What does the AASB's Exposure Draft for Sustainability mean for Australian Businesses?

A Deeper Look into the Australian Sustainability Reporting Standards

Written by Leo Shi, 2024

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Executive Summary

This report focuses on the first drafts of the Australian Sustainability Reporting Standards (ASRS) published by the Australian Government in late 2023. These standards are Australia's adaptation of the ISSB Standards, which govern how the world will meet the requirements of the Paris Agreement. From 2024 onwards, Australian businesses will have to follow tightened regulations around sustainability and climate-related disclosures, primarily affecting annual report construction.

The ASRS was written based on the ISSB Standards, adapted from the TCFD. These standards aim to guide directors and executives in reducing Scope 1, 2 and 3 greenhouse gases and unite in achieving nationally determined contributions (NDCs). Australia's most recently updated NDC was submitted in 2022, committing the nation to reducing its emissions to 43% below 2005 levels by 2005.

The Australian Government hopes that stronger sustainability standards and climate-related declarations will force corporations to prioritise and encourage the discussion around more effective and resilient strategies. The decision to mandate scenario analysis is a prime example of this. Companies can identify and capitalise on reducing their greenhouse gas emissions by legalising the need to look into the short, medium and long-term future.

Directors, executives, and financial and accounting teams are affected by the release of these drafts. This will change the preparation of Financial Statements and Notes, Director's Reports, Continuous Disclosure Obligations and Corporate Governance Statements.

This report was written in January 2024, when the final versions of the ASRS and legislation surrounding the Standards haven't been released yet.

Financial Reporting in Australia

On the 23rd of October, 2023, the Australian Accounting Standards Board (AASB) released the Exposure Draft ED SR1: Australian Sustainability Reporting Standards - Disclosure of Climate-related Financial Information.

"ED SR1 includes three draft Australian Sustainability Reporting Standards (ASRS Standards):

- *[draft] ASRS 1 General Requirements for Disclosure of Climate-related Financial Information, developed using IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information as the baseline but with a scope limitation to climate-related financial disclosure;*
- *[draft] ASRS 2 Climate-related Financial Disclosures, developed using IFRS S2 Climate-related Disclosures as the baseline; and*
- *[draft] ASRS 101 References in Australian Sustainability Reporting Standards, developed as a service standard that would be updated periodically to list the relevant versions of any non-legislative documents published in Australia and foreign documents that are referenced in ASRS Standards."* (AASB, 2023)

The Australian Government has made climate-related disclosures within annual reports mandatory for large businesses and financial institutions. **Climate-related disclosures** remind businesses about the effects of climate change on business, investment, lending and insurance underwriting decisions, prompting entities to better demonstrate responsibility and foresight in their consideration of climate issues (Ministry of Business, 2023).

The bigger picture reveals that the world is not on track to reach the Paris Agreement's goal of limiting global warming to 1.5 degrees Celsius. Australia's commitment to reduce greenhouse gas emissions by 43% below 2005 levels by 2030 and **achieve net zero emissions by 2050** also requires attention (Mills, Kelly, 2023). Mandating transparent climate-related data reduces the risk of greenwashing[1], facilitates the accelerated spread of information by ensuring influential board members are well-versed in the relevant climate change details and fosters an environment of collaboration. The Australian Treasury believes that mandatory climate-related disclosures represent the first component of a broader sustainable finance system capable of facilitating and accelerating economy-wide decarbonisation. This legislation will introduce new data supporting company decisions in transitioning to net zero.

[1] Greenwashing - misleading disclosure of a company's environmental credentials, whether it is through understating the impact of climate change risks or overstating the resilience of their business towards such risks. A telltale sign of greenwashing is evidence of forward-looking uncertainty or incomplete data.

The Australian Government has proposed a staggered approach to implementation, starting with large businesses and financial institutions. It released a rough guideline and criteria alongside the ASRS outlining the legal requirements.

Cohort	Thresholds	Required Reporting Date
Cohort 1	Large private companies that meet two of the three thresholds ● Over 500 employees ● $1bill+ in consolidated gross assets ● $500mil+ consolidated annual revenue	1st July 2024
Cohort 2	Companies that meet two of the three following thresholds: ● Over 250 employees ● $500mil+ in consolidated gross assets ● $200mil+ consolidated annual revenue	1st July 2026
Cohort 3	Companies that meet two of the three following thresholds: ● Over 100 employees ● $250mil+ in consolidated gross assets ● $50mil+ consolidated annual revenue	1st July 2027

Companies in Cohort 1 have the highest contribution to greenhouse gas emissions along with the most labour force to ensure reporting is up to governance standards. Organisations under Cohort 2 and 3 don't need to disclose climate and sustainability-related information mandatorily before their reporting date. However, voluntarily disclosing information may attract shareholders and investors

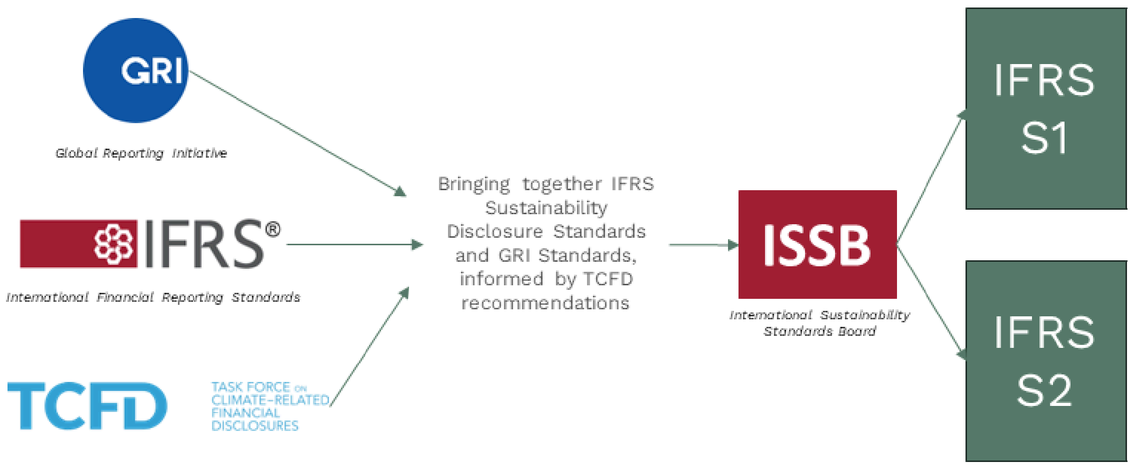
The Development of Internationally Accepted Guidelines

Internationally, the world followed the Task Force on Climate-Related Financial Disclosures (TCFD)[2], which was the widely accepted, principle-based guideline on how information should be structured and prepared. The TCFD provided **core recommendations** around governance, strategy, risk management and meeting metrics and targets. It aimed to improve and increase reporting of climate-related financial information while surveying asset managers and owners on their financial reporting practices.

The International Financial Reporting Standards (IFRS) and the International Accounting Standards Board (IASB) established the ISSB (International Sustainability Standards Board) in 2021. The ISSB issued two new standards in June 2023: IFRS S1 and IFRS S2. Unlike the TCFD, IFRS S1 and IFRS are **standards**, meaning adoption requires compliance with specific, replicable and detailed requirements. Meeting standards requires more detailed and quantitative disclosures of current and anticipated financial effects. IFRS S1 captures **sustainability-related**

[2] The TFCD was created in 2015 by the Financial Stability Board (FSB). As of October 2023, the TFCD is now deemed redundant, hence its disbandment, following the publication of IFRS S1 and IFRS S2.

issues, such as risks arising from dependencies' use of resources. There is a heavy emphasis on consistency between financial statements and sustainability disclosures across the entire value chain. IFRS S2 captures **climate-related** risks and opportunities that could reasonably be expected to affect the entity's cash flow. It builds upon IFRS S1 and primarily focuses on physical and transitional risks associated with moving to a lower-carbon economy. These standards operate in tandem. IFRS S1 and IFRS S2 are now colloquially referred to as the **ISSB Standards.**



Climate-related disclosures primarily focus on the impact of an organisation's activity on climate change. They provide information about the carbon footprint of an organisation's activities, how much greenhouse gases it emits, the effect of extreme weather events on its business, and its plans to mitigate these impacts. Contrastingly, sustainability-related disclosures are broader in scope. They cover other environmental, social, and governance (ESG) aspects. They can include information about the organisation's use of natural resources, its social impact, its governance structures, and its compliance with sustainability regulations.

The Australian Government's declaration for climate-related disclosures follows the ISSB's issuance of new regulations. **Hence, the ASRS is directly based on the ISSB Standards.** The Australian Institute of Company Directors (AICD) hosts the Australian chapter of the Climate Governance Initiative (CGI). The AICD is part of a global CGI network of 29 bodies' promoting the World Economic Forum Climate Governance Principles for boards and effective climate governance within their jurisdictions. The AICD has been involved in preparing a guide to mandatory climate reporting in Australia, intended to assist boards in responding to new reporting standards set by the ASRS.

These stricter standards act as the first step in ensuring the world can meet the demands of the Paris Agreement.

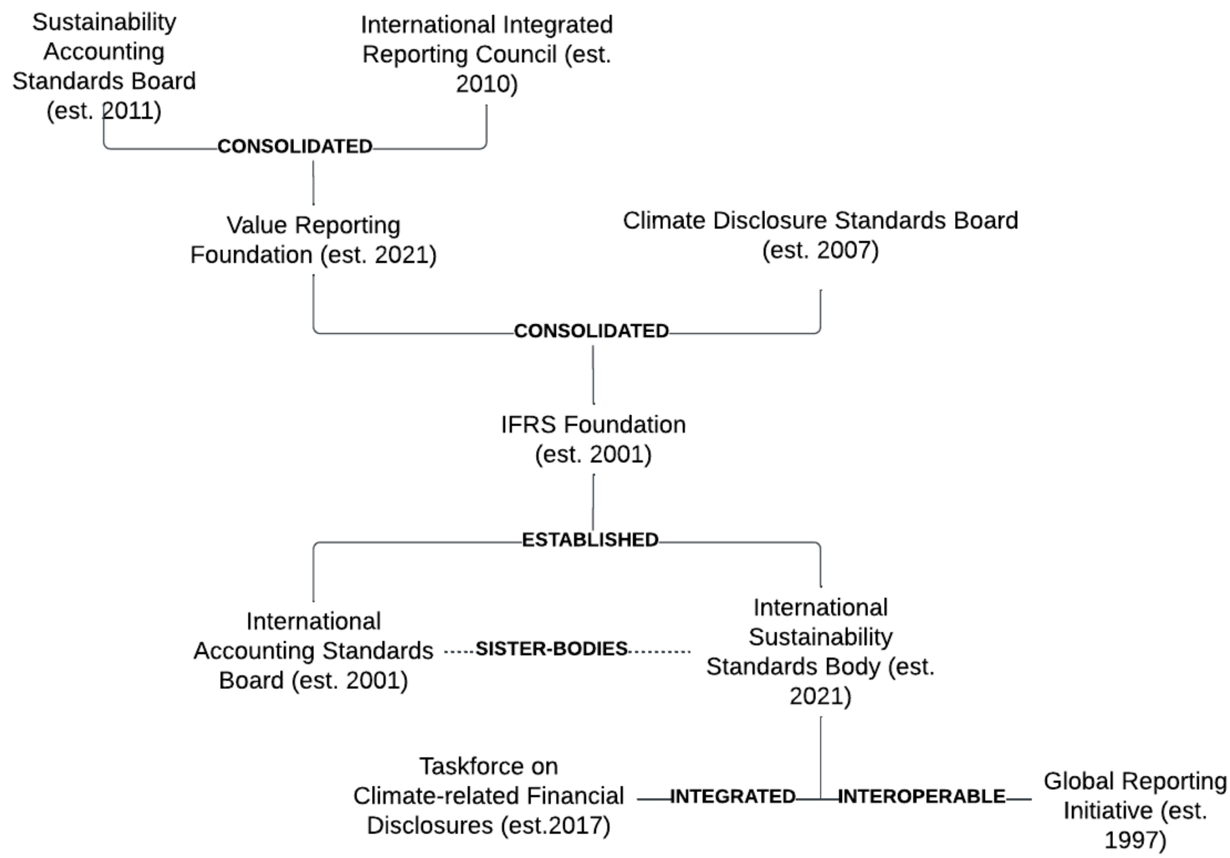


Image 1.1: The harmonisation of global climate and sustainability reporting frameworks[3][4]

A Deeper Dive into the ISSB Standards

Scope 1, 2 and 3 Emissions

It is important to reiterate what Scope 1, 2 and 3 emissions are since the Standards are based on them. Using a wholesaling clothing factory as an example:

Scope 1	Emissions from sources that an organisation owns or controls directly ● Eg. Burning fuel when transporting materials ● Reduction Method: Choosing to purchase electric vehicles to use when transporting materials and retiring petrol-based cars
Scope 2	Emissions that a company causes indirectly through purchasing electricity, steam, heat, or cooling ● Eg. Purchasing the electricity used in factory buildings ● Reduction Method: Installing solar panels to power factories, or choosing an energy company that generates through renewable sources

[3] Consolidated: combine a number of things into a single more effective or coherent whole
[4] Interoperable: when two things are able to exchange and make use of common information

Scope 3	Emissions that the company doesn't produce itself and are not the result of activities from assets owned or controlled by them, but by those that are indirectly responsible for up and down its value chain ● Eg. Retail stores produce emissions when selling products manufactured by the factory. ● Reduction Method: Adopting sustainable supply chain management through sourcing ethically collected raw materials

The Paris Agreement incentivises organisations to set emission reduction targets to minimise Scope 1 emissions and limit global temperature rise. The Paris Agreement encourages countries to set **nationally determined contributions (NDCs[5])** that directly address Scope 1 emissions. These NDCs refer to energy and transportation usually.

Scope 2 emissions involve increasing **renewable energy sources** and improving energy efficiency. To accomplish goals, nations and companies may need to commit to reducing their direct emissions through fossil fuel usage as part of their contributions to achieve climate action plans.

Lastly, while the Paris Agreement primarily focuses on Scope 1 and Scope 2 emissions, addressing Scope 3 emissions is effective in achieving a holistic and impactful reduction in the overall carbon footprint. Scope 3 emissions are not typically binding under the Paris Agreement.

IFRS S1

The objective of IFRS S1 is to require an entity to disclose[6] information about its **sustainability-related risks and opportunities** that are useful to users of general-purpose financial reports in making decisions relating to providing resources to the entity. An entity is required to provide disclosures about:

- the governance processes, controls and procedures the entity uses to **monitor, manage and oversee** sustainability-related risks and opportunities;
- the entity's strategy for **managing** sustainability-related risks and opportunities;
- the processes the entity uses to identify, assess, **prioritise** and monitor sustainability-related risks and opportunities; and
- the entity's performance concerning sustainability-related risks and opportunities, including progress towards any targets the entity has set or is required to meet by law or regulation.

If we used a medium-sized clothing wholesaler with 300 employees based in Sydney as an example, some instances where disclosures are needed could include:

[5] Australia committed to an ambitious economy-wide target to reduce greenhouse gas emissions by 43% below 2005 levels by 2030 as the nation's NDC.

[6] Note the change in language and verbs: Describe and disclose. The TCFD recommended companies describe their actions, while disclosing requires quantitative information and figures to support claims.

Governance Processes: The establishment of a sustainability committee consisting of key executives responsible for facilitating the reduction in carbon footprint by distributing stock by 50% or creating a carbon-neutral scheme to balance out carbon emissions.
Sustainability Strategy: Implementing a comprehensive sustainability policy integrating environmental and social considerations into core business practices, such as carbon-neutral initiatives on each sale. Alternatively, from 2024 onwards, the wholesaler will only purchase electric vehicles for distribution and retire old diesel-powered trucks.
Risk Management Processes: Conduct regular risk assessments to identify potential environmental and social risks in the supply chain, such as resource/material scarcity or labour exploitation.
Performance Monitoring: Providing a transparent account of the wholesaler's performance related to sustainability through KPIs, such as:

- Achieve a 20% carbon emissions reduction by the fiscal year's end.
- Achieve a 15% reduction in water consumption by implementing water-saving initiatives.
- Achieve a 25% reduction in total waste produced by implementing waste reduction strategies.
- Achieve a 30% reduction in warehouse emissions through the implementation of energy-efficient practices and technologies.[7]

IFRS S2

The objective of IFRS S2 is to require an entity to disclose information about its **climate-related risks and opportunities** that are useful to users of general-purpose financial reports in making decisions relating to providing resources to the entity. An entity is required to provide disclosures about:

- the governance processes, controls and procedures the entity uses to **monitor, manage and oversee** climate-related risks and opportunities;
- the entity's strategy for **managing** climate-related risks and opportunities;
- the processes the entity uses to identify, assess, **prioritise** and monitor climate-related risks and opportunities, including whether and how those processes are integrated into and inform the entity's overall risk management process; and
- the entity's performance concerning its climate-related risks and opportunities, including progress towards any climate-related targets it has set, and any targets it is required to meet by law or regulation.[8]

Some examples of disclosures for the same clothing wholesaler include:
Increased Revenue from Products and Services Aligned with a Lower-Carbon Economy: This could involve setting a goal to ensure that 50% of the items produced come from sustainable clothing lines or implementing initiatives to reduce the carbon footprint of their operations, such as printing or transportation.

[7] In order to measure these KPIs, businesses will need to introduce new technologies to track and monitor output, which could cost a significant portion of time, money and manpower.
[8] Note: these are the same standards as IFRS S1, but rather focusing on climate-related risks and opportunities than sustainability-related.

Costs Arising from Climate-Related Events: The wholesaler would need to disclose any costs arising from climate-related events, such as costs related to extreme weather events that disrupt their supply chain or increase their operating costs
Climate-related Risks and Opportunities in the Business Strategy: This could include how they plan to manage physical risks such as extreme weather events, and transition risks such as policy changes or technological advancements. It could also include opportunities such as building solar panels in warehouses to generate electricity on hot, sunny days.
Greenhouse Gas Emissions and Energy Use: The wholesaler would need to disclose their greenhouse gas emissions, including Scope 1 direct emissions from owned or controlled sources and Scope 2 indirect emissions from the generation of purchased energy
Governance Processes, Controls, and Procedures: These could include the role of the board in overseeing these risks and opportunities, and how these processes are integrated into the wholesaler's overall risk management process
Performance Concerning Climate-Related Risks and Opportunities: This could include progress towards any climate-related targets they have set and any targets they are required to meet by law or regulation.

How Do the ASRS Differ from the ISSB Standards?[9]

Draft ASRS 1 is based on IFRS S1. The key differences are that:

- Incorporates terminology suitable for non-profit organisations
- Applies only to the reporting of climate-related financial information. AASB will consider approaching broader sustainability reporting matters in Australia at a later time
- Inserts an extra requirement for an entity that determines there are no material climate-related risks and opportunities to disclose this fact and how it came to this conclusion
- Inserts an extra requirement for an entity to provide information in a manner that enables users to locate its disclosures prepared

Draft ASRS 2 is based on IFRS S2. The key differences are that:

- Removes "unnecessary duplicated" content that has already been included in ASRS 1
- Clarifies that draft ASRS 2 does not apply to other climate-related emissions (except greenhouse gas (GHG) emissions)
- Specifies that climate resilience assessments should be conducted against a minimum of at least two possible future states, one of which must be consistent with the most ambitious global temperature goal set out in the Climate Change Act 2022 (Cth)
- Requires an entity to convert GHGs into a CO2 equivalent value using the global warming potential values
- Aligns with Treasury's second consultation by specifying that an entity is required to prioritise applying relevant methodologies in the NGER Act as the default methodologies in measuring its GHG emissions before referring to other GHG measurement methods or frameworks,

[9] Majority of information is taken from King and Wood Mallesons - Mandatory Climate Reporting Update: AASB Australian Exposure Draft Standards, written by Tim Bednall, Emma Newnham, Linda Le and Tiffany Chan

The Five Core Pillars of ISSB Standards

Directors need to consider these aspects of the standards when altering business procedures:

Topic	ISSB Standards
Governance	Details of board oversight, including **identification of the body/person responsible** and how it is reflected in their role description: ● The process in place to identify and **prioritise climate-related risks** and opportunities ● What is management's specific role in assessing these risks?
Strategy	Disclose any **transition plans** over the short, medium and long term of how the company seeks to achieve targets and where significant climate risks and opportunities are concentrated. The need for **scenario analysis** to determine the impact of climate risks and opportunities and illustrate the **resilience** of the organisation's strategy. **Quantitative information** on the current and anticipated effects of climate-related risks on cash flows and impact on current and **committed investment plans.** ● Consider analysing a company's entire value chain since Scope 1, 2, and 3 declarations are necessary.
Risk Management	Disclose processes used to identify, assess, prioritise and monitor climate-related risks and opportunities, the **input parameters it uses to identify risks** and whether it has changed the processes used compared to the prior reporting period. It is important to disclose how climate risk management is integrated into the company's overall risk management process.
Metrics and targets	Disclose ● Metrics used by the organisation to assess climate-related risk ● Targets used by organisations to manage the risk ● Scope 1,2 and if appropriate, 3 greenhouse gas emissions ● Any transition plans and climate-related targets GHG[10] emissions including **mandatory** Scope 3 emissions, separate disclosure of Scope 1 and 2 Financed emissions for those with asset management, management, commercial banking and insurance activities
Timing and location of reports	Requires disclosure (subject to transitional relief): ● In the financial report ● Issued at the same time as the publication of financial reports ● Covering the same reporting period and the same reporting entity as the financial statements

[10] GHG: Greenhouse Gases

The ISSB Standards require companies to disclose their Scope 1,2 and 3 emissions. The **governance** pillar introduces accountability and the need for companies to disclose accurately. These legal requirements also reduce the temptation to greenwash. The **strategy** pillar directly relates to the Paris Agreement's goal of limiting global warming. Mandating scenario analysis ensures companies keep sustainability at the forefront and their strategy is constantly evolving. The last three pillars ensure compliance with ISSB Standards and encourage companies to improve their sustainability strategy.

Specific Changes in Annual Statements Preparation

An entity is required to provide **quantitative and qualitative information** about the current and anticipated effects of sustainability and climate-related risks and opportunities. Considering Woolworths as an example. Woolworths Group is one of those companies in Cohort 1, meaning their annual reports need to be up to standard with ASRS in 2024. Woolworth's annual report has sections that are nearly in compliance with ASRS.

- *"Addressing climate change and nature together"*
    - This section addresses how Woolworths prepares to reduce greenhouse gas emissions to meet Australia's NDC.
    - However, metrics are currently compared to the TCFD guidelines. Woolworths needs to alter the language used to fit in with the ASRS.
- *"Our governance framework"*
    - This section is a strong example of meeting governance requirements. Woolworths may still need to include personal identification of Board members and executives.
- *"Our pathway to net positive"*
    - This section outlines Woolworth's strategy concerning sustainability
    - There is now a requirement to disclose how the company is resourcing or planning to resource the activities outlined in its transition plans
    - Companies will have to disclose the amount and percentage of their assets or business activities that are vulnerable to transition risk specifically (Chan, 2023).
    - It's important to remember that a transition plan is different from a long-term goal; it needs to be sufficiently detailed to clearly illustrate the company's overall strategy for how it plans to transition towards a lower-carbon economy, as well as setting out specific targets and actions about how it plans to transition (Chan, 2023).
- *"Climate risks and opportunities through climate scenario modelling"*
    - This section touches upon Woolworth's investment in scenario analysis[11] and the desire to understand the resilience of their business strategy. It involves identifying risks and then suggesting mitigations and potential opportunities that Woolworths can capitalise on if that scenario were to occur.

[11] A scenario is a plausible, but hypothetical, path of development leading to a particular future outcome. Scenarios are not forecasts or predictions - they are "what if" narratives designed to inform and challenge strategic thinking.

Additionally, a company's sustainability report will need to be published alongside its annual report. While there is no set guide on how companies should meet the ASRS, it is safe to assume that corporations under Cohort 1 will provide a strong example of how to express these standards throughout Annual Reports.

A Director's Role in Adapting to New ESG[12] Guidelines

The new guidelines must be followed through all official reporting documents, not just annual reports. A director's main objective is to ensure these reports' materiality[13] and legitimacy. If a report's materiality is compromised, it could be said that the information provided is misleading and deceptive. Examples of reporting that directors need to oversee include

- Financial Statements and Notes
- Director's Reports
- Continuous Disclosure Obligations
- Corporate Governance Statements

As there is no way of eliminating liability risk, a director should focus on mitigation. A director needs to confirm that the material information disclosed in financial statements and notes provides a **true and fair view** of the financial position and performance of the company. This can be accomplished by following a thorough and documented due diligence process when gathering, analysing and communicating climate-related disclosures. When ensuring quality, tasks could include:

- Gathering information that may be relevant to disclosure
- Ensuring accountability structures are in place to support compliance with mandatory climate reporting and accuracy of disclosures
- Considering whether current systems and governance structures need to be updated, including to bring sustainability, legal and finance teams together on mandatory climate reporting
- Assessing revenue impacts
    - Eg. an agricultural business' yields falling in areas with extreme weather events
    - Businesses providing single-use plastics experiencing reduced demand due to changing customer preferences or regulations
- Understanding cost line implications
    - Eg. carbon tax or similar levy on exports
    - Changing the use of natural resources or increasing costs
- Develop a work plan based on gap analysis, for how each of the gaps will be addressed, including how additional data will be collected where necessary
- Changing estimated useful lives or residual values

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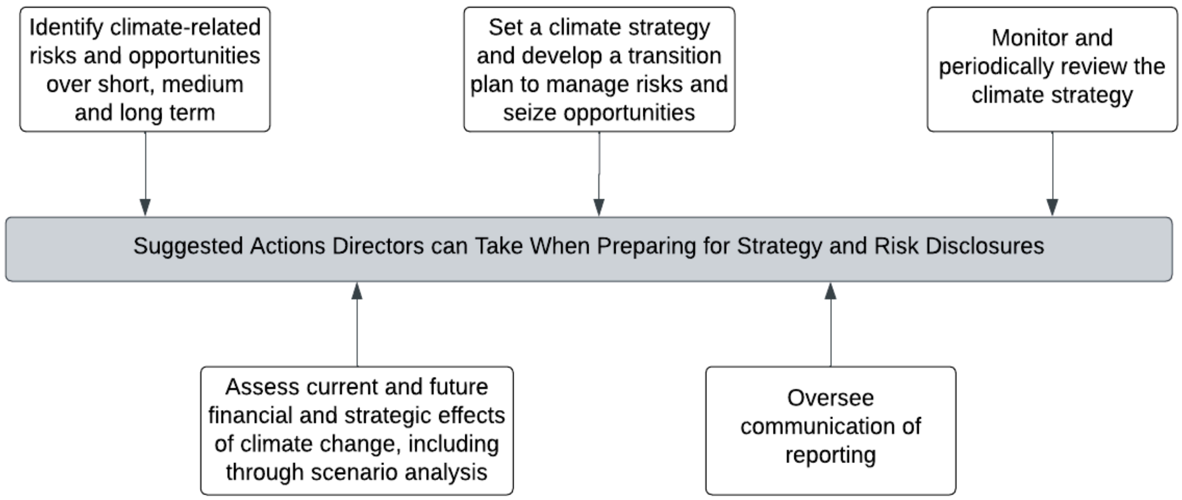
[12] ESG: Environmental Sustainability Goals
[13] Materiality: referring to information that, if omitted, misstated or obscured, could reasonably be expected to influence decisions. Reports materiality needs to be of high enough quality to represent the truth.

    - Eg. less energy-efficient machinery being replaced earlier than expected as more efficient technology enters the market
- Assessing information for relevance and materiality
    - Be able to clearly articulate why they have made a particular decision as to whether to or how to, disclose on a specific metric
    - Eg. why was a particular climate scenario chosen over another?



So how can directors approach these issues to minimise the risk of misleading disclosure? ASRS disclosures will require a prediction or estimation over long (5 - 10+ years) time horizons and be subject to constantly changing assumptions due to decarbonisation trajectories, technological development and changing government regulation, including

- The significant climate-related risks and opportunities that an organisation reasonably expects could affect its **business model** (strategy and cash flow, access to finance)
- **Anticipated changes** to the organisation's business model
- A description of any transition plan and climate targets, including the extent to which the plan relies on carbon credits, the amount of the entity's emission target to be achieved, etc.
- An assessment of how **resilient** it considers the organisation's strategy and business model are to future climate-related changes, developments or uncertainties based on climate scenario analysis[14]

[14] Note: excerpt taken from AICD's director's guide to mandatory climate reporting

Legal Repercussions Behind Misreporting

Under the Corporations Act, civil penalties will be issued against directors who approve of deceptive and misleading forward-looking disclosures.

Directors can either be “primarily engaged” in misleading conduct or “accessorily involved” in their corporation’s misrepresentation. It is based on whether the impression conveyed to a “reasonable user” of the reports is likely to mislead or deceive. This means a director who acted honestly and reasonably in making the relevant statement can still be exposed to liability.

Please note that the ASRS is still a draft, meaning nothing is finalised as of January 2024. The AASB invites stakeholders to provide feedback on ED SR1 by:

- submitting a comment letter on the AASB website;
- completing an online survey – click here to access; or
- attending a roundtable discussion – details to be provided shortly

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