# Risk-based ESG Reporting

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In the past, shareholders of listed companies might be satisfied with the disclosure of just financial reporting. Nowadays, shareholders, investors and regulators require a broader scope of disclosure, and expecting listed companies to fulfill their social responsibilities by protecting the environment, ploughing back to the society and generally maintaining good corporate citizenship. Modern regulatory regimes require companies to disclose their reaction to the surrounding changes with proper risk management and contingency measures to hedge the uncertainty from social and industrial fluctuations and to demonstrate strong internal corporate governance. Investors are increasingly recognizing that environmental, social and governance (ESG) issues present material risks to their investments.

According to research published in the MIT Sloan Management Review, 75% of senior executives in investment firms agree that a company's sustainability performance is important to consider when making investment decisions.

Investors are no longer satisfied with mere financial reporting by listed companies. As such, regulators from across the world, including the Hong Kong Stock Exchange (HKEX), responded by creating a modern framework for ESG reporting to fill the gap and ensure appropriate degree of non-financial risk disclosure.

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## Regulatory Requirements in Hong Kong

Requirements of ESG report disclosure are stipulated in Listing Rule 13.91, with the ESG Reporting Guide being detailed in Appendix 27.

Appendix 27 comprises two levels of disclosure obligations: (a) "comply or explain" provisions; and (b) recommended disclosures.

Listed companies must state whether they have complied with the "comply or explain" provisions set out in the ESG Reporting Guide for the relevant financial year in their annual reports or in separate ESG reports. If a company deviates from the disclosure requirements, it must give considered reasons in its ESG report. Companies must publish their ESG reports on an annual basis, usually together with their annual reports.

Appendix 27 is organized into two ESG subject areas (Subject Areas): Environmental (Subject Area A) and Social (Subject Area B). Each Subject Area has various aspects (Aspects). Each Aspect sets out general disclosures (General Disclosures) and key performance indicators (KPIs) for companies to report on in order to demonstrate how they have performed.

In addition to the "comply or explain" matters set out in Appendix 27, HKEX encourages companies to identify and disclose additional ESG issues and KPIs, including recommended disclosures, that reflect the companies' significant environmental and social impacts; or substantially influence the assessments and decisions of stakeholders. In assessing these matters, the companies should engage stakeholders on an ongoing basis in order to understand their views and better meet their expectations.

The ESG report should state the companies' ESG management approach, strategy, priorities and objectives and explain how they relate to its business. It would be useful to discuss the companies' management, measurement and monitoring system employed to implement its ESG strategy. An ESG report should also state which entities in the companies' group and/or which operations have been included in the report. If there is a change in the scope, the companies should explain the difference and reason for the change. The following Reporting Principles underpin the preparation of an ESG report, informing the content of the report and how information is presented:

(1) Materiality is the threshold at which ESG issues become sufficiently important to investors and other stakeholders that they should be reported.

(2) Quantitative: KPIs need to be measurable. Targets can be set to reduce a particular impact. In this way the effectiveness of ESG policies and management systems can be evaluated and validated. Quantitative information should be accompanied by a narrative, explaining its purpose, impacts, and giving comparative data where appropriate.

(3) Balance: The ESG report should provide an unbiased picture of the companies' performance. The report should avoid selections, omissions, or presentation formats that may inappropriately influence a decision or judgment by the report reader.

(4) Consistency: The companies should use consistent methodologies to allow for meaningful comparisons of ESG data over time. The companies should disclose in the ESG report any changes to the methods used or any other relevant factors affecting a meaningful comparison. Complementing ESG discussions in the Business Review Section of the Directors' Report.

The following "comply or explain" requirements apply currently: (i) for accounting periods beginning on or after January 1, 2016, listed companies in Hong Kong should make General Disclosures under each single Aspect of the ESG Guide Subject Areas: A. Environmental and B. Social; and (ii) for accounting periods commencing on or after January 1, 2017, listed companies in Hong Kong should report with relevant KPIs in the "Environmental" Subject Area of the ESG Guide. The commencement date for KPI reporting on the "Social" Subject Area has yet to be determined by HKEX.

## International GRI Standards

It should be noted that Appendix 27 is not comprehensive and the companies may refer to existing international ESG reporting guidance for its relevant industry or sector. The companies may adopt international ESG reporting guidance so long as it includes comparable disclosure provisions to the "comply or explain" provisions set out in Appendix 27.

According to the FAQs to Appendix 27 of the HKEX, one of the international standards recognized by the HKEX is GRI G4 Guideline (G4), the world's most widely used sustainability reporting disclosure, developed by the Global Reporting Initiative (GRI), an independent body promoting corporate sustainability reporting. In 2016, GRI announced the move to replace G4 with GRI Standards, the world's first global standards for sustainability reporting, while G4 will be phased out by 1 July 2018.

The GRI Standards are a set of 36 modular Standards that facilitate corporate reporting on a wide range of topics such as greenhouse gas emissions, energy and water use, and labor practices. Based on the new format, GRI can update individual topics based on market and sustainability needs, without requiring revisions to the entire set of GRI Standards. The GRI Standards are centered on materiality – focusing on the topics that represent the most significant impacts of the organization and are most important to organizations' stakeholders – which supports sustainability reporting. A company can prepare a sustainability report in accordance with the GRI Standards at core (general) or comprehensive (specifics-ridden) level, or disclose individual topics to meet specific reporting needs..

## Risk-based Approach

In spite of the wide coverage of GRI Standards and Appendix 27, there is no one single formula to ESG reporting that fits all companies at all times. Simply complying with the requirements by box-ticking relevant provisions cannot achieve the ultimate goal of ESG reporting – keep the stakeholders well informed of the non-financial risks and measures adopted by the companies.

In this regard, it is important to understand that the ESG reporting scope of Appendix 27 (or even the GRI Standards) are not "one-size-fits-all", and ESG reporting should adopt a risk-based approach. For instance, a financial institution may face specific risks pertaining to tightened financial crime systems and may need to provide appropriate risk-based disclosure towards such risks in the ESG report. Appendix 27, GRI Standards or any other set of ESG reporting standards should be not meant to have laid down the "only" definitive ESG reporting aspects a company should cover in ESG reporting.

The board must add to the minimum scope under Appendix 27 by addressing any specific risks and issues relevant to the company under its own circumstances. To achieve this, the scope of ESG reporting should be as broad as it needs to be, addressing all critical risks and issues not yet covered by financial reporting of the annual report.

Given this approach, directors of companies should be aware that ESG reporting is not a window-dressing annex to the annual report. It should be analyzing all and every material risks faced by the company (other than those adequately addressed by financial reporting).

Similar to the modern requirement of using financial KPI to address financial reporting issues, companies should use KPI and other ESG data to manage and disclose relevant non-financial risks. This requires moving from a mere compliance mindset to a risk mitigation approach. For example, in the case of an oil producer, a compliance-minder reporter may focus on the company's environmental protection measures. However, a risk-based approach may call for enhanced disclosures that discuss an appropriate backup plan towards shortage of fossil energy sources, and for the company leadership to use the disclosure system as a roadmap to monitor and address the threats. Effective risk management also may encourage the company to disclose that it intends to offset rising oil prices by introducing efficiency efforts to reduce costs and to enhance production streamlining and controls.

According to Appendix 27, while the management is to provide a confirmation to the board on the effectiveness of these systems, it is the job of board has overall responsibility for companies' ESG strategy and reporting, and is responsible for evaluating and determining the companies' ESG-related risks, ensuring that appropriate and effective ESG risk management and internal control systems are in place.

Although companies are expected to comply with all applicable laws, it is up to the board to decide the extent to which a company will undertake additional voluntary ESG measures. Anthony Neoh, former chairman of the Securities and Futures Commission of Hong Kong, stressed the importance that the directors truly "know" the company: not only must they fully understand how each and every department of the company functions, they have to uphold higher threshold of professionalism when it comes to their own expertise, e.g. a director who is a senior financier should shoulder more responsibilities in ensuring compliance with banking and financial laws. Neoh also noted it is crucial for companies to compose a board with well-versed background, in order to promptly identify the looming risks in different aspects of the complicated business environment.

## Conclusion

ESG disclosures should be viewed through the same lens as financial reporting using a risk-based approach. Such approach may be applied across all reported material and information, such as the annual report, prospectuses, offering circulars, internal control disclosures for issues relating to continuing connected transactions, 20-F/10-K disclosures and proxy reports for companies with U.S. listing, and management's discussion and analysis (MD&A) sections in circulars. With an integrated approach, the false distinction between financial and non-financial reporting should be removed.

ESG reporting can also be used as part of a framework to communicate a company's mix of specific issues relevant to the shareholders and other stakeholders, not only for the synthesis of the company's own development strategies, but also to encourage directors and senior management to devise solutions to cope with the risks or potential setbacks that the company may fall into.

With these responsibilities to investors, stakeholders and the society being fulfilled in an integrated manner, systemic ESG reporting could be a key development to cement Hong Kong's status as an international financial center.

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