org.au/2022/12/investing-for-australia-clarifying-climate-risk-expectations-for-the-future-fund/>
- Cummine, A. Sovereign Sustainability Reporting - NSW and Beyond. JMI Policy Insights Paper (2023), available at: <https://jmi.org.au/press-release/walk-the-talk-new-report-argues-that-governments-should-be-disclosing-their-sustainability-impact/>

International alignment of disclosures

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?

There is nothing particularly unique/different about the Australian context that we are aware of, that requires changes to the nature or approach to implementation.

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?

Given the alignment of Australia with IASB, the basic approach by the ISSB should be employed in Australia. However, there is an immediate opportunity to require Australian firms to provide more informative disclosure regarding climate scenario analysis. There is significant variation in the nature and type of climate disclosures by ASX 100 (Ding et al. 2023) and yet there are fewer institutional impediments for developing effective disclosures. There is a clear opportunity to improve disclosure in this regard. More specifically, the government could consider mandating reporting based upon standardised scenarios or provide specific disclosure requirements (such as assumptions employed) that would help stakeholders to interpret the risks and management strategies related to climate change.

It is worth noting that not all governments have adopted the ISSB approach. Below in the section titled ‘Future policy directions’ we discuss, for the purposes of comparison, the European Union’s approach to sustainability reporting which calls on firms to disclose financial and non-financial information relevant to a wider group of stakeholders beyond investors, lender and regulators.

References

- Ding, T., Jona, J., Potter, B. and Soderstrom, N. (2023) Research report on Climate Scenario Disclosure by ASX 100 (2020-2021), Research prepared for the Australian Accounting Standards Board.

Regulatory framework for required disclosures

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)?

Australia should incorporate the obligations for disclosure into legislation and detailed requirements should be built out and implemented via standards and guidance. This way, the requirements would have greater chance of becoming deeply/appropriately embedded into the existing legislation and standard setting framework rather than as a separate disclosure mandate via regulators such as ASIC. If these disclosures are seen as an add-on, or somehow separate and distinct from existing reporting, implementation may also be disconnected and ad hoc, leading to variability in key dimensions of reporting, impeding comparisons and benchmarking. Incorporating disclosure requirements in legislation will reduce a continuing need to harmonise across regulations and will provide the basis for future expansion/evolution of

sustainability reporting to incorporate other dimensions. This strategy will also reduce the costs associated with development and implementation of the requirements and costs of compliance with the regulations. Further, it will provide the government flexibility to update the detailed disclosure requirements as international standards and policy priorities develop.

Periodic reporting requirements

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?

The specific location of the information within the reports is crucial. What is most important is the connectedness of the information. This applies as long as: 1) the timing and periodicity of the information reported (financial, climate) reports is the same; 2) users have specific links to allow access to the entirety of the disclosures available across platforms; and 3) the reporting provides explicit conceptual linkages and value-related implications between the financial and non-financial information provided. An obvious example of this last point is in the case of the valuation of long-term assets and the potential implications of climate for influencing the valuations disclosed.

Materiality of climate risks & Assurance of climate risks

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)?

Materiality is problematic in the financial setting, with relevant research findings consistently indicating that key stakeholders in financial reporting typically revert to using quantitative-based heuristics in making materiality judgements (Choudhary et al. 2019). It becomes more complicated when sustainability considerations are included (Reimsbach et al. 2020). Adding sustainability-related guidance regarding the definition of materiality is crucial. The guidance must be clear on to whom issues are material, in order for the disclosures to become appropriately embedded in reports produced by companies. If the primary users of financial reporting are providers of capital, then materiality should be focused on their decisions. Although sustainability is related to longer term considerations, without providing some focus, companies will be able to manage their approach to materiality, which can impair the quality of reporting for the focal decision-makers.

References

- Choudhary, P., Merkley, K., & Schipper, K. (2019). Auditors' quantitative materiality judgments: Properties and implications for financial reporting reliability. *Journal of Accounting Research*, 57(5), 1303-1351.
- Reimsbach, D., Schiemann, F., Hahn, R., & Schmiedchen, E. (2020). In the Eyes of the Beholder: Experimental Evidence on the Contested Nature of Materiality in Sustainability Reporting. *Organization & Environment*, 33(4), 624-651.
<https://doi.org/10.1177/1086026619875436>

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?

Assurers should be independent and should satisfy quality standards. Research has consistently shown that the market values high levels of assurance by high quality financial statement auditors. Assurance of sustainability-related information has also been shown to be valuable to the market.

Reporting of metrics (including emissions), offsets and transition plans

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?

As we discussed in response to Q7, guidance will need to be provided on how firms assess materiality in their climate-related reporting. Only material emissions should be reported.

Question 10

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

Yes, a common baseline of metrics is important for comparison and benchmarking and to give report users confidence in the information being reported. The disclosure of these metrics should occur, predicated on their materiality.

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?

Consistent with our response to Q4.2, above there should be standardised disclosures in key dimensions of sustainability. In this area, such disclosures should include specific information about the governance structures regarding climate risk management such as existence of a committee of the board of directors, existence of a Chief Sustainability Officer, design of the reporting structure for climate-related matters, etc.

In addition, it is important that firms provide standardised information to allow investors, lenders and others to assess the quality of their climate risk management plans. This includes providing information about the extent to which transition plans are reliant on offsets, details about the source of such offsets and the assumptions underpinning decarbonisation strategies, including regarding the development and/or use of new technologies. The specific details will likely differ across sectors and industries.

Question 12

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

We do not have strong views on this question.

Data and capability to support climate reporting

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?

The capability challenges in Australia are extreme. A more environmentally sustainable future is not merely a technical issue that can be driven by the development and implementation of technical reporting requirements for which compliance is required. For disclosure to be a catalyst for a more sustainable business sector, capability

development is required to assist firm managers, service providers, investors and regulators to think differently about how to achieve a more sustainable future. At present there is only a small pool of professionals with expertise in climate change and other professional areas related to financial reporting, assurance, regulation and in company management.

Most universities are currently seeking to address the capability gap, in part, through accredited courses. However, it will take several years for current graduates to be meaningfully helping companies in this area.

In the short term, the government could support universities develop a platform to provide training programs that can make the expertise that is available at our universities more immediately accessible to business as they adapt to the new disclosure regulations. This type of resource is necessary for current accounting and finance professionals, assurance providers, board directors, regulators, managers and particularly, small business owners.

For example, at the University of Melbourne, MCF is developing an executive micro-credential on climate change drawing on world leading expertise from within the university, which aims to address the capability gap in companies and financial institutions. However, because initiatives like these are additional to existing academic roles, this type of initiative can only be delivered on an ad hoc basis to a small number of participants. These initiatives need additional financial support to be scaled up and have an impact at an economy-wide level.

In relation to data gaps, we are not aware of specific gaps for the Australian market. However, we are aware of growing information asymmetries between data availability in the public and private domains. There is a vibrant and growing market for private climate-related data. To ensure that governments, smaller businesses and others can get access to good quality climate data, it is important to develop the availability of publicly available climate data. Universities are an important platform that could be used for this purpose and can convene multiple actors and catalyse action nationally.

We are not aware of any data initiatives in overseas jurisdictions that provide particularly useful models for Australia.

Governance of supporting information for disclosures

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?

Standardised sources of information/data for input into scenario analysis needs to be readily accessible, with experts or leads to resources available to help businesses

implement the scenario analyses. This is crucial for benchmarking and comparison.

Governance of supporting information for disclosures

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?

The 'reasonable grounds' test regarding disclosure of forward-looking estimates should be sufficient.

Interaction with other reporting obligations

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?

Climate risk does not tend to change materially based upon specific events. Any specific costs/benefits arising from specific events should be reported through their financial consequences through the normal reporting channels. As a result, there should not be a conflict with other reporting obligations.

Other implementation issues

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?

See our answer to Question 5 above and the suggestions for future considerations informing policy and regulatory development below.

Question 18

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

The key for effective climate-related reporting is that it is meaningfully connected to other parts of the firm activities and particularly the core business (and financial results) of the firm.

Ensuring the financial reporting framework is fit for purpose to support climate risk disclosures

Question 19

Potential Structure 1. Confirm the AASB as the entity responsible for developing, making, and monitoring climate and sustainability related standard

Potential Structure 2. Establish a separate sustainability standards board

Potential Structure 3. Reform existing financial reporting bodies into a single, flexible entity

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?

Structure 1 is preferred. Since sustainability reporting is proposed to be an extension of corporate reporting as overseen by the AASB, the appropriate home for sustainability reporting should be the AASB. The AASB has an established standard setting infrastructure that can be drawn on, creating efficiencies.

However, it is also clear that developing the structure to support the AASB in overseeing such a significant change in the nature of reporting is critical. This will likely involve extending the board further and bringing in further technical expertise. It is important to develop and implement appropriate mechanisms to manage effectively the sustainability workplan and agenda.

Part B: Future Policy Directions

This section of the submission offers some suggestions for broader policy development that extend beyond the specific questions raised in the Consultation Paper.

Climate-related risk reporting is an area of rapid growth. Governments around the world are introducing new reporting requirements, new methodologies, sources of data and metrics continue to develop, researchers continue to evaluate the performance of emerging standards and regulatory approaches and, as such, international best-practice continues to evolve. Given this context, even if the Australian government introduces a reporting framework for climate-related risks, it may be beneficial to consider areas where best practice may evolve. In this section, we outline some future policy directions that the government may wish to monitor and integrate into future iterations of its regulatory framework. These suggestions relate to four key points:

- Broadening the scope of disclosure;
- Incorporating a diversity of expertise;
- Embedding a whole of government approach;
- Recalibrating the approach for accounting for emissions.

Expanding climate reporting to a broader range of stakeholders and on firm impacts on climate change

Climate (and corporate social responsibility) reporting approaches differ in scope. Approaches like the ISSB's concerning 'climate-related financial disclosures' focus on investors as the intended audience and provide "information that is financially material to investors for their decision-making". However, this does not necessarily require entities to disclose their impacts on the environment if the firm does not bear the direct costs (Christensen, Hail, and Leuz 2021, 1178, 1182).

Alternative approaches such as 'climate-related disclosures' focus on a "diverse set of stakeholders" beyond investors, such as civil society, individuals, and governments. Under such approaches, the firm "not only reports how it is affected by ESG issues, but also the firm's impacts on the environment and society, including the externalities it causes". The key criterion for disclosure is "double materiality", reporting the entity's vulnerability to climate impacts and their contribution to the impacts of climate change (Christensen, Hail, and Leuz 2021, 1178, 1182). An example is the Corporate Sustainability Reporting Directive (previously the Non-financial Reporting Directive) in the European Union. This EU directive calls for entities to report in five areas: business model; policies, including due diligence processes; the outcomes of those policies; risks and risk management; and key performance indicators. Entities are required to provide both forward-looking and retrospective information as well as qualitative and quantitative information.

References

- EU Council Directive 2022/2464 of 14 December 2022 Amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as Regards Corporate Sustainability Reporting.
- Christensen, H.B., Hail, L. & Leuz, C. Mandatory CSR and sustainability reporting: economic analysis and literature review. *Rev Account Stud* 26, 1176–1248 (2021). <https://doi.org/10.1007/s11142-021-09609-5>.

A multi-disciplinary and inter-disciplinary approach to climate reporting

As the AASB develops its expertise, the Australian Government may consider adopting a multi-disciplinary and inter-disciplinary approach to further developing, implementing, and enforcing a framework for climate-related disclosures (Monciardini et al 2020). This would bring together expertise from accounting and finance, law, economics, management, politics and policy, natural sciences etc. It would seek to recognise that reporting for financial information and reporting for social and environmental impact are different processes.

References

- Monciardini, D., Mähönen, J.T., and Tsagas, G. Rethinking Non-Financial Reporting: A Blueprint for Structural Regulatory Changes. *Accounting, Economics, and Law: A Convivium*, 10(2) (2020). <https://doi.org/10.1515/ael-2020-0092>.

Embed a 'whole of government' approach to climate change:

To complement climate-related disclosures, the Australian Government could consider integrating sustainability principles across departmental and organisational mandates. For example, the Australian Government might introduce a provision in the *Climate Change Act 2022* (Cth) similar to s 20 of the Victorian *Climate Change Act 2017*. Section 20 provides that the government "will endeavour to ensure that any decision made by the Government and any policy, program or process developed or implemented by the Government appropriately takes account of climate change if it is relevant by having regard to the policy objectives and the guiding principles".

In addition, authorising legislation or guidance for Commonwealth departments and agencies such as ASIC and APRA might provide these entities with a net zero mandate. For example, in the United Kingdom, recommendations from the Treasury in 2021 to the Financial Conduct Authority and the Prudential Regulation Committee in 2021 provided that these entities ought to have regard to the UK government's commitment to achieving a net zero economy by 2050 under the *Climate Change Act 2008* (UK) (see [here](#) and [here](#) respectively). While these letters of advice have been superseded, the

UK continues to be bound by its commitment to net zero in the Act (see [here](#) and [here](#) respectively).

Recalibrate the approach by which emissions are accounted

There are growing calls to change the way that greenhouse gas emissions are accounted for. The main approach that firms currently use to account for their carbon emissions is through the 'Greenhouse Gas Protocol'. Developed in 2001 as a tool to manage risk in response to growing carbon pricing mechanisms, the Protocol classifies emissions into three 'Scope' categories: direct emissions (Scope 1), purchased energy emissions (Scope 2) and upstream and downstream supply chain emissions (Scope 3). However, analysts and firms have raised persistent concerns about Scope 3 and to a lesser extent, Scope 2, emissions, which are challenging to account for and often get double counted through supply chains. For Scope 3 emissions in particular, the implementation challenges have meant that few firms use primary data to report their emissions, and instead rely on industry estimates, or simply do not report such emissions.

In response to the shortcomings of the GHG Protocol, new approaches are being developed and advocated for to better account for emissions. For example, a new 'E-liability' approach has been proposed which borrows from inventory and cost accounting to calculate carbon emissions in a supply chain as costs in tons of CO₂. Each product in a supply chain would have an e-liability score, and when a firm sells a good or service it passes the allocated total e-liability associated with the product to the buyer. Much like cash -flow, firms will track their e-liability flow through a supply chain until the sale of a final good. Firms could choose to offset these liabilities through carbon removal or pass them to consumers.

As new methods for accounting for emissions are developed, it may be necessary to revisit the approach taken under any climate-related financial risk reporting scheme.

References

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- Kaplan, R. S., Ramanna, K. We Need Better Carbon Accounting. Here's How to Get There. *Harvard Business Review* (Apr 2022), available at <https://hbr.org/2022/04/we-need-better-carbon-accounting-heres-how-to-get-there>