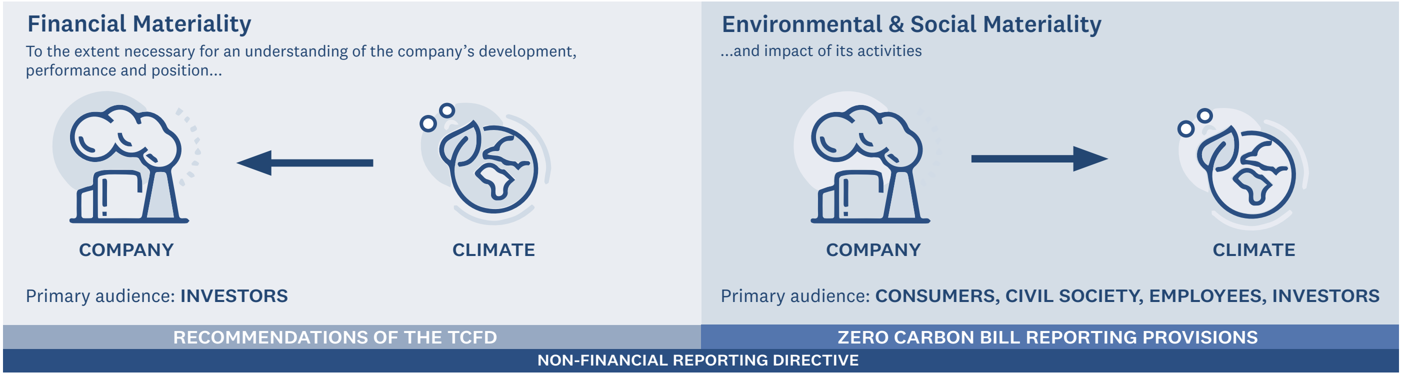
Exploring Ways to Embed Climate Reporting in the Existing Framework

Think Piece 32: September 2019



The double materiality perspective of the Non-Financial Reporting Directive in the context of reporting climate-related information adapted from (European Union, 2019, p. 5).

This think piece was prepared specifically for the Select Committee hearing on the Climate Change Response (Zero Carbon) Amendment Bill (the Zero Carbon Bill).

This is a supporting document to *Discussion Paper 2019/01 – The Climate Reporting Emergency: A New Zealand case study*, which explores ways to embed requirements to disclose climate-related information in the existing accounting and assurance framework.

The McGuinness Institute fully supports the purpose of the Zero Carbon Bill, which is to 'provide a framework by which New Zealand can develop and implement clear and stable climate change policies that contribute to the global effort under the *Paris Agreement* to limit the global average temperature increase to 1.5° Celsius above pre-industrial levels' (Explanatory note). However, this think piece outlines our concerns about the reporting provisions – namely that new information on international initiatives and their effects that has become available since the Bill was drafted indicates that New Zealand is falling behind international best practice, especially in the UK and EU. Three key initiatives illustrate this emerging gap in practice and conceptual thinking:

1. By 2020, approximately 12,000 companies in the UK will publicly report on GHG emissions in their directors' report as part of their annual filings with the Companies House (the UK equivalent to New Zealand's Companies Register) (Carbon Trust, 2019; DEFRA & BEIS, 2019, p. 35). If New Zealand adopted the same threshold and practices as the UK, all the Deloitte Top 200 companies would be required to report GHG emissions (scopes 1 and 2) in their directors' report and their directors' report would be filed on the Companies Register. Currently in New Zealand, only financial statements are required to be filed for a select number of companies. In 2018, the Institute could not locate the financial statements of 64 companies from the Deloitte Top 200 on either the Companies Register or the companies' individual websites (McGuinness Institute, 2019, p. 10).

2. By 2022, all quoted companies (the equivalent to listed companies) and large asset owners are expected to disclose in line with TCFD recommendations (BEIS & HM Treasury, 2019, p. 23).

3. In June 2019, the EU issued *Guidelines on non-financial reporting: Supplement on reporting climate-related information*, which highlights the importance of stakeholders understanding a 'company's view of how climate change impacts its business model and strategy, and how its activities can affect the climate, over the short, medium and long term' (European Union, 2019, p. 8). The guidelines also includes a diagram slightly adapted to form the header image above, which illustrates what the EU refers to as 'the double materiality perspective'.

The double materiality perspective draws a distinction between the impacts of the climate on entities (financial materiality, covered by the recommendations of the TCFD) and the impacts of entities on the climate (environmental and social materiality). The EU's non-financial reporting directive covers financial materiality as well as environmental and social materiality, but the Zero Carbon Bill in its current form arguably focuses on environmental and social materiality as disclosed by the entities outlined in cl 5ZV(4). Figure 1 illustrates the difference between public policy terminology and accounting terminology used in reporting standards. Although we see the advantage of legislating requirements for the organisations in cl 5ZV(4) first, we believe significant private sector entities should be included in the reporting provisions as well.

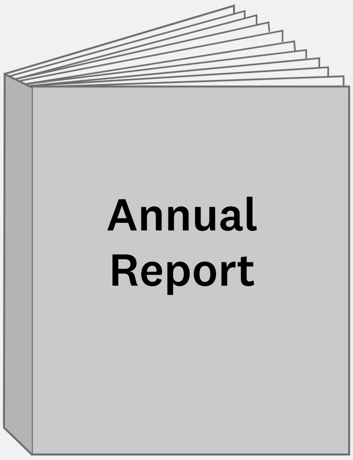
Figure 1: Two reporting perspectives

Entity type	Public policy perspective		Accounting perspective	
	Public	Private	Public benefit entities	For-profit entities
Public sector entities (e.g. Crown entities)	✓		✓	
Public sector for-profit entities (e.g. SOEs)	✓			✓
Private sector not-for-profit entities (e.g. registered charities)		✓	✓	
Private sector for-profit entities (e.g. listed companies and FMC reporting entities)		✓ #		✓

[grey box] Covered under the Climate Change Response (Zero Carbon) Amendment Bill

Includes approximately 25 privately held lifeline utilities as defined in Schedule 1 of the Civil Defence Emergency Management Act 2002

The centre of this think piece is a diagram mapping out the existing reporting framework in terms of relevant international organisations and pronouncements and legislation and the New Zealand framework and legislation. Policy levers that could be used to embed climate reporting requirements in the existing framework are indicated with the numbered key overleaf. These levers are discussed in more detail in *Discussion Paper 2019/01*, alongside a broader overview of the climate reporting system.



Content of an annual report

- Directors' report
- Financial statements
- Auditors' report
- Corporate governance statement
- *Statement of Climate Information* [new] 6

Policy Levers

1 A: IPSASB (public sector only)
    (a) Create a CC standard

  B: IASB (for-profit only)
    (a) Create an IFRS CC standard
    (b) Expand PS 1
    (c) Expand PS 2

2 XRB create new CC standard or guidance and/or adopt Australian guidance

3 Embed TCFD in the NZ reporting regime (similar to UK Green Finance Strategy)

4 Strengthen chair's/directors' report
    (a) Embed CC information outside of the FS (similar to UK requiring GHG emissions in directors' reports of 12,000 companies) – s 131 and s 137
    (b) Expand directors' duties – s 131 and s 137
    (c) Expand contents of annual report – s 211
    (d) File chair's/directors' report on the Companies Register

5 Expand Corporate Governance – FMA and NZX

6 Create new *Statement of Climate Information* for inclusion in annual report – s 211 for selected entities

7 Create new regulations under the Bill and/or a domestic standard is developed by XRB under s 17(2)(iii)

Organisations ◯

AASB	Australian Accounting Standards Board
AUASB	Auditing and Assurance Standards Board (Aus)
FMA	Financial Markets Authority
FSB	Financial Stability Board
FRC	Financial Reporting Council (Aus)
IASB	International Accounting Standards Board
IAASB	International Auditing and Assurance Standards Board
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS F.	IFRS Foundation
IPSASB	International Public Sector Accounting Standards Board
MBIE	Ministry of Business, Innovation and Employment
NZASB	New Zealand Accounting Standards Board
NZAuASB	New Zealand Auditing and Assurance Standards Board
NZX	New Zealand Stock Exchange
TCFD	Taskforce on Climate-related Financial Disclosures
XRB	External Reporting Board

Pronouncements and Legislation ☐

IFRS	International Financial Reporting Standards
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
ISAE	International Standards on Assurance Engagements
ISRE	International Standards on Review Engagements Standards
PBE	Public Benefit Entity

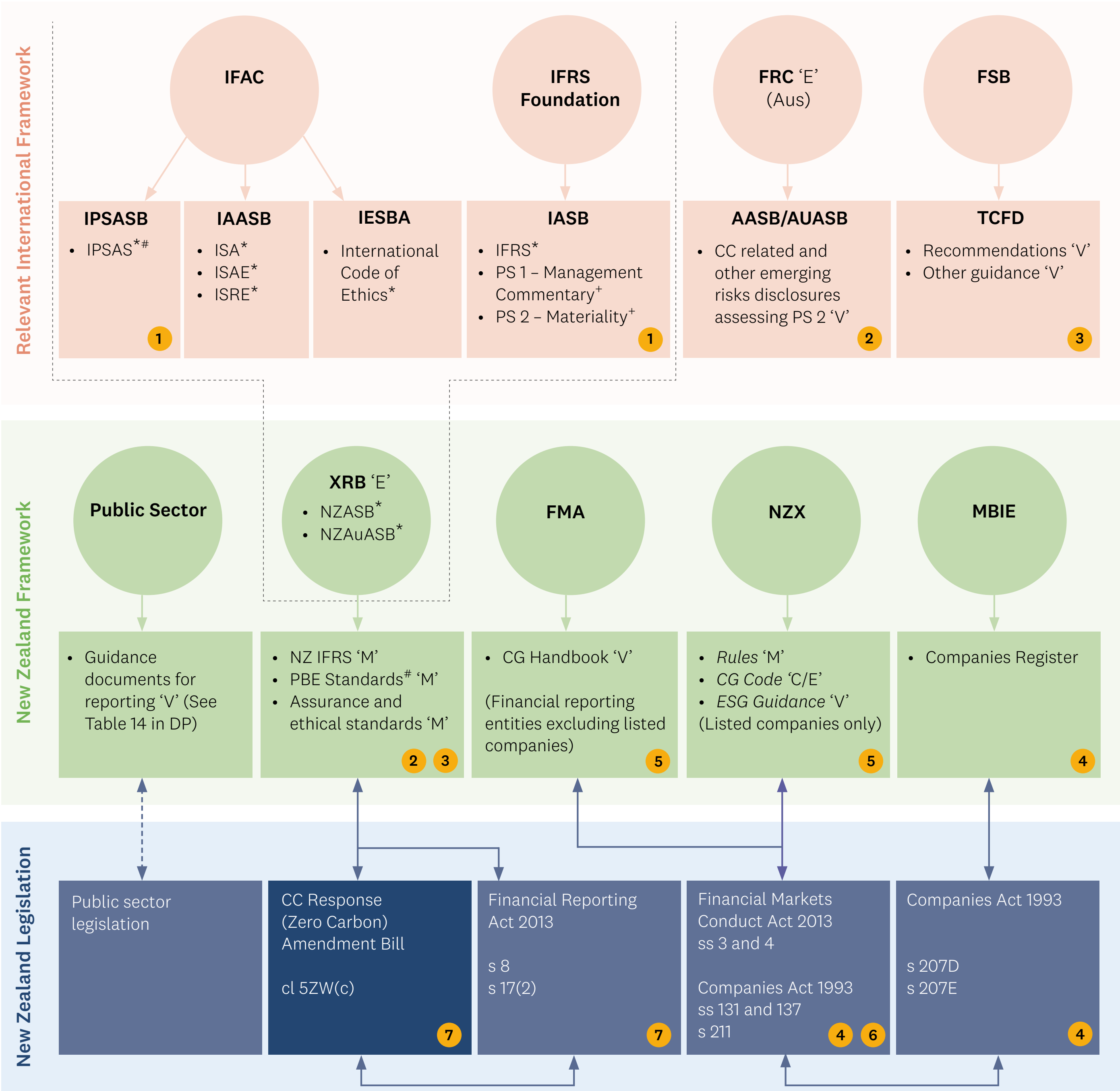
Reporting Obligations

'C/E'	Comply or explain
'M'	Mandatory
'V'	Voluntary

Other Abbreviations

CC	Climate change
CG	Corporate governance
CR	Companies Register
DP	MI Discussion Paper
FS	Financial statements
PS	Practice Statement

Map: Exploring ways to embed climate reporting into the existing framework



* International standards are issued for voluntary adoption at the international level and are mandatory when adopted by the XRB as New Zealand standards (e.g. NZ IFRS or ISA (NZ)).

\+ IFRS PS 1 and PS 2 are issued for voluntary adoption at the international level but have not been adopted by the XRB. For-profit entities applying IFRS Standards are not required to comply with IFRS PS 1 and IFRS PS 2 in order to state compliance with IFRS Standards.

\# XRB's PBE Standards are based on IPSAS.

'E' FRC, AASB and AUASB are the Australian equivalents to the XRB, NZASB and NZAuASB respectively.

The remainder of this think piece is excerpted from Section 8 of *Discussion Paper 2019/01*, which puts forward a range of ways New Zealand might improve transparency and accountability and become a fast follower in terms of disclosing climate-related information.

Goal 1: Improve the quality and accessibility of climate-specific information in New Zealand

1. Review the entity reporting framework with a view to developing an integrated, flexible and robust strategy on climate reporting.
2. Require a *Statement of Climate Information* to be included in the annual report by amending s 211 of the Companies Act 1993. This could be limited to say a maximum length of four pages, to be signed by the chair and to include risk identification (e.g. by using scenarios and developing priorities), measurement (e.g. GHG emissions reporting) and management (e.g. the entity's strategy to the *Paris Agreement*).
3. Consolidate and centralise all reporting in the annual report:
   (a) Require a corporate governance statement to be included in the annual report by amending s 211 of the Companies Act 1993.
   (b) Require all entities that currently file financial statements with the Companies Office to instead file their full annual reports (including the *Statement of Climate Information*). This could be voluntary for the first 24 months.
   (c) Treasury to produce a consolidated annual report of the Government in addition to the consolidated financial statements of the Government, which includes the equivalent of a chair's report, a corporate governance statement and *Statement of Climate Information*.

Goal 2: Ensure those who are responsible for governance in New Zealand think long-term and are future-focused

1. Require a *Climate Change Mitigation and Adaptation Strategy for New Zealand* to be prepared to help guide reporting requirements.
2. Amend s 131 and/or s 137 of the Companies Act 1993 to strengthen directors' duty of care by including a duty of care to be future-focused.
3. Amend s 211(1) of the Companies Act 1993 to require a chair's report to:
   (a) Be from the board only (i.e. not jointly signed with the CEO). This is to ensure that the lines of accountability are clear and that governance/strategic matters are distinct from operational matters.
   (b) Require the board to be strategic and consider long-term risks, opportunities and impacts.
   (c) Require the chair's/directors' report to be filed with the Companies Office (as in the UK).
4. Amend s 211 of the Companies Act 1993 to require the inclusion of a strategic report in the annual report and outline its key contents (similar to the UK Companies Act). To assist entities in implementation, the XRB (or the FMA) should prepare and issue guidance or a standard outlining specific content requirements of the strategic report. The XRB has the widest remit.
5. Amend s 211 of the Companies Act 1993 to require selected entities to prepare a range of climate change scenarios to be included in their *Statement of Climate Information*. For example, specific types of scenarios could be prescribed for local bodies, such as 1°C increase in sea temperatures, or a 1m rise in sea levels. Climate change scenarios will assist boards in identifying, measuring and managing risks and improving their preparedness for a range of eventualities. This will capture risks that are not currently material (i.e. not currently disclosed in the financial statements) but are likely to become material in the longer term (i.e. may be disclosed included in the financial statements in the future) (see Goal 1).
6. Remove the requirement in the *NZX Listing Rules* to produce half-year reports to reduce short-termism and free up management to focus on long-term thinking.
7. XRB to extend the 'relevant period' of consideration for going concern from the current 12-month basis to five years from the date of the auditor's current report to take the nature of climate risks into account. This would specifically involve amending paragraph NZ13.2 and reissuing the auditing and assurance standard *ISA (NZ) 570* (XRB, 2015, p. 9).
8. Government departments to be required to replace their four-year plans with 10-year plans. These should align with local government plans and should be written for the general public as shareholders. The 10-year plans should be prepared every three years (in alignment with local government).

Goal 3: Cater to the disclosure needs of broader stakeholders in New Zealand

1. Audience of the annual report should be extended to include stakeholders more broadly, rather than only shareholders or primary users (investors, creditors, etc.).
   (a) Amend s 211(1a) of the Companies Act 1993 to replace shareholders with stakeholders. This will clarify the role of the chair's report (our early research indicates the audience of the chair's report is already stakeholder-focused, see *Survey Highlights: A summary of the 2017 Extended External Reporting Surveys*).
   (b) *NZX Code* to require disclosure of the impacts of the company on its broader stakeholders. This would be more in line with the current consideration of stakeholder interests required in Principle 9 of the *FMA Corporate Governance Handbook*. For greater consistency and alignment, the *NZX Code* and *FMA Handbook* could be jointly revised and published, producing one code with different criteria for different entities.
2. XRB to provide climate-related disclosure guidelines based on the IASB's *IFRS Practice Statement 2: Making Materiality Judgements*. Alternatively, New Zealand could adopt the Australian Accounting Standards Board (AASB) and Australian Government Audit and Assurance Standards Board (AUASB) 2019 guidelines in *Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2*.
3. Preparers to ensure that all related risks (financial and non-financial) are appropriately grouped in the notes to the financial statements (this is implied in accounting standards but could be better applied in practice). The XRB to undertake a review and provide guidance on this.
4. Amend s 137 of the Companies Act 1993 to strengthen directors' duty of care by including a duty of care owed to stakeholders.

Goal 4: Improve the existing international framework of reporting standards to cover climate-related information

1. Stakeholders to directly/indirectly influence and liaise with the IASB to strengthen existing standards and develop new standards and guidance to cover climate-related information.
2. Voluntary frameworks need to converge or at least develop a set of shared principles to align and prevent confusion for preparers and users alike.

References for this think piece can be found on the McGuinness Institute website at www.mcguinnessinstitute.org/think-pieces.

The McGuinness Institute is a non-partisan think tank working towards a sustainable future, contributing strategic foresight through evidence-based research and policy analysis.
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