Hong Kong Exchange Proposes Changes to the Environmental, Social and Governance Reporting Guide and Related Listing Rules

Background

Global and regional regulatory authorities are increasingly requiring their regulated entities to broaden the spectrum of information disclosures. For companies listed on the Stock Exchange of Hong Kong (HKEX), environmental, social and governance (ESG) reporting is one of the latest additions to these information disclosures.

HKEX recently issued a consultation paper, "Review of the Environmental, Social and Governance Reporting Guide ("ESG Guide") and Related Listing Rules," outlining its enhanced requirements of listed companies with regard to their reporting of ESG issues. The ESG Guide was first introduced in 2013, with a subsequent upgrade in 2016, to require listed companies to publish their ESG reports to disclose certain ESG information on a 'comply or explain' basis. However, HKEX observed, amongst others, that some issuers approached the ESG disclosures as a "check list" and were failing to meet the intended purpose of the guidelines. This prompted HKEX to review the ESG Guide and related Listing Rules and propose changes aimed at improving the quality of both ESG performance and reporting through enhanced disclosures of ESG governance, process and metrics.

Though these proposed changes are not yet final, their adoption is widely anticipated. To prepare, listed companies in Hong Kong should understand the proposed changes to the ESG reporting requirements and make necessary adjustments to their ESG infrastructure.

Key Proposed Changes to the ESG Guide and Related Listing Rules

1. Shortened Timeframe for Publishing ESG Reports – To align with the publication of annual reports, the HKEX proposes that listed companies publish ESG reports as follows: for Main Board issuers, four months after the year-end date; and for Growth Enterprise Market (GEM) companies, three months after the year-end date.

2. Introducing Mandatory Disclosure Requirements (MDR) – On top of "comply and explain" provisions and recommended disclosures, the following disclosures are proposed as mandatory:

   a. A statement from the board containing a disclosure of the board's oversight of ESG issues; the process to identify, evaluate and manage material ESG issues; and the mechanism for the board to review the progress made against ESG goals and targets. The vision behind this rule is to enable the board to take a lead on ESG-related issues as well as to have oversight of those issues.

   b. An explanation from listed companies on how the reporting principles are applied in the preparation of the ESG report. Certain amendments to the existing reporting principles related to "materiality" and "quantitative" have also been proposed. The HKEX makes it clear that materiality of ESG issues has to be determined by the board and proposes to enhance the disclosure of the process and criteria for determining materiality. Moreover, additional disclosures on the standards, methodologies, assumptions made, and other information on the calculation of emissions/energy consumption are required.

   c. An explanation of reporting boundaries (entities and operations) and the process used to set the boundaries of the ESG report.

3. Climate Change and Other Environmental Key Performance Indicators (KPIs) – This amendment proposes to add a new climate change KPI to the environmental subject area. Listed companies would be required to disclose the measures taken to identify and mitigate significant climate-related issues, how climate change impacts the company, and the mitigating actions taken. The HKEX also proposes to revise the environmental KPIs to require disclosure of targets including, but not limited to, emissions, energy use, water efficiency, waste reduction and greenhouse gas emissions as well as the steps taken to achieve those targets. While the disclosure of historical data must be quantitative, targets may be expressed by way of directional statements.

4. Social KPIs and Supply Chain Disclosures – Until now, social KPIs have been regarded as recommended disclosures only. Recognizing that managing social risks is no less important than managing environmental risks, the HKEX has proposed to upgrade the disclosure of all social KPIs to "comply or explain" provisions. Furthermore, there are some additions, clarifications and amendments

to the existing social KPIs. Some key amendments include requiring a disclosure of how environmental and social risks are identified and managed along the supply chain of the company, and the practices undertaken to promote environmentally responsible products when selecting suppliers.

Other than the above key proposed changes, there are clarifications on the existing rules. While independent assurance remains non-mandatory, the HKEX provides additional details regarding what should be disclosed if such independent assurance is obtained.

Protiviti's Point of View

Most listed companies in Hong Kong have historically released ESG reports, thus making such reports a requirement does not constitute a big change for them. Aligning the publication of ESG reports with the timeline for annual reports also does not pose a material challenge for these companies. Further, tracking of data to fulfil the disclosure requirements for social KPIs is relatively easy as much of this data is already present in human resource systems.

On the other hand, there are certain changes which may necessitate listed companies to make alterations to their business infrastructure to fulfil the proposed ESG reporting requirements. We recommend that listed companies understand the new requirements, re-evaluate their existing ESG management and reporting capability, and take timely action. Below are some key points for consideration:

Oversight, Governance and Culture

Even though listed companies have been issuing their ESG reports for some years, the involvement of the board of directors in the ESG effort has been quite limited, with some boards becoming involved only after an ESG report has been drafted. Senior management and directors of listed companies need to discuss the HKEX key proposed changes to raise their awareness of ESG matters, strengthen their ESG governance structure to enable the board of directors to discharge their oversight responsibility, and provide necessary sponsorship from the board and senior management to build the necessary culture to support the management of ESG issues. Additionally, the board of directors should have a higher involvement in the overall ESG process, including ESG strategy and objective setting, and risk evaluation.

Management of ESG-Related Risks

ESG responsibility is not limited to disclosure of related information to stakeholders. ESG-related risks can have an impact on an organisation's reputation, customer loyalty, financial performance and even survival. As such, one of the proposed MDRs requires listed companies to disclose the process used to identify, evaluate and manage material ESG-related issues, including risks to the company's business. Additionally, under the proposed new climate change disclosure, organisations must divulge climate-related issues which have impacted, and those which may impact, the company, and the actions taken with respect to them. A company with an effective ESG risk management programme can help address these issues and requirements.

For effective management of ESG-related risks, companies may consider the use of a risk management framework such as the [COSO Enterprise Risk Management (ERM) Framework] in building the necessary infrastructure for management of ESG-related risks. The COSO ERM Framework covers more than just the process of risk identification and management – it defines ERM as "the culture, capabilities and practices, integrated with strategy-setting and performance, that organisations rely on to manage risk in creating, preserving and realising value." The COSO ERM Framework provides comprehensive guidance for organisations to reference when establishing their ESG-related risk management infrastructure in a way that aligns with organizational strategy to enhance the value of the organisation.

Get Started Sooner Rather Than Later

With an estimated implementation date for the revised guidelines of 1 January 2020, and considering the need for tracking ESG data to show comparative, year-over-year KPIs, listed companies are advised to start their preparation for the new disclosure requirements as early as possible. The following actions should be undertaken now:

- Make changes to existing processes and systems as needed to allow for the tracking of data necessary to meet the new and revised disclosure requirements.
- Review the need for new ESG-related policies that may be needed to support an ESG-related risk assessment. In particular, the new requirement for the identification and management of ESG risks along the supply chain is highly likely to be an area where additional measures need to be established to manage these risks. Examples include policies to promote environmentally preferable products and services when selecting suppliers; processes for identifying social risks along the supply chain; tracking of suppliers by region for the purpose of disclosure, etc.

- Review and formalise the existing methodologies for scoping the reporting boundaries, the calculation and classification of carbon emissions, etc., to ensure that they are described in enough detail for disclosure purposes.

Closing Thoughts

The HKEX's consultation paper emphasises the importance of the proper governance, oversight and board involvement in ESG efforts. The upgrade of social KPI disclosures to "comply or explain" provisions, together with other strengthened disclosures, is consistent with the growing global trend of meeting stakeholders' demand for ESG-related information. Stakeholders include investors whose interest in understanding how listed companies manage environmental and social issues increasingly underlies investment decisions.

Further, consideration of ESG-related risks goes beyond regulatory compliance or investor demands. It also aligns with the goal of protecting and enhancing the value of the organisation. ESG reports offer insights into the potential for achieving long-term returns and mitigating future risks to enterprise value that often are missing from the balance sheet. Hence, ESG efforts are worthy of attention in both the C-suite and boardroom and should be viewed as building long-term sustainability for a business rather than a mere compliance matter.

How Protiviti Can Help

Protiviti provides deep expertise in enterprise risk management, compliance, internal audit, data analytics, technology, and process improvement for clients across the globe. We help organisations to:

- Establish the necessary infrastructure (policies, processes, organisation, methodology, etc.) for ESG reporting.
- Establish or enhance ERM programmes by incorporating ESG-related issues and reporting into the programmes.
- Assess clients' existing ESG and other non-financial reporting processes for opportunities for improvement.

About Protiviti

Protiviti is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and our independently owned Member Firms provide consulting solutions in finance, technology, operations, data, analytics, governance, risk and internal audit to our clients through our network of more than 75 offices in over 20 countries.

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