The two sides of governance in climate-related reporting

Australian companies are on the verge of being required to publicly disclose their governance processes over climate-related risks. Good governance will play a central role in the transition.

The introduction of a mandatory climate-related financial disclosure regime in Australia (for financial years starting on or after 1 January 2025) will require companies to disclose how climate-related issues are embedded within their governance approach (refer Appendix A for who is in scope), along with their strategy, risk management, and metrics and targets. In this paper, we explore the role of governance in two dimensions:

1. Governance of climate risks and opportunities as required by the proposed Australian Sustainability Accounting Standards (ASRS standards)
2. Governance of reporting to enable robust disclosure and manage reporting risk

For many organisations, the transition represents a significant uplift in the amount of disclosures that an entity must make. An entity's approach to drafting these disclosures and in determining whether to uplift its underlying business activities requires careful consideration by management and Directors given these climate disclosures will:

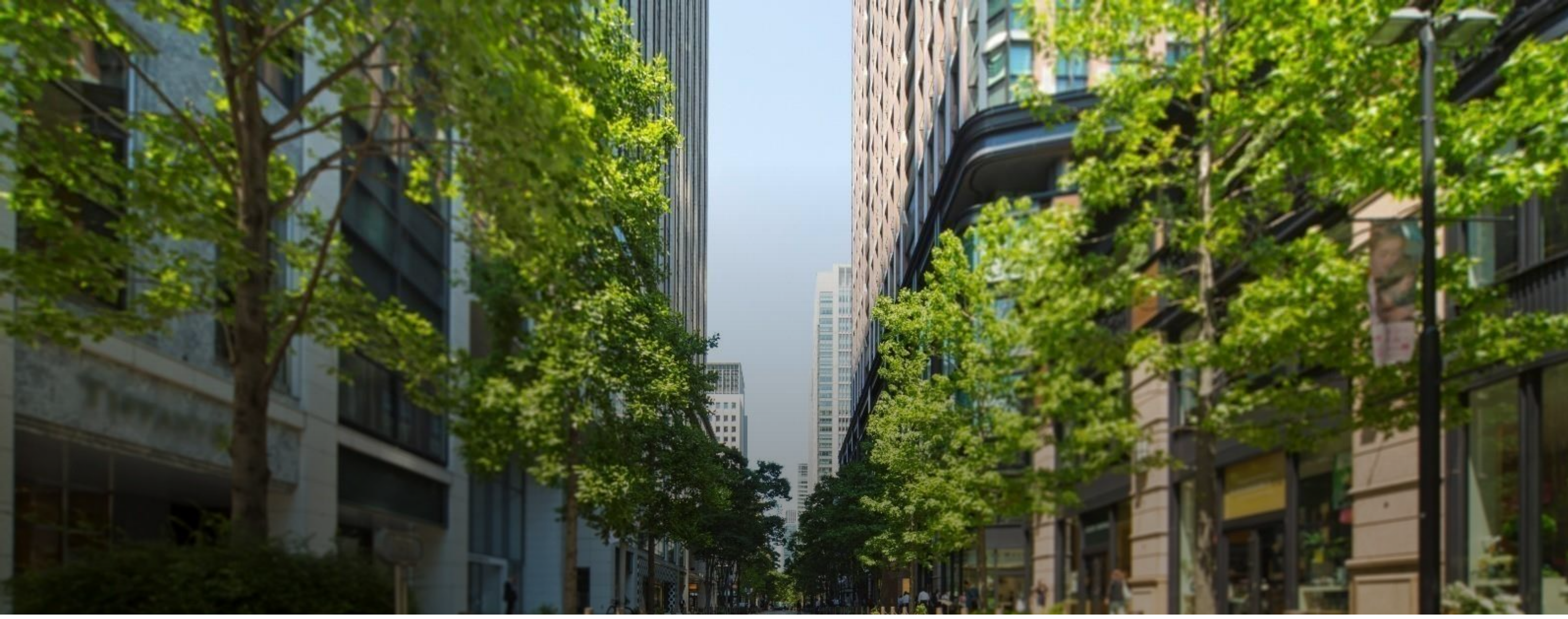
- Be publicly available
- Receive significant scrutiny from a range of stakeholders
- Form part of the AGM agenda for public companies
- Require a cross-functional response given climate risk is multi-faceted

With the introduction into Parliament of the *Treasury Laws Amendment (Financial Market Infrastructure and Other Measures) Bill 2024*, Australian entities will soon be required to report on their governance arrangements relating to climate, which we expect will also drive better governance of climate data and reporting.

Two sides of governance

Disclosure requirements	Reporting process
▸ Oversight of climate risks and opportunities	▸ Accountability for reporting
▸ Skills and experience of directors	▸ Pro-forma reviews
▸ Integration into decision-making	▸ Alignment with other reporting
▸ Remuneration implications	▸ Assurance processes
▸ Management responsibilities	▸ Management certification

> “Good governance means ensuring that companies meet their various obligations and appropriately set up their structures to capture opportunities.
>
> Emma Herd
> Partner, Climate Change and Sustainability Services, EY Australia | Co-Lead, EY Net Zero Centre



1. Governance of climate

What are the governance disclosure requirements?

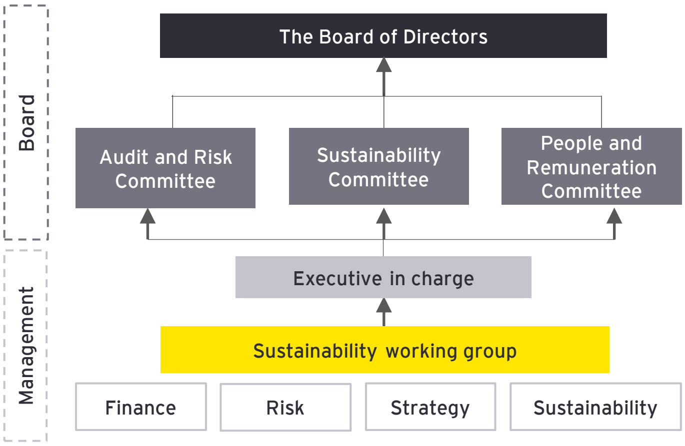
The core requirement for Australian reporting entities is to disclose the processes, controls, and procedures to monitor, manage and oversee climate-related risks and opportunities (CRROs) within an entity's governance structure.

The governance related disclosure requirements (outlined in Appendix B) include:

- How the board determines whether it has the skills and experience mix to oversee strategies to respond to CRROs
- The oversight of CRROs and integration into decision-making
- How the Board monitors progress
- How performance metrics related to CRROs are factored into remuneration considerations

They also include management's responsibilities, specifically:

- How the control and procedures to oversee CRROs are delegated and integrated into specific management functions or into dedicated roles or functions



What does good governance look like?

Previously treated as ad hoc agenda items or discussed solely within environmental risk contexts, CRROs are now often a standing item in board agendas and company strategy days. Recognising climate as a pervasive risk and opportunity throughout the organisation is essential for comprehensive governance.

Holistic view of risk and opportunity

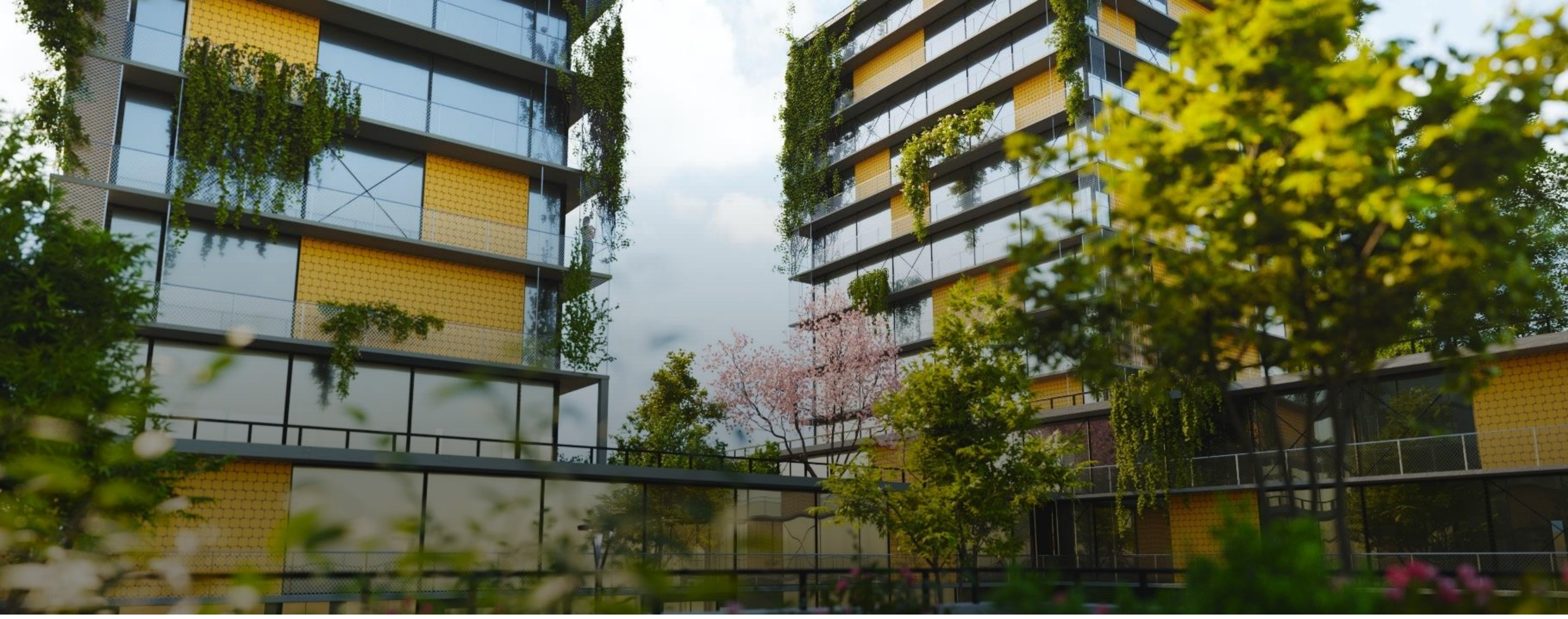
Climate issues transcend traditional silos, impacting every facet of an organisation. Companies with strong governance and risk frameworks should be able to easily integrate CRROs, and many are. However, there is also an acknowledgement that in some organisations climate is an emerging risk and needs a dedicated focus and deliberate work to integrate it into enterprise risk frameworks.

Multi-function, multi-level and holistic

CRROs affect whole organisations and should be considered by various committees, including audit, remuneration and risk. The climate mandate should also be explicitly woven into these committees' responsibilities, regardless of whether there is a standalone committee for climate or ESG. There is an emerging practice of holding joint board committees to ensure consistency when discussing CRROs, as well as board and committee charters referring to climate risk and giving that dedicated responsibility.

There should be an equivalent approach from management, where sustainable finance, investor relations and communications teams need to work together. Strong Chief Financial Officer (CFO) involvement is leading practice, especially involving the finance teams early when looking at risks and opportunities and integrating these into company strategy and transition plans.

Explaining this structure through a clear and concise diagram, supported with examples of how it practically works is good practice.



What are the different roles and responsibilities for the board and management?

Management bears responsibility for executing the strategy and ensuring this is in alignment with the board's long-term vision. Meanwhile, boards shoulder the responsibility for providing oversight, setting the strategic compass, navigating uncertainties, safeguarding the organisation's long-term sustainability, and steering the organisation towards its objectives.

Directors' fiduciary duty extends beyond short-term returns for shareholders. Long-term sustainability entails safeguarding the company's reputation, which significantly influences bottom-line performance and share prices for listed entities. With an evolving regulatory landscape and mounting pressure on climate issues, directors must maintain a bird's-eye view and contemplate the entity's transformation in the face of climate challenges. They should also look towards the interaction between climate and other risks and opportunities.

Balancing intersectional and dedicated responsibility

Over the years, many companies have established a dedicated Board Sustainability Committee or embedded explicit responsibility for sustainability strategy into an existing committee with an expanded remit (for example Environment, Health and Safety or Community, People and Sustainability Committee). However, oversight of reporting and disclosure traditionally sits with the board's Audit Committee, particularly when reporting becomes mandatory and embedded within the financial audit process (refer 'Good governance of reporting' on page 5).

Approaches to managing the enterprise-wide nature of risks, alongside dedicated risks, will vary across organisations based on maturity, industry, and risk profiles. The decision on where to embed, and how to manage, oversight of sustainability and climate is a question for what works best for each company. Different aspects of performance oversight may also sit within different bodies (e.g. climate risk with Risk Committee, Renumeration Committee oversight of executive KPIs and renumeration, strategy with the board's Sustainability Committee). Under the ASRS Standards the key requirement is that the policies and procedures for managing risks and opportunities are clear and transparently disclosed.

Companies will need to consider how to best bring committees together to get joined-up thinking on CRROs without necessarily having full board meetings on a rolling basis to get across all the detail that needs to be covered. Intersectionality between committees, such as having audit and risk chairs sit across both committees so they can raise this with the board as needed, can help in promptly addressing emerging issues.

Questions for the board to consider:

- How will accelerating climate disruptions impact your key markets and stakeholders? Which parts of the business are most exposed to climate risk, and what opportunities arise?
- Is the board structured appropriately to ensure CRROs are elevated and considered on an ongoing basis, and how does messaging cascade to management with respect to implementation and monitoring?
- How is the Board able to demonstrate integration of climate into decision-making?
- How are disclosures tying individual director's qualifications with the board's specific oversight needs now and moving forward?
- How are we as a board ensuring that we continually bring expertise into the board? Could we use specialist committees to ensure strong sustainability expertise informs the board's work?

Should climate-related targets sit in long term incentives (LTIs), short term incentives (STIs) or neither?

The proposed ASRS standards require disclosure on whether and how climate-related metrics are included in executive remuneration policies. Analysis of FY23 remuneration reports by EY teams found that fewer than half of ASX 100 companies disclose a climate-related metric in their STI, indicating that the market will need to consider how to meet this obligation. Companies should start conversation with their Remuneration Committees early to fully consider the impact on the overall remuneration framework.

Long-term goals, short-term milestones

Linking targets that are decades from now to executive remuneration in the present is a key challenge, as is incentivising executives to deliver long-term value for the organisation and stakeholders. Companies need to acknowledge that climate change is a long game with short term action. Having tangible milestones in the short-term, such as through the development of strategies, transition plans and specific climate-related projects, are important for executives to demonstrate that they have delivered against their responsibilities. Developing these components is also critical for communicating the upfront investment required for climate initiatives and the impact on short-term financials.

With this long-term context, consideration will need to be given about how climate metrics are incorporated into executive remuneration. For example, whether to introduce into Short Term Incentive or Long-term Incentive plans, the use of gateways, and selection of meaningful climate metrics.

In climate-related disclosures, it will be important for any chosen remuneration KPI to be aligned to a company's climate strategy and for there to be a baseline measurement, so that the calculations for incentive targets are robust. 'Soft' non-financial targets are a key focus area of institutional shareholder and proxy advisors.

Entities are also required to disclose the percentage of key management personnel remuneration that is linked to climate-related considerations. Importantly, this could be broader than just climate-related metrics and could apply where an element of remuneration is only partially climate-related. Developing a framework for determining these considerations, and working out the respective percentage, will be important.

How should a company assess whether they have the appropriate climate-related skills and competencies?

Directors are not expected to be experts in climate issues, but having a foundational understanding is essential. The degree of importance placed on climate will vary depending on the company's industry and sector. For instance, climate considerations would be more material to a mining company than they would be for a tech firm.

Leverage directors' strengths and experiences

While specialised skillsets may be necessary in some cases, companies should leverage the strengths and experiences that their directors bring. Boards should comprise members from diverse backgrounds and expertise from various industries and sectors, even if they lack specific knowledge of climate.

To ensure effective governance, companies should regularly review the composition and skills matrix of their boards to identify gaps and areas requiring upskilling. There has been a noticeable uptick in focus on upskilling efforts. However, there is also a concerning decrease in how boards rate themselves in terms of competency. This trend is reflective of the growing demands from stakeholders for informed governance practices and highlights the challenges directors face in keeping pace with evolving climate-related issues. This is where management's role is crucial. They need to provide boards with sufficient information to make informed decisions, allowing them to draw upon their experiences to benefit the company's governance practices.

2. Governance of reporting

Transition from voluntary to regulatory reporting with mandatory assurance is bringing a laser like focus on maturing how reporting is executed. Governance is a critical aspect of this particularly for Directors who will need to provide a declaration on the climate statements and organisations who are facing into increased disclosure risks around greenwashing. Governance of reporting includes accountability across Board and management for preparation, review and sign-off of climate-related financial disclosures, the robustness of systems and processes and management of assurance.

Clear delineation of responsibility

Clear delineation and allocation of responsibility is paramount for effective governance of climate-related reporting. Issues that could arise from ambiguity around who holds responsibility for which areas of climate related reporting. Management is responsible for preparing the disclosures while boards bear the ultimate responsibility for signing off on disclosures, but in practice the response is multidisciplinary with a number of board committees having accountability for content areas (e.g. remuneration, financial impact, enterprise and climate risk) and a number business functions providing, preparing and reviewing disclosures (finance, sustainability, risk, strategy etc). The development of a clear RACI for reporting which addresses this interplay and drives clear accountability is one approach.

Effective review

Boards need to be confident that the information presented has reasonable grounds, and they should engage in constructive interrogation of management to ensure the integrity of the disclosures. Constructive interrogation requires directors to know when and where to probe, fostering clear lines of responsibility and adopting a holistic approach across the organisation. Confidence with uncertain or estimated and forward-looking information could be a challenge for many in governance of climate reporting. Uncertainties in underlying information include scope 3 emissions, scenario analysis and transition planning. The Climate Disclosures Bill included modified liability requirements for directors and auditors apply in these three areas of disclosure. Notwithstanding this transition relief for Directors, transparency and in some cases education may be required for effective sign-off and governance of these complex disclosures.

Applying the same rigour as financial reporting

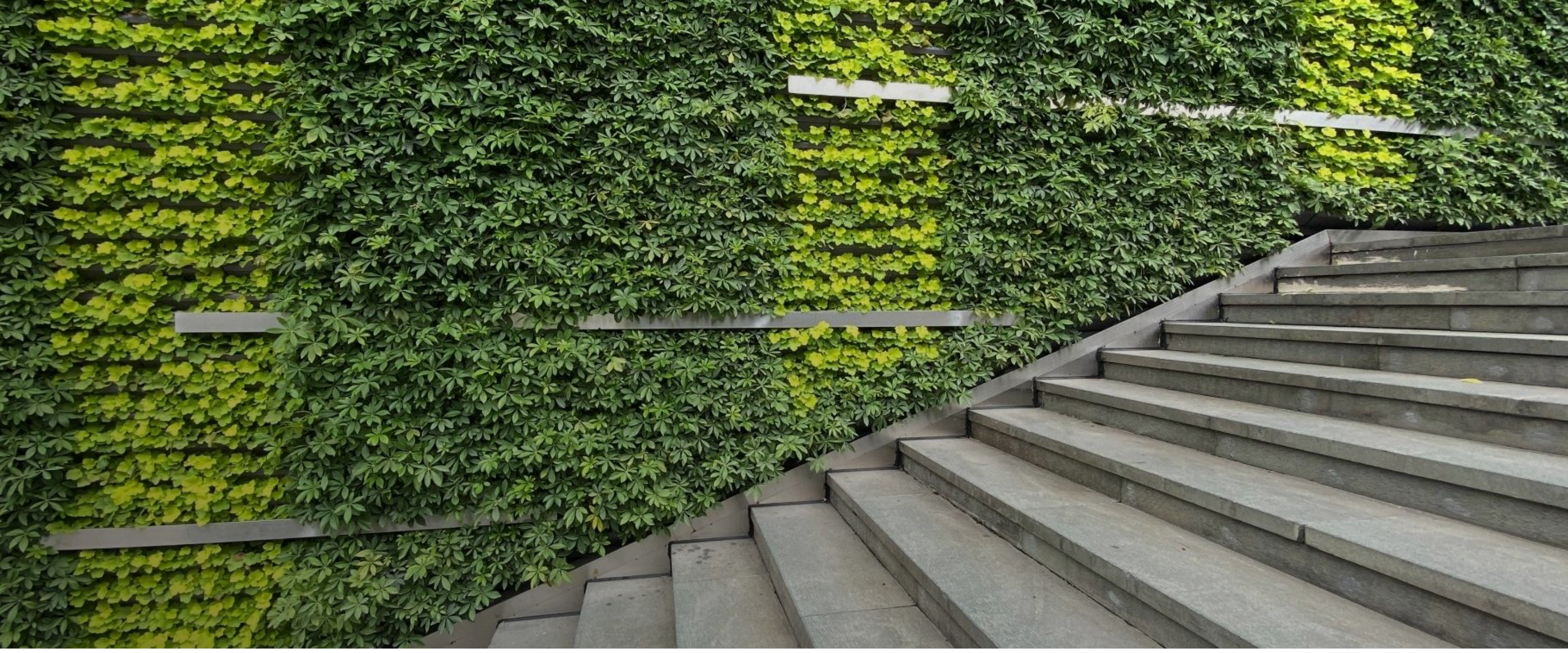
Listed companies adhere to stringent requirements for interim and annual financial reporting, ensuring transparency and accountability. The governance of climate disclosures similarly necessitates the same level of rigour to that applied in financial reporting. Aligning the quality of data, processes, systems, and oversight for sustainability reports with financial reporting standards is essential. A rigorous governance approach entails applying a similar process, encompassing top-down (structures) and bottom-up (processes) approaches at the board, committee, and management levels, especially given regulators' focus on the connectivity between the information reported in the financial report and the information disclosed in the sustainability report.

Assurance mechanisms, including internal assurance requirements driven by the three lines of defence, bolster confidence in disclosed information. While limited assurance has been customary for sustainability reports, it is crucial to acknowledge that there is a significant step change in effort between this limited assurance and the full audit that companies undertake for their financial statements and notes. With the financial auditor signing we have observed a shift in accountability for the governance of climate-related reporting towards the Audit Committee.

Greenwashing and forward-looking statements

Good governance plays a role in minimising the risk of greenwashing, particularly in the current regulatory environment and mandatory disclosures.

Companies need to make sure that they have reasonable grounds for their statements increasing use of internal verification platforms.



Key takeaways

As discussed in this paper, good governance is key to achieving the dual purpose of:

1. Overseeing risks and opportunities
2. Enabling robust disclosure and managing reporting risk

This can be done through having the right structures, the right skills at board and management, clear responsibilities both between and across levels, deliberate planning about remuneration considerations, and sufficient supporting and enabling risk controls and processes that apply same rigour as financial reporting.

From governance of climate perspective, companies should:

- Approach CRROs holistically, i.e. from both risk and opportunity lenses. Transition plans can support a holistic approach to CRROs as well as provide the backing for credible disclosures and the measurement of executive performance.
- Leverage their board's diversity of strengths and experiences and apply those to climate-related issues.
- Set long-term goals for the organisation while using short-term milestones to track performance against targets.

From a governance of reporting perspective, companies should:

- Engage in constructive interrogation of management to ensure the integrity of the disclosures.
- Apply the same rigour as financial reporting to climate-related disclosures in terms of supporting systems and processes, as well as external assurance.
- Make sure that they have reasonable grounds for their statements increasing use of internal verification platforms.

Ensure that there is a clear delineation between roles and responsibilities while maintaining communication between and across board and management levels is critical from both a governance of risk and a governance of reporting perspectives.

Appendix A: Who is in scope?

The *Treasury Laws Amendment (Financial Market Infrastructure and Other Measures) Bill 2024* (Treasury Bill) introduced into Parliament on 27 March 2024 specifies that an entity will be required to make climate-related financial disclosures if the entity is required to lodge financial reports under Chapter 2M of the Corporations Act and either the entity:

- Meets the prescribed size thresholds (see below)

  Or

- Is a 'registered corporation' under the NGER Act (or required to make an application to be registered)

A three-phased approach to implementation will apply based on the following thresholds, noting that both listed and unlisted entities that meet these criteria and thresholds will be within the scope of mandatory climate disclosures:

Group	Timing of reporting	Climate reporting criteria and thresholds		
		Size test (two or more are met)	Asset owners**	NGER Act reporters
1	2025 onwards*	>500 employees Consolidated total assets > $1b Consolidated revenue > $500m	Not applicable	Above NGER publication threshold
2	1 July 2026 onwards	>250 employees Consolidated total assets > $500m Consolidated revenue > $200m	Assets under management > $5b	All other NGER reporters
3	1 July 2027 onwards	>100 employees Consolidated total assets > $25m Consolidated revenue > $50m	Not applicable	Not applicable

* The Treasury Bill clarifies a commencement date for financial years beginning on or after 1 January 2025 for Group 1

**Asset owners (which are registered schemes, registrable superannuation entities or retail corporate collective investment vehicles with assets of $5b or more) will be a Group 2 entity even if they would otherwise meet the Group 1 size test.

Group 3 entities only need to provide climate-related financial disclosures if they identify material climate-related risks or opportunities for that reporting period. Group 3 entities that do not have material risks or opportunities would be required to disclose that fact and keep records that explain the methods, assumptions and evidence used in reaching that conclusion.

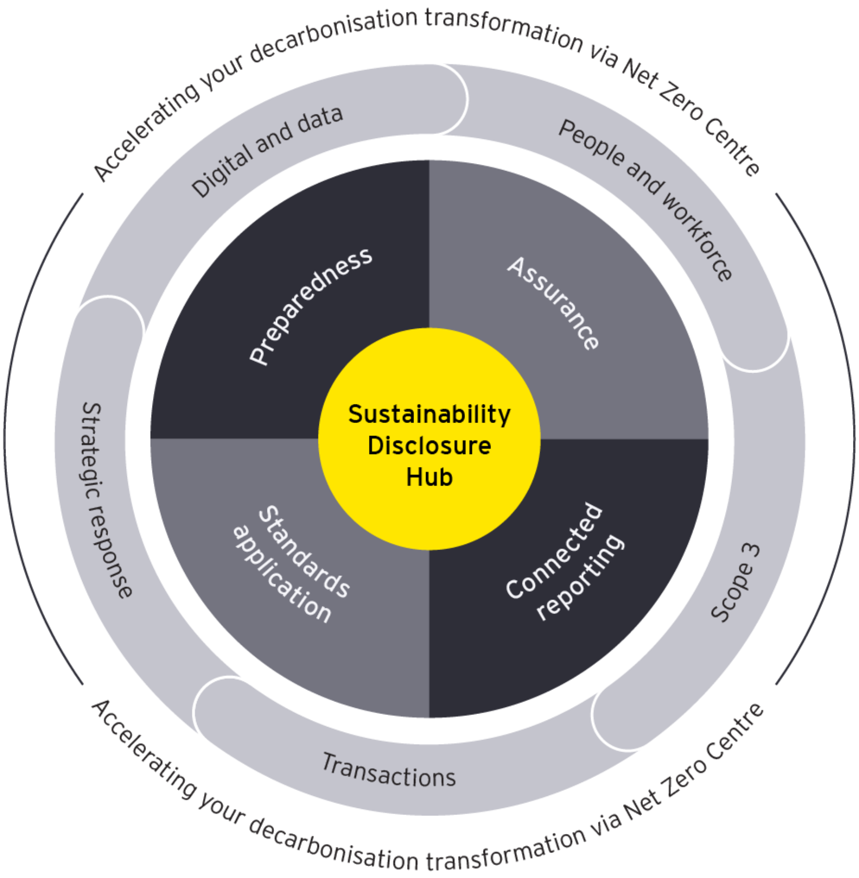
Appendix B: What are proposed disclosure requirements for governance?

The core requirement for Australian reporting entities as it relates to governance is to disclose the processes, controls, and procedures to monitor, manage and oversee CRROs within an entity's governance structure.

Specifically as per *[Draft] ASRS S1* paragraph 26 to 27 an entity shall disclose information about:

Theme	Disclosure requirement
The governance body responsible for oversight of CRROs	(a) the governance body(s) (which can include a board, committee or equivalent body charged with governance) or individual(s) responsible for oversight of climate-related risks and opportunities. Specifically, the entity shall identify that body(s) or individual(s) and disclose information about:
Oversight	(i) how responsibilities for climate-related risks and opportunities are reflected in the terms of reference, mandates, role descriptions and other related policies applicable to that body(s) or individual(s).
Skills and competencies	(ii) how the body(s) or individual(s) determines whether appropriate skills and competencies are available or will be developed to oversee strategies designed to respond to climate-related risks and opportunities.
Cadence	(iii) how and how often the body(s) or individual(s) is informed about climate-related risks and opportunities.
Embedding	(iv) how the body(s) or individual(s) takes into account climate-related risks and opportunities when overseeing the entity's strategy, its decisions on major transactions and its risk management processes and related policies, including whether the body(s) or individual(s) has considered trade-offs associated with those risks and opportunities.
Target setting and remuneration	(v) how the body(s) or individual(s) oversees the setting of targets related to climate-related risks and opportunities, and monitors progress towards those targets, including whether and how related performance metrics are included in remuneration policies.
Management's role in governance	(b) management's role in the governance processes, controls and procedures used to monitor, manage and oversee climate-related risks and opportunities, including information about:
Delegation	(i) whether the role is delegated to a specific management-level position or management-level committee and how oversight is exercised over that position or committee.
Integration of controls and procedures	(ii) whether management uses controls and procedures to support the oversight of climate-related risks and opportunities and, if so, how these controls and procedures are integrated with other internal functions.

Sustainability Disclosure Hub



The EY Sustainability Disclosure Hub offers practical guidance to assist companies across the region prepare for mandatory reporting of climate and sustainability-related reporting.

Headed by Oceania market-leading financial and non-financial reporting professionals, the Sustainability Disclosure Hub brings together EY capability locally and across the globe – coupling financial and non-financial reporting strategy, readiness and assurance capabilities that have an intimate knowledge of the work of the International Sustainability Standards Board (ISSB) and local market insights, including the development of the climate-related disclosure requirements by the Australian Accounting Standards Board (AASB) and New Zealand's External Reporting Board (XRB).

The Sustainability Disclosure Hub collaborates closely with the EY Net Zero Centre, which helps EY clients to make the right decisions at the right times and set themselves on a pathway for success in a net zero economy.

Please reach out to the EY Sustainability Disclosure Hub team to discuss what the requirements in the exposure draft mean to you.

Contact us

Sustainability Disclosure Hub

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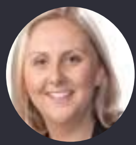

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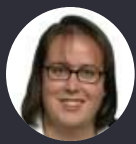

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