ESG Reporting in Australia

Change afoot, but are companies ready?

pwc

Introduction

Since PwC started analysing ESG (environmental, social and governance) reporting across Australia's leading companies three years ago, there has been a steady increase in the comprehensiveness of ESG reporting. This year we have continued to see a significant uplift in the number of companies reporting on ESG performance.

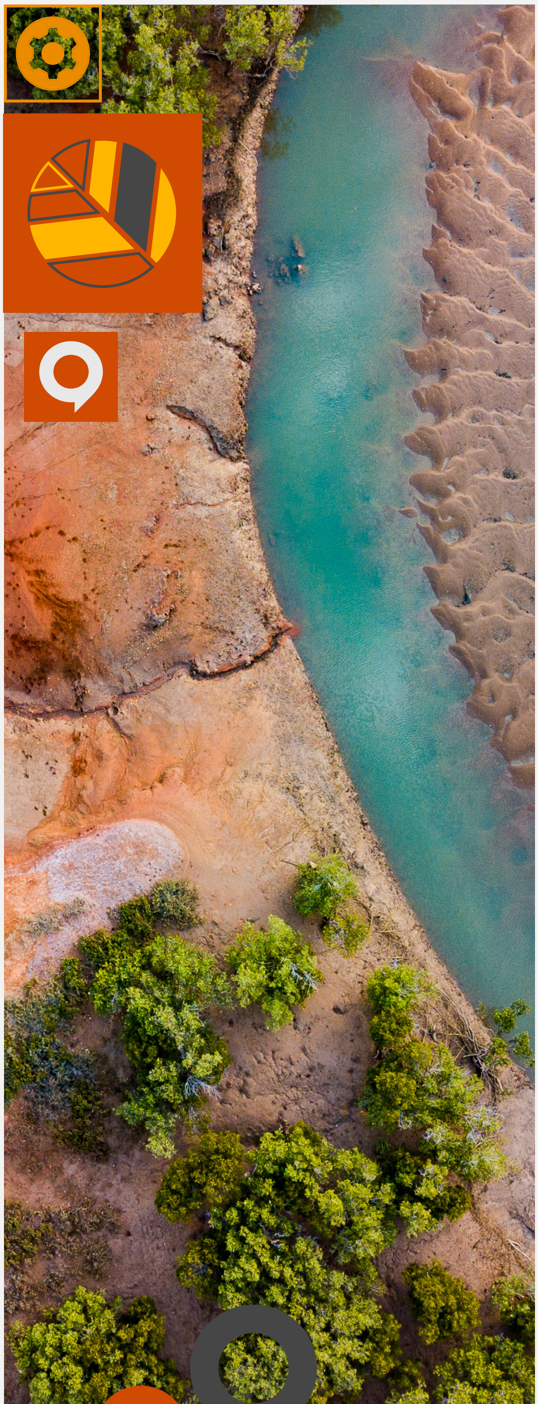
While ASX200 companies across the board have progressed in the maturity of their ESG reporting this year, there are compelling reasons for them to accelerate their efforts.

The International Sustainability Standards Board (ISSB), formed by international accounting standards-setter, the International Financial Reporting Standards (IFRS) Foundation, is merging various voluntary ESG frameworks into a single set of global disclosure standards.

This means that the ASX200 can, for the first time, assess their reporting maturity against the proposed standards endorsed by the IFRS Foundation. Many companies are still working through the ISSB's two draft standards, which are not yet finalised or mandatory.

The bar for alignment with these proposed draft standards is high. Companies must quantify and disclose the current and anticipated future effects of significant sustainability and climate-related risks and opportunities on their business model and value chain over the short, medium and long term. With further disclosures required, and stakeholders placing increasing value on ESG metrics, many companies will need to revisit their methodologies to report this data confidently.

According to our analysis, despite year-on-year improvements in ESG reporting, ASX200 disclosure levels will need to be significantly enhanced to meet the proposed standards of the ISSB, particularly in quantifying the financial impact of risks and opportunities.



This year's analysis of ESG reporting maturity covers ASX200 companies that have reported since the ISSB Drafts were released. In other words, companies that are December, March and June year-ends that have released their FY22 reports by 14 October 2022. Throughout this report, where we note 'ASX200', the number of reports included in the analysis from the top 200 companies is in fact 165.

In this report

Part One:
Examines how well the ASX200 compares against the Exposure Draft ISSB standards.

Part Two:
Explores ESG reporting challenges for companies to be aware of and the means to address them.

Part Three:
Draws our conclusions from the analysis.

The ISSB released the Exposure Drafts for its first two standards earlier in 2022. The first (Exposure Draft IFRS S1) sets out general sustainability-related disclosure requirements, while the second (Exposure Draft IFRS S2) specifies climate-related disclosure requirements. This year's analysis is different from prior years[1]. Given we expect the ISSB to become the market (if not regulated) standard in Australia and most geographies, our analysis compares current market practice with the requirements of the Exposure Draft ISSB Standards as the basis for analysing the maturity of ESG reporting.

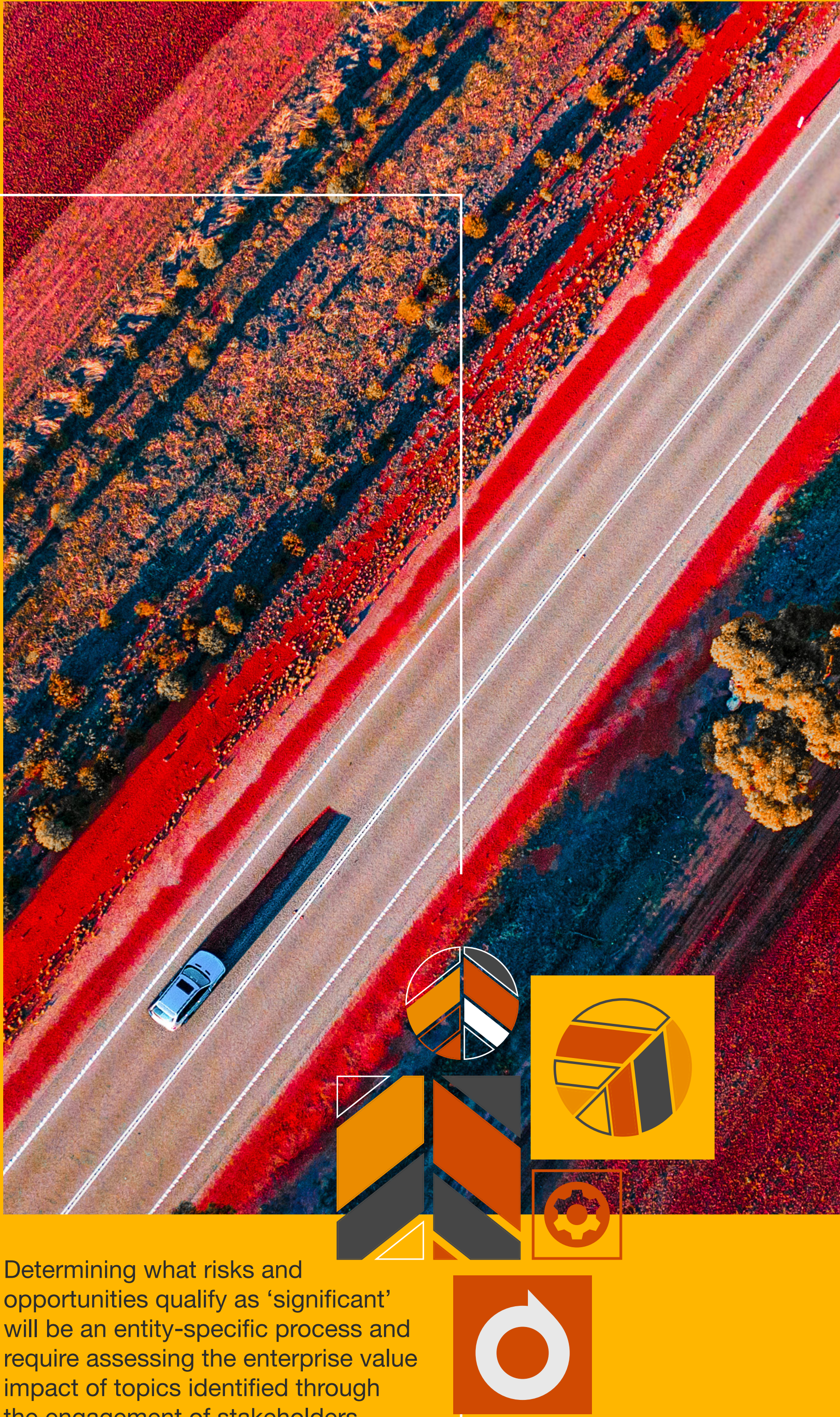
[1]In previous years, our methodology to analyse the maturity of ESG reporting was our Building Public Trust Insight Framework, based on three voluntary standards – the Global Reporting Initiative (GRI), The World Economic Forum (WEF) and the Task Force on Climate-Related Financial Disclosures (TCFD)

What are the ISSB's S1 and S2 Draft proposed ESG standards?

Until a global baseline is developed for all aspects of ESG reporting, companies have to navigate measuring their ESG performance against multiple standards. These include frameworks from the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the Taskforce on Climate-Related Financial Disclosures (TCFD) and guidance from the World Economic Forum (WEF).

The ISSB seeks to formalise two ESG measurement and disclosure standards by the end of 2022 once it has reviewed the extensive feedback from various stakeholder groups and jurisdictions – including PwC[2].

The ISSB disclosures are designed to give capital market stakeholders insight into how sustainability and climate-related risks and opportunities affect a company's enterprise value. Drafts S1 and S2 will require entities to provide information structured under four pillars: governance, strategy, risk management, and metrics and targets.



Exposure Draft S1

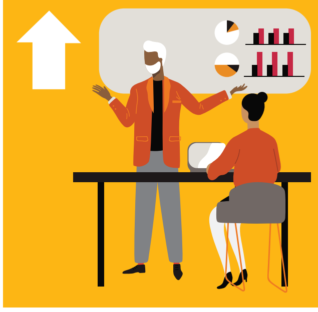
Is a general standard that requires all entities (regardless of industry) to disclose significant sustainability-related risks and opportunities that can reasonably be expected to affect an entity's enterprise value. These might include write-downs to fixed asset values, availability and cost of labour and materials, or the impact of carbon prices on a company's bottom line if introduced to drive decarbonisation. Further clarification and definition of what is 'significant' was a key point of feedback from almost all bodies to the ISSB in the feedback process.

Determining what risks and opportunities qualify as 'significant' will be an entity-specific process and require assessing the enterprise value impact of topics identified through the engagement of stakeholders, including those across its value chain.

Exposure Draft S2

Is a thematic standard that sets out the requirements for identifying, measuring and disclosing climate-related risks and opportunities. S2 has been drafted using the TCFD as a base but has more extensive reporting requirements.

[2]Our submission to the ISSB can be seen using this link: https://www.pwc.com.au/assurance/esg/pwc-australia-response-to-aasb-ed-321.pdf



There's been a 13% increase

in companies disclosing a **Net Zero commitment** (now 49% have a commitment).

However, among the companies with a Net Zero target

only 55%

have incorporated a discussion of their transition plan, including the activities that will enable them to reach Net Zero.

We've seen a 10% increase

in companies **disclosing** short, medium and long term **climate risks** and **opportunities**.

However, only 4%

specifically **evidence** these as **aligned** to the **the Intergovernmental Panel on Climate Change (IPCC) suggested time horizons.**

30% uplift

in the number of companies disclosing a gender diversity policy (that includes a target and reports against performance) with 77% now including disclosure in this area.

33%

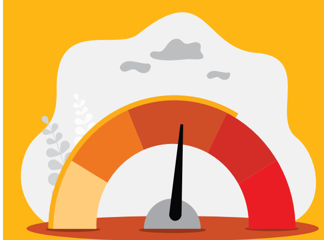
have a **reconciliation plan** endorsed by Reconciliation Australia (versus 24% in 2021).

75% of the ASX200

don't have a board member with climate competencies.

Only 6%

discuss **training plans** for board members.



55%

have **identified climate change** as a current or emerging risk.

But only 18%

discuss how their **financial position may** change over time because of **climate change-related risks** and **opportunities.**

57%

of companies have **targets** and **show evidence** of monitoring performance against these for most of their **material ESG topics.**

43%

of companies have some level of **external assurance**, a 9% uplift from the prior year.

Part One

How well the ASX200 compares against the Exposure Draft ISSB standards

This year's analysis reveals that while the volume of ESG reporting has increased, much of it is focused on the impact companies have (i.e. impact materiality) rather than the impact the issues are having on enterprise value (i.e. financial materiality).

The ASX200 has made significant progress in measuring climate and sustainability performance, with 49% of companies including some disclosure of Scope 3 emissions. However, many organisations will need to disclose the quantification of the financial impact of the risks and opportunities in a rapidly changing environment.

Overall, the ASX200 showed year-on-year improvements in reporting on their sustainability strategies and identifying material topics. However, many companies are still working up the maturity curve in setting specific targets in these areas and developing disclosures that measure progress against targets.

Digging further into the data paints a more detailed picture of how well the ASX200 currently reports in comparison to the requirements of the draft S1 and S2 standards.

A year of improvements in climate-related disclosures

There continues to be a gradual improvement in disclosures around the risk of climate change to Australian businesses, just over half (55%) identify climate change as a current or emerging risk that is being considered by the board and management.

More companies are reporting Net Zero targets, with 49% committing to Net Zero. Of these, half (55%) include a reasonable level of detail on a transition plan to achieve their target.

There has been an increase in the understanding, measurement, and reporting on emissions, including Scope 3. 49% of companies have disclosed Scope 3 emissions in some form, a third of which have included emissions from their own operations as well as upstream and downstream through their value chains. While companies are making good first efforts in reporting Scope 3 emissions, these are often excluded from the scope of external assurance. We expect this to change over time as the quality and availability of underlying data improves.

A delicate balance; sharing the right ESG information to support investor and stakeholder decision making

While we won't know the ISSB's final stance on climate reporting for some time, the Exposure Drafts paint a reasonably clear picture. Organisations will need to anchor ESG reporting to impacts on enterprise value. For example, how will companies drive performance given climate goals? Currently, perspectives on this are unclear. And, while in some instances, obtaining information will feel relatively straightforward, there is an extremely fine balance for organisations to manage how much they disclose without putting themselves at commercial risk.

Data around forward-looking estimates and market-sensitive information is not typically disclosed publicly, particularly concerning opportunities. Companies may look to understand how safe-harbour mechanisms for forward-looking estimates and judgements are provided before disclosing such information.

ISSB's changes won't happen overnight. A tiered approach may occur (for example, the ASX100 may be required to comply in the first year, with others across the market following suit later). However, companies should consider the proposed requirements now and prepare accordingly.

Only 18% have disclosed the potential financial impact of climate risk and opportunities. Most companies have yet to consider broader 'significant' sustainability-related risks and opportunities that may affect enterprise value, such as natural capital.

Requests for further clarification and practical guidance on determining whether a sustainability-related risk or opportunity is ‘significant’ under standards were a key theme of the ISSB’s consultation process.

Key findings

ASX50 against the S1 sustainability reporting standard

78% of the ASX50 (of which 46 are included in our analysis as they had reported results by 14 October) provide some level of disclosure on ESG topics relevant to their industry, as identified by the SASB standards being leveraged by the ISSB.

However, companies require more guidance on what constitutes a ‘significant’ sustainability risk and opportunity to meet ISSB reporting requirements.

Disclosure has improved regarding how companies identify, prioritise and address ESG topics considered most important to their business. Over 74% of the ASX50 disclosed the process undertaken to identify these topics, with 44% of those companies further describing the frequency this process is updated (an improvement over the prior year of approximately 10%). Similarly, we have seen an improvement in the description of engagement with internal and external stakeholders, with 22% of the companies outlining the critical issues relevant for all stakeholder groups and outlining actions in response to these concerns.

While this is good progress, identification of these topics to date has typically focused on two dimensions: first, importance to stakeholders, and second, importance to the business.

With the ISSB’s focus on ‘significant’ sustainability risks and opportunities that could affect enterprise value, companies will need to consider how these processes change in the future to align with broader risk assessment processes. Additionally, they will need to consider what information on these significant ESG risks is material to investors’ financial materiality while not ignoring the expectations of broader stakeholders regarding the company’s impact materiality.

The ‘double materiality’ concept

Double materiality is an extension of the key accounting concept of materiality of financial information. Information on a company is material and should therefore be disclosed if “a reasonable person would consider it important”, according to the US Securities and Exchange Commission[3].

Information on the economic value creation by the company, for the primary benefit of its investors.

Financial Materiality

+ → Double Materiality

Information on the company’s impact on the economy, environment and people for the benefit of multiple stakeholders, such as investors, employees, customers, suppliers and local communities.

Impact Materiality

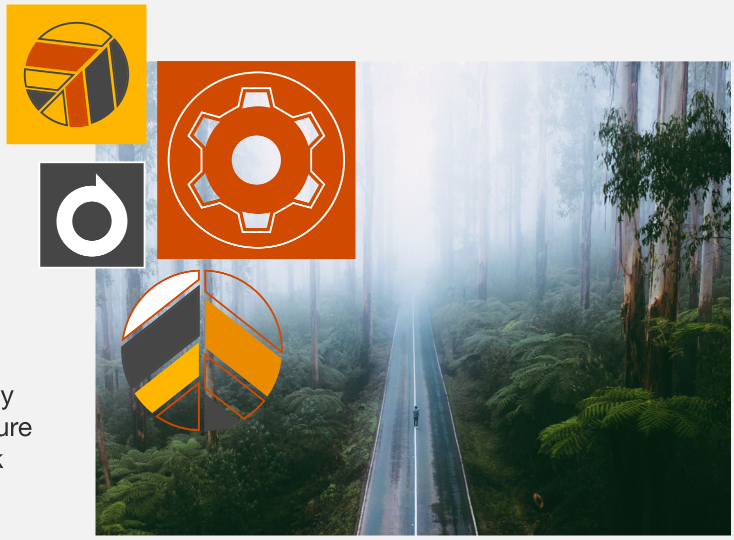
S1 outlines an expectation that significant sustainability-related risks and opportunities are assessed across short, medium and long time horizons, as well as for their potential impact on enterprise value.

Our review found that currently 30% of companies are close to meeting that threshold on at least one of their material areas of focus, which is almost always climate change.

[3] https://www.sec.gov/interps/account/sab99.htm

Key findings

Comparing against the S2 climate reporting standard



The disclosure requirements under S2 are comprehensive and set a high bar. Companies aligned to the TCFD and already performing climate scenario analysis enjoy a head start on compliance. This was evidenced by approximately half of the ASX50 providing some level of disclosure under the four pillars of governance, strategy, risk management, metrics and targets outlined in the S2 Draft.

When looking at the broader cohort of the ASX200, there is the need for further disclosure under the four pillars of the S2 guidance.

For governance, the most significant gap is around the disclosure of skills, in particular:

- currently, only 25% disclose the specific expertise of board members concerning climate change
- only 6% disclose the training the board have undertaken or are about to undertake

For strategy, the most significant gap is assessing the financial impact of the risks and opportunities, with only one in five companies providing disclosures in the following areas:

- disclosure of performing scenario analysis to quantitatively assess transition and physical risk, including a greater than 2 degrees C scenario, with a discussion of underlying assumptions
- how significant climate-related risks and opportunities affected the most recently reported financial position, financial performance and cash flows
- how the financial position will change over time for a given strategy to address climate-related risks and opportunities

To meet the proposed S2 requirements, companies will need to provide more detailed disclosure of decarbonisation transition plans to address climate risks. For example, disclosures on how transition plans will be resourced are shown for approximately a quarter of companies. Providing a reasonable basis for how a company will achieve emission reduction targets, for instance, in the form of a resourced transition plan, provides confidence to stakeholders on the validity and achievability of these ambitions.

For risk management, while many companies have identified climate change as a material risk, only approximately one-third describe how this assessment fits into their already-established risk assessment framework.

Further, highlighting and describing opportunities identified through a transition to a lower carbon economy is limited.

This may be driven partly by the fact that companies haven't yet been able to articulate their opportunities in a commercially-sensitive manner. Companies are also grappling with managing the risk of greenwashing, which is now on regulators' radars. The Australian Securities & Investments Commission (ASIC) is already undertaking greenwashing investigations, according to press reports, and has warned companies about making misleading statements and offering guidance on how to minimise greenwashing risks.

For metrics and targets: The draft standard requires an extensive range of information relating to metrics and targets that Australian companies do not currently disclose.

Examples include:

- Amount and % of assets or business activities vulnerable to physical risks (83% do not at all) and transition risks (88% do not disclose)
- Amount and % of assets or business activities aligned with climate related-opportunities (64% do not disclose)
- Deployment of capital towards financing or investment (87% do not disclose)
- Use of internal carbon prices (72% do not disclose)
- Link to remuneration with disclosing how executive management's KPIs are aligned to meeting climate-related targets (72% do not disclose)

Part Two

ESG reporting challenges to be aware of and how to address them

Our analysis supports the common challenges we see in the market. We've identified five critical areas for companies to focus on and improve to help meet proposed ISSB disclosure standards.

To get ahead of these challenges, companies can establish working groups with sustainability, risk, financial and legal representation to focus on the following areas outlined in this section.

1. Financial quantification of future financial impacts of sustainability-related risks and opportunities

A key reason for the disclosure gap is the potential forward-looking nature of reporting in alignment with the ISSB standards. Estimating the potential future financial impact on a specific asset or liability balance or revenue or cost line under evolving scenarios carries risk. Adopting disclosures while maintaining commercial/competitive advantage also presents a challenge.

There is no precedent where a company has disclosed the right amount of information to comply with draft ISSB requirements. Consequently, consideration of safe harbour provisions for companies disclosing forward-looking information will be important in this context.

To address this challenge, companies can:

- Stay engaged with the ISSB process and aware of practical application guidance as it starts to be released
- Work / take part in industry groups to leverage experiences and insights

2. Skills shortage and literacy gap

Internally, companies are still working through who owns sustainability performance and reporting. Different models exist depending on a company's size. Responsibility could be delegated to a sustainability, risk, finance function or a combination thereof.

Regardless of the current working model, the workload required to set up measurement, quantification and reporting of sustainability and climate risk and opportunity under ISSB will be significant. Finding people with the right skills in the existing labour market shortage is a challenge.

Even where ownership for sustainability reporting is clear and adequately resourced, there is still a need for robust oversight at the governance/board level to ensure fulsome governance over climate and broader ESG risks.

Companies still need to improve ESG competencies at the board and executive levels, with only 25% and 7% of companies disclosing climate change as a competency of at least one board member and executive, respectively.

Solutions to address skills and talent issues include:

- Identify and utilise existing skills across your organisation; bring them together and have them educate each other. The optimal strategy is a cross-skills and cross-function solution
- Start to mobilise people across the company who have the skills to address the challenges
- Bring the accountants in to help interpret and apply the standards
- Use economics/modelling teams to work with sustainability leads
- Upskill executive management and the board across key sustainability issues to strike the right balance between experienced leadership skills and those needed to navigate emerging risks

3. Data quality and process management

Collecting and validating the data required to comply with the ISSB Drafts and quantifying the forward-looking financial impact on assets and business activities is challenging.

An example is the significant amount of data required to measure and report on Scope 3 emissions, which the proposed ISSB S2 will require reporting of. Currently, 14% of companies have measured operational, upstream and downstream Scope 3 emissions. However, measurement methods will continue to develop as more accurate information becomes available through supply chains.

Companies will need a quick and significant uplift in digital capabilities around sustainability data to meet the ISSB reporting requirements.

Solutions to address data and process challenges include:

- Understand the data you have, look at mapping the gaps to compliance, and think about the process, systems and controls needed to achieve these
- Technology solutions are available and gaining in sophistication, but the outputs will only be as good as the data inputs putting pressure on companies to get their houses in order first

49%
of companies have disclosed some Scope 3 emissions

24%
disclosed from their own operations only

11%
also include some upstream

14%
also include downstream

What are scope 3 emissions?

Scope 3 emissions are all indirect emissions that occur in the value chain of the reporting company. Material Scope 3 impacts will vary by industry and business model. Still, for many companies, significant emissions occur upstream via suppliers and raw materials or downstream through the use and disposal of sold products. Given the far-reaching impact of Scope 3 emissions requirements, every business area could be affected, from supply chain and product development to reporting and marketing and, of course, sustainability teams.

4. Implementation costs to clarify and report climate-related disclosures

Adding to other critical challenges of meeting future ISSB requirements is the cost associated with verifying data that underpin disclosures across essential topics. Such disclosures include greenhouse gas emissions data, information from supply chains on labour practices and their own emissions, diversity and inclusion information and data on the impact of natural capital, just to name a few.

Companies could face high costs to mature their functions, for example, people, processes, and verification. Looking to recent US Securities and Exchange Commission (SEC) announcements to enhance and standardise climate-related disclosures for investors[4], the estimated increased total expense for US businesses ranges from US$3.9 billion to US$10.2 billion, depending on the maturity of their ESG approach[5].

To address these additional costs, companies must start planning for the change in reporting expectations and allocate resources accordingly.

5. Evolving global regulatory frameworks

Alongside the ISSB, the European Financial Reporting Advisory Group (EFRAG) and the SEC have proposed new sustainability and climate reporting requirements. Companies with a global footprint face a growing risk that multiple jurisdictions will implement different frameworks (guiding principles) and standards (rigid requirements).

While there are common aspects across the three reporting proposals (including broad alignment with the TCFD frameworks), differences exist in the nature, level of detail and timelines for implementation.

To address this challenge, companies should work with specialists who can keep them abreast of the ongoing developments in various territories.

[4] https://www.sec.gov/news/press-release/2022-46
[5] https://www.greenbiz.com/article/counting-true-cost-climate-change

Part Three

Conclusion

Benefits for early adopters of the ISSB

ESG reporting requirements are driving large-scale shifts in overall business strategies and approaches locally and abroad. Looking at initiatives across the globe, mandatory ESG regulation requirements continue to gather pace. Undoubtedly, Australia will follow suit. Stakeholder activism on ESG topics continues to gain traction as regulators become increasingly concerned with greenwashing.

All of this points to an obvious need for companies to address reporting shortfalls sooner rather than later. Alongside complying with ISSB's sustainability and climate standards, companies must maintain momentum in other ESG areas such as modern slavery, First Nations, diversity and privacy, which still require significant attention.

Looking across the broader spectrum of ESG areas, there has been an overall improvement in reporting. There has been a 9% uplift in reconciliation plans endorsed by Reconciliation Australia, a 30% increase in companies disclosing a gender diversity policy with metrics and targets and a 9% uplift in the number of companies obtaining external assurance over at least some sustainability metrics.

The ISSB's standards allow companies to re-evaluate how they manage and operate their business and identify not just their climate and sustainability-related risks but their opportunities too.

Companies that develop a financial understanding of the impacts of sustainability and climate change, and that take them into account in regular decision-making, can gain significant competitive advantage.

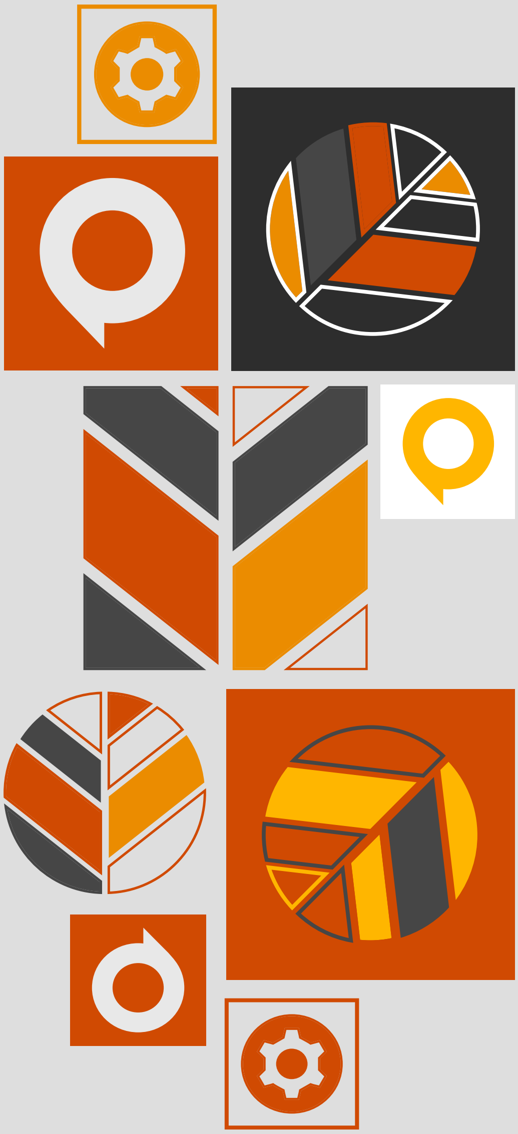
From identifying new markets and products to well-informed risk assessment, this shift can improve internal decision-making while allowing companies to give internal and external stakeholders the information needed to make operational and investment decisions. Ensuring disclosures comply and reflect how a business strategy is being assessed internally provides further validation and comfort for investors and broader stakeholder groups.

The task that lies ahead is tremendous.

Boards and executives are asked to work towards a 'no regrets path'. They must stay on top of the developing regulatory landscape, ensure a collaborative and 360 view is being formed for their organisation, and prepare for impending ISSB changes. This year's analysis shows companies are making progress on this path.

However, given the pace and extent of the changes required, many companies may require additional support to achieve the full value of transparency on sustainability and other ESG issues.

To learn more about ESG reporting and governance, please reach out to our team below.



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