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Thoughts on Improving ESG Reporting Practice in Hong Kong

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Introduction

With the deepening of various global crises - climate change, pollution, poverty, and the latest COVID-19 pandemic, to name a few - the centrality of sustainability as a value and goal has become increasingly evident in public policy. Against this background, environmental, social, and governance (ESG) standards have been incorporated in the corporate governance and regulatory regimes in many economies, and impacted the investment strategy and portfolio decisions of many institutional investors.

As an international financial centre and with a stock exchange ranking fifth in the world with a market capitalization of 6,805.8 billion USD[3], Hong Kong has enacted and implemented the Listing Rules and the ESG Reporting Guide (hereafter 'the Reporting Guide') since 2016, which requires all listed companies to disclose their ESG information annually. Compliance has been lacklustre, however, and

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[3] Securities and Futures Commission (2021). 'Table A- Market Capitalisation of the World's Top Stock Exchanges'. Available at: https://sfc.hk/-/media/EN/files/SOM/MarketStatistics/a01.pdf [Accessed 10 October 2021]

studies have revealed gaps in Hong Kong's disclosure performance when compared to other major stock exchanges.[4]

To improve the ESG reporting regulation, in July 2020, Hong Kong Exchanges and Clearing Limited (HKEX) issued a revised version – also the latest to date - of the ESG Reporting Guide which stresses the role of the board of directors in the process of ESG reporting, including the board's approach to oversee and assess ESG matters and risks. Besides, mandatory reporting on climate change related information is added to double down the efforts to address global concerns over climate change. The new principle of 'comply or explain' requires an explanation for any refusal to disclose. These new changes to the ESG reporting requirements are intended to strengthen Hong Kong's position in the global financial market.

ESG reporting in Hong Kong: Room for Improvement

In response to the global trend of ESG legalization, Hong Kong listed companies have been required to disclose their ESG matters on an annual basis since 2016. As explained by an informed source we interviewed, HKEX has adopted a 'hybrid' model of ESG reporting which can be reflected by the standardization of KPIs and the flexibility of reporting framework. For disclosing information in environmental and social areas, companies are required to report relevant information in terms of certain standardized units of measurement, such as hazardous waste produced in tonnes and employee category in percentage. On the other hand, the items listed in the Reporting Guide are regarded as 'minimum parameters for reporting'[5] and the board has the liberty to determine which areas or aspects are most material to its business and to be addressed in their ESG report. However, under the 'comply or explain' principle, the company should explain in the report if any aspect is considered not to be material and no disclosure is made.

From a compliance perspective, most listed companies have duly complied with requirements under the Reporting Guide and ESG information has been disclosed in either section of an annual report or a standalone ESG/sustainability report.[6] HKEX and other professional bodies, however, found that the quality of ESG reports published by Hong Kong listed companies is generally unsatisfactory. For instance, KPMG's survey published in 2017 reflects that some companies merely 'tick all boxes' without defining the relevant reporting boundaries and assessing the materiality of the risks.[7] After reviewing a sample of 400 ESG reports issued between December 2016 and June 2017, HKEX found that some reports only have 'short and simple statements without any explanations or details, or lengthy narratives that purported to respond to the disclosure requirement'.[8] A few reports lack details on stakeholder engagement and materiality assessment.[9] The 'box-ticking approach' to ESG reporting in

[4] Corporate Knights (2017) *Measuring Sustainability Disclosure*. Available at: https://www.corporateknights.com/reports/2017-world-stock-exchanges/ [Accessed 11 April 2021]. Also see Corporate Knights (2020) 'Helsinki Stock Exchange tops sustainability disclosure ranking while most flatlined', Available at: https://www.corporateknights.com/reports/2019-world-stock-exchanges/helsinki-stock-exchange-tops-sustainability-disclosure-ranking-flatlined-15796512/ [Accessed 11 April 2021

[5] HKEX (2020) 'Frequently Asked Questions Series 18'. Available at: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/HKEX_FAQ_18.pdf [Accessed 10 October 2021]

[6] HKEX (2018) *Analysis of Environment, Social and Governance Practice Disclosure in 2016/2017*. Available at: https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Environmental-Social-and-Governance/Exchange-Publications-on-ESG/esgreport_2016_2017.pdf?la=en [Accessed 11 April 2021]

[7] KPMG (2017) *The ESG journey begins: 2017 ESG reporting survey of Hong Kong listed issuers*. Available at: https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2017/11/the-esg-journey-egins.pdf [Accessed 12 April 2021]

[8] Ibid, p.3.

[9] Ibid, p.9.

some companies aims at satisfying compliance requirements at its minimum but would 'deprive the company and its stakeholders of the benefits of ESG reporting'. In December 2019, HKEX issued the second analysis on ESG reporting practices based on a sample of ESG reports issued in 2018. Apart from the recurrence of the 'box-ticking approach' problem, HKEX observed that less than one-third of the reports had offered description about board's oversight of ESG matters and 14% provided details on the board's role in managing ESG issues though the board is expected to play an essential role in the reporting process. Even worse, only 5% of the samples contain information related to the board's review on the progress of ESG goals and targets.[10]

Given these observations, HKEX urged companies to incorporate ESG issues into their business operation and corporate management. The current approach to ESG reporting would not be able to identify the more urgent and relevant issues and thus fails in effecting communication between management, investors, and stakeholders.

Refining Reporting Guide and Outstanding Issues

In May 2019, HKEX issued a consultation paper on the review of the Reporting Guide and related regulations to tackle the problems of limited board-level engagement and insufficient disclosure on materiality assessment. In the consultation conclusions, HKEX announced several key changes to the Reporting Guide (see Table 1).

Table 1: Key changes in the Reporting Guide (effective for financial years commencing on or after 1 July 2020)

Key Changes	Details
1. Introducing mandatory disclosure on Governance Structure	• Statement from the board containing: - (i) a disclosure of the board's oversight of ESG issues - (ii) the board's ESG management approach and strategy (e.g. process used to evaluate and manage material ESG issues) - (iii) how the board reviews progress made against ESG-related goals and targets and explain their relevance to businesses
2. Introducing mandatory disclosure on Reporting Principles and Boundary	• Describe or explain the application of Reporting Principles - Materiality: the process used to identify and the criteria for selecting material ESG factors and information related to stakeholder engagement - Quantitative: information on standards, methodologies, and calculation tools etc., for emission or energy consumption - Consistency: disclosure on changes of method or KPIs used

[10] Hong Kong Exchange (2019) *Analysis of Environment, Social and Governance Practice Disclosure in 2018.* Available at: https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Environmental-Social-and-Governance/Exchange-Publications-on-ESG/esgreport_2018.pdf, p.8-9. [Accessed 12 April 2021]

	• Explanation on reporting boundary and description of the process used to identify which entities are included.
3. Extending the scope of required disclosure and amending disclosure obligation	• Introducing climate-related aspects as required disclosure • Upgrading all Social KPIs to 'comply or explain' • Amending certain key performance indicators (KPIs) on Environmental and Social aspects
4. Encouraging independent assurance	• For strengthening the credibility of ESG disclosure, listed companies are encouraged to seek independent assurance

Source: HKEX (2019) Consultation Conclusions: Review of the Environmental, Social and Governance Reporting Guide and Related Listing Rules, p.2-3

The major revisions in the latest 'tougher' reporting requirements,[11] was effective for financial years commencing on or after 1st July 2020. One of the major amendments is to strengthen managerial or top-level engagement in the process of preparation of ESG reports by emphasizing the role of the board of directors. The board is now required to issue a statement to describe its approach and strategy for handling ESG matters. From the regulator's perspective, board-level engagement is essential for ESG reporting since the directors or top management, who possess knowledge and authority, should be in a better position to determine what ESG issues are most relevant to the company and how ESG risks can be mitigated. Through the formal engagement of the board in the reporting process, not only the awareness of ESG matters can be raised within a company, but investor confidence in ESG disclosure can also be promoted.[12] In addition, the regulator can also directly identify the subject of responsibility. According to *Leadership Role and Accountability in ESG: Guide for Board and Directors* published in March 2020, the board's duties in ESG reporting include: overseeing the assessment of the company's environmental and social impacts, carrying out 'materiality assessment and reporting process to ensure actions are well followed through and implemented', and promoting a culture that considers ESG elements in business operation.[13] The board, as the highest level of authority in a company, is made accountable for the process and result of the ESG reporting. For example, it is explicitly stated that while materiality assessment may be conducted by other staff members, 'the board remains ultimately responsible for the process and outcomes of the materiality assessment.'[14]

Can the quality of ESG reports be improved by simply strengthening board-level engagement in the reporting process? The idea is to raise the level of involvement of the boards of companies in the ESG reporting of the companies, and to hold them accountable for the reports, so as to improve the quality of the reporting. The question is whether an explicit statement of accountability in the revised Reporting Guide will achieve the purpose. While time will tell, the problem is likely to be more complicated. First, those failing to address ESG more strategically have been found to suffer a deficit in ESG expertise, and they often do not have sufficient resources to enable them to bridge the deficits.[15] KPMG's 2017 survey finds that 58% of companies with a market capitalization of HK$ 10,000 million or above have disclosed materiality assessment process in their ESG reports. In contrast, those with a market capitalization of less than HK$10,000 million have a lower percentage of disclosure, ranging from 10%

[11] Que, A., Lau, C., Chan, E., Wong, G., Cheung, K., Leung, M., Cheng, P., Yung, R., Chow, R. and Fung, S.(2020) 'Tougher ESG reporting requirements to take effect from July 2020'. Available at: https://www.deacons.com/news-and-insights/publications/tougher-esg-reporting-requirements-to-take-effect-from-july-2020.html [Accessed 2 July 2021]
[12] HKEX (2020) *Leadership Role and Accountability in ESG: Guide for Board and Directors.* Available at https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Environmental-Social-and-Governance/Exchanges-guidance-materials-on-ESG/directors_guide.pdf?la=en, p.2. [Accessed 10 October 2021]
[13] Ibid, p.1.
[14] Ibid, p.16.
[15] KPMG (2018) *ESG: A View from the Top*, p.18.

to 39%.[16] Similar observations are found in BDO's latest survey on ESG reporting performance in 2020: of the 40% of companies that did not provide information on materiality assessment, most are the smaller listed companies[17]. One possible interpretation is related to the availability of resources: smaller companies simply do not have sufficient resources to spend on ESG reporting and on materiality assessment in particular. Small listed companies have thus often opted to the 'box-ticking approach' – ticking All ESG areas and aspects shown in the Reporting Guide.

As the nature of business across industries varies, their material ESG issues should also be different. Take the HSI ESG Index as an example. The Index was launched in May 2019 and contains 60 constituents (as of October 2021) of 11 industry classifications, including 'Financials', 'Properties & Construction', 'Consumer Discretionary', 'Healthcare', 'Utilities', and 'Information Technology' (Table 2). It is expected that environmental ESG aspects and KPIs (especially air and greenhouse gases emissions, energy consumption, impacts on the environment and natural resources) are highly relevant to transportation (including airlines and logistics) and manufacturing but less material to financial and banking.

Table 2: HSI ESG Index

Industry Classification	No. of constituents	Weighting (%)
Consumer Staples	4	2.57
Consumer Discretionary	10	8.51
Healthcare	4	3.48
Energy	3	1.55
Industrials	4	2.73
Telecommunication	2	2.90
Utilities	4	7.32
Financials	11	37.47
Properties & Construction	12	13.93
Information Technology	4	16.78
Conglomerates	2	2.77
Materials	0	0

Source: Hang Seng Indexes (2021) 'HSI ESG Index'. Available at: https://www.hsi.com.hk/static/uploads/contents/en/dl_centre/factsheets/hsiesge.pdf [Accessed 12 October 2021]

Companies in the same industry may share similar concerns and risks. According to the standards developed by Sustainability Accounting Standard Board (SASB), there are specific issues that are commonly concerned by peers of an industry and their stakeholders. For instance, 'safety of clinical trial participants', 'affordability and pricing', and 'drug safety' are identified by companies and stakeholders of biotechnology and pharmaceuticals as the most relevant topics. But Hong Kong listed companies in this industry are not mandatory to disclose information on these topics since none of them is included in the current Reporting Guide. From a local pharmaceutical company's 2019 ESG report, we find that the company's materiality assessment identified more than 27 material topics that are almost identical to those listed in the Reporting Guide but none of them covers any aforementioned industry-specific issues.

[16] KPMG (1997), p.17.

[17] For example, BDO (2021) 'BDO Survey: Fourth-year ESG reporting performance survey shows the evolvement in overall ESG involvement of majority listed companies but which remain inadequate to meet the requirements of the Revised Guide'. Available at: https://www.bdo.com.hk/en-gb/news/2021/bdo-survey-fourth-year-esg-reporting-performance-survey-shows-the-evolvement-in-overall-esg-involve [Accessed 2 July 2021]

HKEX has stressed that listed companies should identify their own material ESG issues as a 'one-size-fit-all' ESG reporting framework does not exist.[18] Allowing companies to choose international reporting standards or frameworks avoids inflexibility that is commonly found in stricter rule-based approaches.[19] At the same time, we should not ignore the challenges encountered by companies for preparing ESG reports under the present framework, including difficulties in understanding which reporting standards should be adopted, determining how breadth and depth of ESG issues should be reported, and how social issues (which are always context-dependent and vary between industries) should be identified.[20] In one of our interviews conducted in June 2021, a stakeholder from the financial sector observes that even the latest Reporting Guide has been implemented, the board and management of some companies are still incapable of carrying out materiality assessment and determining which issues should be considered as material. Smaller companies also cannot minimize the burden or increase the efficiency of reporting practices.

Without properly addressing these complexities, companies may have limited eagerness to disclose their ESG information. It will not only affect the overall quality of ESG reports in Hong Kong but limit the usefulness of ESG data for financial markets.[21] It is because a lack of comparability between companies and the absence of appropriate quantitative information are two factors that most limit respondents' ability to make an investment decision based on non-financial information, according to a CFA Institute survey.[22] Under this situation, not only will companies have great difficulty benchmarking themselves against their peers, regulatory bodies and the general public will also encounter the same problem in understanding the ESG performance of listed companies.[23]

Thoughts on further improving ESG reporting

The above discussion identifies challenges in the ESG reporting performance in the context of the latest Reporting Guide issued by the HKEX. Board-level engagement and enhanced accountability of the boards featured highly in the new Reporting Guide as a means to improve the quality of ESG reporting but many of the smaller-sized companies are still confronting capacity issues to enable substantial improvement.

In the preceding consultation on the Reporting Guide in 2019, stakeholders have suggested that HKEX should make reference to SASB's Materiality Map to identify material issues for companies in different industries or sectors.[24] It is a challenging objective and will demand abundant resources and time.

On the other hand, developing industry-specific reporting guidance carries its merits. One advantage is that as the major ESG issues for specific industries will be identified, the process of materiality assessment can be simplified. This will considerably relieve the burden of smaller companies and thus

[18] Hong Kong Exchange (2020), p.2.
[19] CFA Institute (2020). *Future of Sustainability in Investment Management: From Ideas to Reality.* Available at: https://www.cfainstitute.org/-/media/documents/survey/future-of-sustainability.ashx, p.38. [Accessed 4 July 2021]
[20] World Economic Forum, Allianz SE, and Boston Consulting Group (2019). *Seeking Return on ESG: Advancing the Reporting Ecosystem to Unlock Impact for Business and Society*. Available at: https://www3.weforum.org/docs/WEF_ESG_Report_digital_pages.pdf, p.12. [Accessed 5 July 2021]
[21] Ibid.
[22] CFA Institute (2017). *Environmental, Social and Governance (ESG) Survey*. Available at: https://www.cfainstitute.org/-/media/documents/survey/esg-survey-report-2017.ashx, p.18. [Accessed 5 July 2021]
[23] World Economic Forum, Allianz SE, and Boston Consulting Group (2019), p.13.
[24] HKEX (2019), *Consultation Conclusions: Review of the Environmental, Social and Governance Reporting Guide and Related Listing Rules.* Available at: https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/May-2019-Review-of-ESG-Guide/Conclusions-(December-2019)/cp201905cc.pdf?la=en, p.18. [Accessed 5 July 2021]

improve the overall quality of ESG reports. Another related advantage is that an industry-specific reporting guidance will carry a higher chance of quality compliance, as the key ESG issues contained therein are identified through the participation of and dialogue between major industry stakeholders. It not only helps companies, especially those that have difficulties in carrying out materiality assessment, to improve the quality of their ESG reports, but also builds a foundation of comparable ESG information for other stakeholders.

To enhance the comparability of ESG information, the HKEX should consider establishing a set of clearly defined and standardized key performance indicators, which can avoid the complexities of interpreting and choosing among different metrics or measurements. Investors and other stakeholders can also easily understand and differentiate the performances of companies in the same industry.

Conclusion

There is no doubt that ESG reporting and relevant issues are essential to future economic development. In July 2021, the European Commission released the latest sustainable finance strategy.[25] For improving the financial sector's contribution to sustainable development, actions will be taken to 'improve the reliability, comparability, and transparency of ESG research and ratings'. At the same time, the International Organization of Securities Commissions (IOSCO) also published a consultation report on improving ESG and sustainability-related rating.[26] The message is clear: to ensure the healthy development of a sustainable economy, we need a more reliable, transparent, and comprehensive ESG rating system to facilitate stakeholders' understanding of the relevant information.

Against this background, we believe that it is important to develop industry-specific ESG reporting frameworks to guide companies to provide more relevant ESG information to stakeholders and also to increase the comparability of ESG performance. Industry-specific rating systems based on a common reporting ground can better score the ESG performance of companies in a specific industry. More research on these areas should be highly desirable and supported to uplift the ESG reporting quality and enhance the development of a green finance hub for sustainable investment in Hong Kong.

[25] European Commission (2021). *Strategy for Financing the Transition to a Sustainable Economy.* Available at: https://eur-lex.europa.eu/resource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF [Accessed 10 October 2021]

[26] The Board of the International Organization of Securities Commissions (2021). *Consultation Report: Environmental, Social and Governance (ESG) Ratings and Data Products Providers.* Available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD681.pdf [Accessed 10 October 2021]