Financial Reporting Council 財務匯報局

Getting ^more Serious About ESG Compliance

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Introduction

What will this Session Address?

- What is ESG and why does ESG Compliance matter?
- What is expected in relation to ESG Compliance and how can Companies get more serious about it?
- What is changing in ESG Compliance?

What is ESG and why does ESG Compliance matter?

What is ESG and why does it matter?

- “ESG” refers to three areas of potential risk to “sustainable development”.
  - E is for Environment
  - S is for Social
  - G is for Governance
- These are areas of risk that are increasingly taken into account by stakeholders of entities in making decisions about their relationships with the entity; for example:
  - Shareholders and potential investors (in making investment decisions)
  - Customers and employees (in making consumption and employment decisions)
  - Society as a whole, government and regulators (in establishing and enforcing public policy, laws and regulations)
- These types of risk are key areas of concern to the sustainable development movement that has evolved significantly since the 1950’s, at global level under the auspices of the UN.

What is Sustainability and Sustainable Development?

- “Sustainability” is a very modern buzzword - it is searched more on Google than… “Star Wars” or “Steve Jobs” and the tag “sustainable” has been applied liberally to many things.

- What is Sustainable Development?

- According to the Brundtland Report (UN, 1987): *Our Common Future*

  Sustainable development is development that*…“meets the needs of the present without compromising the ability of future generations to meet their own needs”*.

Why does Sustainable Development matter?

- The UN promotes sustainable development in the context of the impacts of development on sustainability in three dimensions:
  - Economic (Profits and economic growth)
  - Environmental (the well-being of the Planet)
  - Social (the well-being of People)
- The impacts of economic (and other human) activities can damage or enhance the well-being of Planet and People as well as Profit.
- Business decisions may impact sustainability in all three dimensions.
- Concurrent consideration of these impacts in all three dimensions can result in more balanced decision-making by Companies.

Why does ESG Compliance matter for Companies?

Stakeholders care

- ESG Compliance matters because the sustainable development movement is leading a paradigm shift in what is expected of entities in the pursuit of profits.

- The sustainable development movement is gaining momentum amongst many mainstream stakeholder groups and beginning to challenge Nobel prize-winning economist Milton Friedman's 1970's maxim that "the sole purpose of a business is to generate profits for its shareholders".

- This is especially true of the investment community – in the May/June 2019, edition of the Harvard Business Review Professor Robert Eccles wrote of an "Investor Revolution", saying that "Shareholders are getting serious about sustainability".

- This is evident internationally in the progress of the UN Principles for Responsible Investment (PRI) and its network of signatories.

Why does ESG Compliance matter for Companies?

Investors care

- The UN PRI organisation works to:
  - understand the investment implications of ESG factors; and
  - support its international network of investor signatories in incorporating these factors into their ownership decisions

- The evolution of the sustainable investment community can be judged by the growth in UN PRI's signatory numbers and the assets under management (AUM) of those signatories.

- UN PRI now has over 4,000 signatories and over US$120 trillion of assets under management ("AUM") (at commencement in 2006, it had 63 signatories and US$6.5 trillion of AUM).

The PRIs assert a signatory's intent to:

(1) incorporate ESG issues into their investment analysis and decision-making;
(2) be active owners incorporating ESG issues in their ownership policies;
(3) seek appropriate ESG disclosures by their investees;
(4) promote the PRIs in the investment industry;
(5) work together with other signatories to implement the PRIs; and
(6) report on their progress in implementing the PRIs.

Why does ESG Compliance matter for Companies?

Big investors care and want investor grade information

- As a signatory of the PRI, the Hong Kong Monetary Authority believes that responsible investment is highly relevant to its investment work as the investment manager of the Exchange Fund.
- As ESG information becomes increasingly important to investors to enable them to implement their sustainable investment approaches, they are already beginning to demand more, and more reliable, ESG information.
- This demand for "investor grade" information has already begun to cause a realignment and restructuring of the institutions that have been responsible for the development of the international standards used for reporting.

Why does ESG Compliance matter for Companies?

Governments and International Regulatory Institutions care

- The absence of a global standard for ESG reporting has been a barrier to progress in this area but much has changed in the last year:
  - Merger of the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) in June 2021 to form the Value Reporting Foundation.
  - Many jurisdictions are reforming ESG reporting requirement (including to require disclosures in line with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD))
  - The International Financial Reporting Standards Foundation (IFRS Foundation), which is already responsible for governance and oversight of the International Accounting Standards Board (IASB) under the auspices of the IFRS Foundation Monitoring Board (a global group of capital market authorities), is set to launch the International Sustainability Standards Board (ISSB) later this year.
- Meanwhile, the International Auditing and Assurance Standards Board (IAASB) published guidance to assist assurance practitioners in the application of its standard for performing assurance engagements (the non-financial equivalent of an audit) on non-financial reports such as ESG reports, which it refers to as Extended External Reporting (EER) in March 2021.

Why does ESG Compliance matter for Companies?

Are investment managers legally able to pursue impact investing?

- One key resistance point for sustainable investment has been the tension between this and the traditional view that Institutional Investment Managers (IIMs) had no wider responsibility than to generate financial returns (a similar tension to that created for Companies by Milton Friedman's maxim already referred to)

- Building on their previous 2005 report, in June 2021 Freshfields Bruckhaus Deringer published a report: *A Legal Framework for Impact – Sustainability Impact in Investor Decision-Making*.

- The report was commission by The Generation Foundation (TGF) (established by Al Gore), the UN PRI and the UN Environment Programme Finance Initiative (UNEPFI)

Why does ESG Compliance matter for Companies?

The Freshfields Report – what it addressed

- The questions addressed by the report include:

    - Can delivering financial returns be the sole objective of IIMs now that the world has broader environmental and social goals, many of which have an impact on asset values?
    - Even if it should be the sole objective, does that exclude the pursuit of environmental and social goals?
    - To what extent can and should IIMs use their power and influence to generate a positive sustainability impact and what role does the law play in this?

- The report analyses the law in 11 global investment hubs, including China, to identify whether it permits or even requires IIMs to seek to influence the activities of their investees and others to achieve a positive sustainability impact, either in pursuit of their financial goals or as a separate goal.

Why does ESG Compliance matter for Companies?

The Freshfields Report – what they found

- Inevitably there were differences between jurisdictions findings include:
  - Where sustainability impact approaches can be effective in achieving financial goals, IIMs are likely to be required to consider them and act accordingly.
  - Cases where IIMs can pursue sustainability goals for their own sake in parallel with financial goals are more limited but there are some instances in most jurisdictions, usually subject to prioritising financial goals.
- Where investing for sustainability impact is not enabled by the law, the report suggests how policy makers might address the gap.
- Whilst this report is likely to be of most practical use to IIMs in clarifying the legal position on this question, it will now form the basis for a three year work programme for TGF, UN PRI and UNEP FI with a view to reshaping legal and regulatory systems.
- The findings and recommendations of the report are significant for investees of IIMs as they signal the future direction of sustainability investment.

What is expected in relation to ESG Compliance and how can Companies get more serious about it?

What is expected in relation to ESG Compliance?

Unlisted companies

- Unless exempted, HK companies are required under the Companies Ordinance to prepare a directors' report each year that includes a business review including:
  - A discussion on the company's environmental policies and performance
  - A discussion on the company's compliance with relevant laws and regulations that have a significant impact on the company
  - An account of the company's key relationships with its employees, customers and suppliers and others that have a significant impact on the company and on which the company's success depends
- The business review should also include a description of the principal risks and uncertainties facing the company.
- These requirements create an expectation that directors will consider non-financial issues, including ESG issues, in addressing them.

What is expected in relation to ESG Compliance?

Listed companies

- Listed companies
  - (whether or not they are HK companies)are required to comply with the business review requirements of the Companies Ordinance.
  - Are required to issue an ESG report within 5 months [NEW 2021-previously 3 months of publication of annual report] of the financial year end, which may be presented in the annual report or as a separate report [NEW 2021-not required to print if separate report]
  - have significant additional disclosure obligations in the ESG report, which are mandatory or "comply or explain" provisions.
  - The additional ESG report disclosures are expected to complement those in the business review
  - A Board statement on ESG governance is required, covering [NEW 2021]
    - How the Board oversees ESG issues
    - The Board's management approach and strategy, including how material ESG issues (including the related risks faced by the company are evaluated, prioritised, and managed)
    - How the Board reviews progress against ESG targets and how they relate to the Company's business.

What is expected in relation to ESG Compliance?

- Mandatory disclosure obligations:

- How the required "Reporting Principles" were applied in preparing the ESG report [NEW 2021]

Reporting Principles

1. **Materiality** – threshold at which ESG issues are sufficiently important to investors and other stakeholders to include them in the ESG report

   Disclose:
   - process to identify, and criteria for, material ESG factors
   - if stakeholder engagement conducted, information about the stakeholders involved, the process and outcomes

2. **Quantitative** – Historical data KPI's should be measurable; targets to reduce impacts should be set that are numerical or directional; quantitative information should be accompanied by explanatory information and comparatives.

   Disclose:
   - information on standards, methods and assumptions, and sources of energy conversion factors

3. **Balance** – ESG report should provide an unbiased picture of the issuer's performance

4. **Consistency** – apply consistent methodologies to allow meaningful comparisons over time

   Disclose:
   - Changes in methods or KPIs or any other factors affecting a meaningful comparison.

What is expected in relation to ESG Compliance?

- An explanation of the [NEW 2021] "Reporting Boundary" and of the processes applied to identify the reporting entities or operations within the boundaries, and of any change in boundaries and the reasons for such changes.

Reporting Boundary

ESG reporting is about the impact of the Company's activities on each of dimensions (Environment and Social). These impacts may occur directly as a result of the companies activities or indirectly, for example because the company buys raw materials or sells finished products. Indirect impacts usually occur outside the financial reporting "Control" boundary of the Company. By definition, it may be less practicable for the entity to exercise sufficient control to measure such impacts. The reporting boundary is the boundary of the entity's "sphere of impact", enclosing where the reported scope of impacts occurs. Reporting boundaries are not prescribed and are matter of judgement for the Company.

What is expected in relation to ESG Compliance?

- Comply or explain disclosure provisions:
  - These provisions address for each of the Environment and Social dimensions of sustainable development a series of “Aspects” of the dimension which may be impacted by the Company’s activities.
  - For each aspect addressed, general disclosures and one or more KPI’s are identified for disclosure.
  - The Governance dimension disclosures are addressed by the requirements of the Corporate Governance Code.
  - An issuer may adopt different reporting boundaries for different Aspects
  - Targets are only specified for disclosure for four KPI’s, and then only on a comply or explain basis – but Companies may disclose targets for all KPIs that are material.
  - New Aspect A4: Climate Change added and a new KPI on how significant climate-related issues have impacted or may impact the Company and actions taken to manage. [NEW 2021]
  - Revised Environmental KPIs to specify targets and steps taken to achieve them; upgraded social KPIs from “recommended” to “comply or explain”; enhanced requirements for certain social KPIs. [NEW 2021]
  - Encouragement of independent assurance - noting that Company may procure this to strengthen credibility of the ESG information disclosed. [NEW 2021]

What is expected in relation to ESG Compliance?

Materiality

- Applying the concept of "materiality" in relation to ESG reporting is critical to making effective disclosures and efficiency in managing ESG issues.

- Only ESG issues that, due to their impact, are sufficiently important to investors and other stakeholders should be:
  - Subject to ESG governance and management processes
  - Reported in the ESG report

- Reporting on immaterial items can unduly burden management and may obscure the importance of understanding the Company's progress in addressing material ESG issues

- The concept of materiality is broadly similar to the concept of materiality in financial reporting but there are subtle differences and hours of debate about the similarities and differences that we don't have time to discuss today!

What is expected in relation to ESG Compliance?

- One difference worth noting is that the concept of materiality is applied at the level of an ESG topic (eg. An Aspect), whereas in financial reporting it is generally applied in determining whether to include or exclude information about a topic (class of financial statement elements).

- How are materiality decisions to be made? There are various ways to achieve this:
  - Proactive shareholder and other stakeholder engagement at the entity level is perhaps conceptually ideal – in fact some ongoing level of such engagement is required.
  - SASB has produced a "Materiality Map" for sustainability topics that are generally material for entities in particular industries, determined by evidence-based research methods.
  - If you are planning to use the Materiality Map, its important to understand the concept of materiality used by SASB, in particular the scope of SASB's assumed stakeholders.
  - SASB's concept is investor oriented and when applied identifies ESG topics that are reasonably likely to impact the financial condition or operating performance of the Company.
  - The Materiality principle has to be applied in conjunction with the entity's understanding of the Investors and other stakeholders that are the intended users of its ESG report.
  - The specified disclosures relating to materiality are therefore important in helping readers of the ESG report to understand it form that perspective.

What is expected in relation to ESG Compliance?

Factoring ESG into Financial reporting

- Although ESG reporting is not generally considered to include financial reporting, the silent “E” (in “EESG”) is the third (Economic or Profits) dimension in which impacts on sustainable development have to be considered for completeness.

- This is not currently required by the Listing Rules.

- Getting more serious about ESG reporting could therefore include considering making disclosures about the economic or financial impacts of ESG.

- One aspect of the impact of ESG factors on financial reporting was recently addressed in an educational paper issued by the IASB in November 2020: *Effects of climate–related matters on financial statements. (Educational Guidance)*

What is expected in relation to ESG Compliance?

IASB's Educational Guidance

- Climate change is of increasing interest to investors because of its potential impact on a Company's business model, cash flows, financial position and financial performance.

- The Educational Guidance provides examples illustrating when the International Financial Reporting Standards may require consideration of climate-related matters in applying the measurement and disclosure principles in preparing the Company's financial statements.

- Where such considerations have material effects on measurements and related disclosures, it may be appropriate to provide related navigational cross-references between those disclosures and the discussion of the same ESG factors in the ESG report.

What is expected in relation to ESG Compliance?

IASB's draft revised Practice Statement

- The IASB is also consulting on a proposed comprehensive framework for companies preparing management commentaries, which represents a major over and of IFRS Practice Statement/ *Management Commentary.*

- The proposed revised Practice Statement aims to enable Companies to address all the information that investors need to assess a Company's long-term prospects, explaining not only the financial statements but also providing insights into "EESG" and other factors that affect a Company's ability to create value and generate cash flows, including in the long-term.

- An important principle underlying the draft revised Practice Statement is basing the disclosures on the information used to manage the business. This again highlights the importance, in getting serious about ESG Compliance of integrating "EESG" factors into the Company's governance and management processes from strategy development, through risk management to internal and external reporting.

Getting Serious about ESG Compliance

- Good corporate governance and good ESG disclosure are important pillars of the quality and reputation of HK's capital markets

- In the report published by the Hong Kong Stock Exchange (HKEX) in December 2020: Making inroads into good Corporate Governance and ESG Management:

"Delivery on good corporate governance practices and ESG measures is more than a box-ticking exercise: it is important for issuers to appreciate the value of integrating corporate governance and ESG into their strategies and operations. Strong commitment, collaboration and strategic direction from the Board is an essential first step". (Head of Listing, Bonnie Chan)

"The role of corporate governance and ESG in investment strategies is fast becoming mainstream, supported by regulators, indices and exchanges. There is increasing evidence that balancing short-term performance with sustainability, transparency and good governance leads to long-term success for issuers and investors alike…Rules and sanctions clearly can have a place, but on their own they will not deliver behavioural change. The change needs to begin at the top of organisations. This makes the role of the Board more critical than ever, as Boards are expected to drive the corporate governance and ESG agenda of their companies". (Chairman, CG/ESG Standing Sub-committee of the Listing Committee, Keith Pogson)

Role of Governance in Sustainable Development

- Good governance is seen as an essential enabler of sustainable development by individual entities.
- A key role of the Board is to steer the entity's development course, through taking ownership of and overseeing the entity's strategy development and implementation.
- Strategy reflects the entity's purpose – the Board should determine whether that purpose relates only to profits or also to well-being of planet and people.

Role of Governance in Sustainable Development

- The Board may also wish to consider:
  - If the entity's purpose relates only to profits, whether the strategy is sustainable in the longer term; and
  - If it also relates to the well-being of planet and people:
    - How to integrate the Board's aspirations for the entity's impact on each dimension of sustainable development into their statement of purpose and in setting strategic goals.
    - How to integrate the handling of ESG issues, together with traditional economic resource management issues, in the entity's governance and management processes, including strategy development, risk management, internal control, stakeholder engagement and external reporting.

Role of Governance in Sustainable Development

- It is important to recognise that many entities are in a process of transition in addressing this paradigm shift and need to be supported on their journeys.

- One of the most significant challenges is integrating ESG issues and related risk factors into the entity's governance and management processes in this transition.

- Getting more serious about ESG compliance means:

    - putting ESG more centre-stage for governance and management
    - at the same time, recognising that it may not yet be fully understood and owned by the Board, and therefore establishing appropriate mechanisms and support to get through the transition.

What Practical Steps can Companies take to enhance integration of ESG?

- Does the Board have the necessary diversity and relevant ESG expertise?
- Are Board Members, including INEDs, asking questions about both financial and ESG performance?
- Is ESG appropriately addressed in induction programmes for new Board Members?
- Has the Board established an appropriate governance structure to integrate ESG issues?
- Are ESG issues appropriately integrated not only into the work of the Board but also that of the Company Secretary (as an internal champion of governance and compliance), the Risk Committee, the Audit Committee and the Investor Relations team?
- Does the Board have appropriate external advisory input on ESG matters, especially if ESG issues are not yet fully understood and owned by the Board?
- Is there an appropriate plan and resources to get through the transition to integrated management of ESG issues?

What Practical Steps can Companies take?

- Has the Board understood which ESG issues are material for the Company and has it focused its efforts in addressing these?
- Has the Board considered its relevant stakeholders and established ongoing stakeholder dialogue to support its materiality assessment?
- Has the Board considered supplementing stakeholder engagement with research-based inputs and surveys of other industry participants in addressing materiality?
- Does the Board regularly review the Company's progress in integrating ESG issues?
- Does the Board understand the maturity of it's ESG reporting process?
- Has the Board considered appointing an assurance provider to provide assurance on its ESG report and how such an appointment might provide feedback on the maturity and quality of it's ESG reporting process?

What is changing in ESG Compliance?

Upcoming Changes in ESG Compliance

ESG Compliance is in a state of rapid evolution – change is likely to be the norm for some time to come.

Upcoming changes:

- Enhanced requirements for Calendar 2021 ESG reports (see annotations on earlier slides)
- April 2021 consultation proposals to enhance the CG Code:
- Reporting date for ESG report proposed to be aligned with Annual Report (already shortened to five months from 2021)
- Align Company's Culture with its purpose, values and strategy
- Elaborate further linkage between Corporate Governance and ESG
- Important elements of TCFD disclosures were introduced for 2021. Following HK Government announcement of aim to achieve carbon new neutrality by 2050, The Green and Sustainable Finance Cross-Agency Steering Group announced:
  - An initiative towards mandatory TCFD-aligned climate-related disclosures by 2025.
  - Its support for the ISSB to develop a new standard based on the TCFB framework.
  - That it will collaborate with FRC and HKICPA to evaluate and potentially adopt the standard.

Thank you