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Riding the ESG Wave

Navigating Climate Reporting and Decarbonization Across the Borders

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Introduction

Companies are increasingly being required to disclose their greenhouse gas emissions and climate-related financial risks. Whilst these disclosures may be seen as a critical step for holding business accountable and driving the transition to decarbonize, as transparency grows, regulation is fragmented across jurisdictions. This results in a complex and often confusing landscape for companies trying to navigate a patchwork of regulation globally.

With this in mind, and the rapid adoption of regulation by jurisdictions requiring companies to make climate disclosures, there are common threads throughout the regulation that companies must address and be able to disclose. There also are common risks for companies making these disclosures, from director duties to greenwashing (defined on page 6).

Synopsis

1. Regulation is fragmented globally with respect to climate disclosures, but there are consistent themes with the disclosure requirements. Generally, requirements sit underneath the broad headings of governance, strategy, risk, metrics, and targets.
2. Directors should understand their obligations regarding climate disclosures, particularly regarding risk, strategy, and disclosures.
3. Quantifying and managing Scope 3 (value chain) emissions is a challenge for companies and requires a strategic approach.
4. Risks such as climate litigation and greenwashing are increasing at a rapid pace.
 - Greenwashing is when companies deceptively market themselves or their products as environmentally friendly.

Setting the Context – Regulatory Overview

Historically, some companies elect to make voluntary sustainability related disclosures against an array of voluntary disclosure standards. There were many drivers for companies making such voluntary disclosures from a marketing or competitive advantage perspective to climate reporting being aligned with core business values. This resulted in inconsistent and incomparable disclosures by companies globally, with companies adopting various voluntary disclosures standards or frameworks such as the Global Reporting Initiative or Task Force on Climate-related Financial Disclosures (TCFD) (defined below). Furthermore, some companies would make climate disclosures that were not aligned against such standards or frameworks. This inconsistency resulted in difficulties and challenges for investors and stakeholders to make comparisons between companies. In response, global initiatives have resulted with the intention to harmonize reporting standards, forcing companies to make comparable, reliable, and transparent disclosures.

Milestones with the adoption of global sustainability reporting standards are:

1. The Paris Agreement (2015): adopted by 195 countries at the COP21 summit, it commits countries to limiting global warming to below 2°C above pre-industrial levels and pursue efforts

to limit it to 1.5°C above pre-industrial levels. This agreement led the groundwork for climate action and commenced regular reporting of greenhouse gas emissions by signatory countries.

2. TCFD: established in 2015 by the Financial Stability Board, TCFD was a voluntary framework for disclosing climate-related financial risks and opportunities. The focus of TCFD is governance, strategy, risk management, and metrics, which has influenced global reporting frameworks particularly relating to financial exposure as a result of climate risks.
3. Corporate Sustainability Reporting Directive (CSRD): introduced in the EU in 2021 commencing 2023 (phased in reporting requirements) with the intent to expand the scope of Environmental, Social, and Governance (ESG) disclosures. CSRD requires detailed sustainability reporting. Assurance is required and the CSRD is closely aligned to TCFD, aiming to create consistent and comparable sustainability data.
4. International Financial Reporting Standards (IFRS) and International Sustainability Standards Board (ISSB): in 2021, the IFRS launched ISSB, which aims to develop a global baseline for sustainability reporting. The ISSB is designed to provide companies with globally accepted sustainability reporting standards, integrating TCFD into its reporting framework. To date, thirty-six (36) jurisdictions have adopted or otherwise used the ISSB Standards or are in the process of introducing to regulating frameworks. ISSB frames climate disclosures from a financial lens and has an overarching purpose of looking at the financial impacts of a company's climate related financial risks and opportunities.

Other regulation in jurisdictions includes Japan's Corporate Governance Code and Stewardship Code, which encourages companies to disclose ESG related data. Furthermore, the Tokyo Stock Exchange moved towards ESG disclosures for listed companies. In China, the Environmental Information Disclosure introduced regulations requiring publicly listed companies and particularly heavy industries with significant environmental impact to disclose environmental information. In India, the Securities and Exchange Board introduced Business Responsibility and Sustainability Reporting which seeks to align with global reporting frameworks.

Fragmentated But Commonality

Although much of the regulation set out above seeks to harmonize reporting, it still remains relatively fragmented. Different regions and countries adopt varying standards or iterations of global standards, which can result in inconsistencies, differing scopes of reporting and incomparability. Fragmentation creates challenges for multinational companies, which are navigating a patchwork of reporting requirements.

That said, particularly with ISSB and CSRD, there are consistencies with reporting requirements, with key threads and themes. Furthermore, for companies that elect to make voluntary disclosures, alignment against a framework is recommended to add credibility and reduce risks of greenwashing (discussed below). The following sets out commonality across jurisdictions, which has occurred as a result of wide

adoption of ISSB, and key areas for companies when making climate disclosures.

Governance

Companies should disclose their processes, controls, and procedures used to monitor and manage climate related financial risks and opportunities. Disclosures include:

- Governance bodies or individuals responsible for oversight over climate related financial risks and opportunities.
- How responsibilities over climate related financial risks and opportunities are delegated.
- How companies and individuals take into account climate related financial risks and opportunities when overseeing business strategy.
- Management's role in governance processes, controls, and procedures used to monitor, manage and oversee climate related financial risks and opportunities.

Strategy

Disclosure should be made by companies regarding the approach used to manage and address climate related financial risks and opportunities. This includes:

- The relevant climate related financial risks and opportunities that could reasonably be expected to affect the entity's prospects.
- Current and anticipated effects of those climate related financial risks and opportunities on the business model and value chain.
- The effects of climate related financial risks and opportunities on strategy and decision making.
- The effects of climate related financial risks and opportunities on financial performance, financial position and cash flow, anticipated effects on the same over the short, medium, and long term, and how this is factored into financial planning. When considering short, medium, and long term, these timeframes differ depending on the company and the timeframes for its strategic planning.
- Resilience of an entity's strategy to these climate related financial risks. For many jurisdictions, this requires an assessment against at least two future climate states (i.e., temperature scenarios). This is commonly known as scenario analysis. In Australia's mandatory climate reporting standards, the *Corporations Act 2001* (Cth) prescribes that reporting entities must conduct scenario analysis against a low warming scenario (1.5°C above pre-industrial levels), which represents strong global climate action, and a high warming scenario (well exceeding 2°C above pre-industrial levels), which represents limited or delayed action. The purpose of these scenarios is that companies identify vulnerabilities under future climate states, test strategic responses, and improve transparency for investors and stakeholders.

Risk Management

The processes used to identify, assess, prioritize, and monitor climate related financial risks and opportunities should be disclosed.

This typically includes the parameters used to assess these risks, how the company uses the nature, likelihood and magnitude of these risks, and how these risks are prioritized amongst broader risk management processes.

Metrics and Targets

Disclosure of performance in relation to climate related financial risks and opportunities, including progress towards any climate targets set, and assessment against climate related metrics. Companies must disclose their Scope 1, Scope 2, and Scope 3 greenhouse gas emissions as gross greenhouse gas emissions expressed as metric tonnes (mt) of CO₂ equivalents (t CO₂e-).

The Greenhouse Gas Protocol is the global carbon accounting standard for a company to measure, manage, and report their greenhouse gas emissions. It includes various standards such as the Corporate Standard and the Corporate Value Chain (Scope 3) Standard, which assists and guides companies with making disclosures of greenhouse gas emissions.

Regarding what constitutes Scope 1, Scope 2, and Scope 3:

- Scope 1 is the emissions that a company owns or controls directly. An example of this could be facility production.
- Scope 2 is the indirect emissions associated with a company's operations. An example of this could be purchased electricity.
- Scope 3 is all other indirect emissions in a company's value chain. This includes upstream emissions such as supply chain emissions, business travel and waste, and downstream emissions such as freight and the use of sold products.

Commonly, companies only disclose Scope 1 and 2 greenhouse gas emissions. The reason for this is that Scope 1 and 2 greenhouse gas emissions are more easily calculated and quantified by a company given direct control of the greenhouse gas emissions sources. Furthermore, often the data required to calculate Scope 1 and Scope 2 greenhouse gas emissions is more readily available.

Scope 3 is much more complex for a company to disclose because these emissions are indirect and often occur across complex global value chains such as through suppliers and customers, which is outside of a company's control. This often results in data that is hard to collect and standardize, which leads to inconsistencies and challenges with quality and auditable data. Some specific challenges with Scope 3 greenhouse gas emissions include:

- Emissions sources like raw material production and product use mean companies depend on third parties such as suppliers and customers, which companies often are unable to access. Many suppliers also are not sophisticated in the space and often are struggling to provide this information to their customers in a format, which is usable by their customers.
- Obtaining accurate and specific data from numerous global third parties is challenging; it can be incomplete, time consuming, outdate quickly, or be based on averages that is misleading as opposed to actual and accurate measurements.
- Value chains are complex and opaque, and traceability is difficult when the organization is unable to trace further down their supply chains than their direct suppliers.
- Emissions factors can be inconsistent and based on international metrics, which can result in methodological gaps.
- It is resource intensive to calculate Scope 3.

Notwithstanding the difficulties and challenges with calculating Scope 3 greenhouse gas emissions, it is necessary for a company to disclose Scope 3 greenhouse gas emissions because:

- It often represents the largest proportion of a company's total greenhouse gas emissions. If disclosures then are made about a company's climate impact or greenhouse gas emissions reductions, not disclosing Scope 3 greenhouse gas emissions may hide a company's true climate impact and may mislead key stakeholders making decisions using this data.
- Third parties often assess Scope 3 greenhouse gas emissions for climate risk, not disclosing may hide potential material unreported risks and increase investor and financial risk.
- Not disclosing lacks transparency and increases the risks of greenwashing.
- Ignoring Scope 3 greenhouse gas emissions may increase the risks posed to the company from third parties such as suppliers who may face material climate risks which are not identified by the company. This may result in disrupted supply chains.
- Not disclosing Scope 3 greenhouse gas emissions may mean a company cannot set accurate and reliable targets or manage and measure its full environmental impact.

Director Liability

Climate is increasingly becoming relevant for directors, particularly relating to duties regarding due care and diligence to a company. The extent of which depends on the circumstances of the company however a targeted assessment of risk is necessary and to that end, whether there is foreseeable harm to a company against potential benefits that could have been expected to the company from the conduct in question.

For directors, irrespective of any mandatory climate reporting obligations, consideration should be given to the following:

- Identifying, assessing, and addressing climate risks and opportunities given climate is an understood and foreseeable business risk. This could be from resource availability, disruption of supply chains, regulatory compliance to reputational damage.

- Acting with due care and skill to a company and preserving the reputation and standing of a company in the short, medium, and long term includes consideration of climate risks and opportunities.
- The intersection of impact of climate on the short, medium, and long term profitability of a company.
- Ensuring that climate risks are appropriately disclosed.
- When making any declarations or signing off on sustainability reports or similar disclosures, the risks associated with the data and methodologies behind the disclosures and the accompanying risks regarding misleading or deceiving consumers (greenwashing risk).

Given this, directors should consider when making disclosures:

- The requirements of relevant climate reporting standards.
- Pertinent climate risks and opportunities that relate to the company and the methodology behind how these climate risks and opportunities have been assessed.
- What actions are being implemented to address climate related risks and opportunities, and how are these climate risks and opportunities are incorporated into a company's long-term strategy.

Greenwashing

"Greenwashing" is misleading or deceptive sustainability disclosures relating to the company itself or the products or services that it provides. The means of disseminating greenwashing disclosures and materials can be varied, whether through advertising, vague public commitments, or misleading imagery utilized in advertising materials. The impact of sustainability disclosures that "greenwash" is that they mislead consumers, investors, the public, and other stakeholders.

In the last few years, there has been an exponential rise in climate litigation globally. For example:

- In Italy, the Italian Competition Authority has fined SHEIN €1 million for using misleading and deceptive claims relating to sustainable materials, recyclability, and emissions reduction goals in the promotion of its clothing products.
- In Australia, the Australian Competition and Consumer Commission ("ACCC") instituted legal proceedings against Clorox Australia Pty Ltd ("Clorox") for misleading and deceptive claims around its kitchen and garbage bags which were allegedly made of recycled "ocean plastic." The Federal Court ordered Clorox to pay penalties of AUD\$8.25 million for these misleading and deceptive claims.
- In Australia, the Federal Court found that LGSS Pty Limited, the trustee of the Active Super superannuation fund ("Active Super"), made misleading representations in relation to its ESG investment screening credentials. Active Super was ordered to pay \$10.5 million in penalties.

More recently, there also is an emphasis on greenwashing in transition plans and goals.

To address and mitigate greenwashing risks, when preparing disclosures relating to sustainability, companies should (in accordance with sustainability guidance):

- Make accurate and truthful claims.
- Have evidence to back up claims.
- Not leave out or hide important information.
- Explain any conditions or qualifications on claims.
- Avoid broad and unqualified claims.
- Use clear and easy to understand language.
- Ensure visual images do not give a wrong impression.
- Be direct and open.

Careful consideration should be given to vague terms such as carbon neutral, green, eco, carbon friendly, and carbon positive. Further, carbon neutral claims based on offsetting with carbon credits should carefully considered and may be ill advised.

Impact on Value Chains

The impact on value chains should also be considered by a company. As a company starts to gather information regarding its Scope 3 greenhouse gas emissions, it will require liaising with third parties such as suppliers. A systematic and strategic approach will be required to assess the climate impact of value chains.

Questions that management should be asking with respect to Scope 3 greenhouse gas emissions includes:

- How does a Scope 3 greenhouse gas emissions strategy enable a business to meet decarbonization goals?
- What will the cost be to business to calculate and manage Scope 3 greenhouse gas emissions?
- How should Scope 3 greenhouse gas emissions be reported?
- How will a company collaborate with and incentivize suppliers to measure, report, and reduce greenhouse gas emissions?
- How can data quality be improved?

Further, a climate risk and opportunities assessment involves analyzing climate risks and opportunities with value chains. Such assessment could highlight for example supply chain vulnerability if a company relies on sourcing goods from a jurisdiction that is particularly vulnerable to climate change.

Broader Legal Considerations

When a company is making sustainability disclosures, the role of legal is critical to broader considerations including:

- Reporting boundary considerations. This involves an assessment of the entities within a corporate structure or group that are caught by mandatory reporting arrangements. As part of this consideration, legal can assist with streamlining reporting based on common reporting requirements and advising on whether multiple sustainability reports may be required.
- Developing compliance roadmaps from an initial gap analysis against the reporting standards (i.e., assessing what disclosure requirements can be met and identifying gaps that the company can work towards fulfilling). This includes specific roadmaps to address climate governance and risk management given legal's oversight over the governance structures of a company.
- Reviewing sustainability reporting and disclosures, particularly relating to mandatory requirements and content preparation, and providing legal assurance for greenwashing risk.
- Assessment of risk factors such as disclaimers, methodology, assumptions, dependencies, and definitions of terminology used.
- Regulatory aspects and the interface between climate disclosures and other duties such as director duties.
- Contractual considerations from looking at template contracts and amendments that may be required. For example, reviewing supplier agreements to implement clauses to support requesting information from suppliers to obtain data to support Scope 3 greenhouse gas emissions disclosures.