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An audit committee lens on ESG Reporting

Expectations for public and private companies to build sustainability and awareness of environmental, social, and governance (ESG) issues into their business have grown significantly in a year impacted by a global pandemic, racial justice, and economic weakness, as well as the ongoing effects and long-term impact of climate change.

Such ESG risks and opportunities and their impacts on long-term value creation are top of mind for investors and other stakeholders. They want to understand which issues are of greatest risk or strategic significance to the company, how they are embedded into the company's core business activities, and whether there is strong executive leadership behind the ESG efforts as well as enterprise-wide buy-in.

As such, there are more rules from the Stock Exchange of Hong Kong Limited (HKEX) to require companies to be more transparent with their ESG issues and disclosures. The requirements include but not limited to the revised ESG Reporting Guide and HKEX Guidance Letter published in December 2019 and July 2020 respectively.

To that end, boards should encourage their management teams to reassess the scope and quality of the company's sustainability and ESG reports and disclosures. How is the company benchmarking against peers? What reporting frameworks have been considered? Are risks explicitly stated and disclosure provided on how they are mitigated? Is the link to strategy clear?

Overall speaking, the board's responsibility for overseeing ESG issues should be strengthened in accordance with the revised ESG Reporting Guide. In particular, a board statement should be established to cover (i) board's oversight of ESG issues, (ii) board's ESG management approach and strategy and (iii) how the board review progress towards ESG-related goals and targets and relevance to the business.

How oversight for ESG strategy is handled at the board level is often a matter of preference. Companies may have separate committees dedicated to oversight of environment, health, and safety issues; others include ESG oversight within the audit committee or governance committee.

Yet, no matter where the issues sit at the board level, the intensity of data and information in sustainability reporting brings the audit committee's expertise into play.

For boards and audit committees taking a deeper look at the company's ESG reporting practices, here are some critical questions to consider:

What are the ESG topics that align to company's and stakeholders' priorities?

Audit committees should take the time to understand stakeholders' priorities and the company's material ESG issues, particularly, where those two topics overlap.

To help focus decisions on corporate initiatives as well as reporting strategies on ESG, companies may perform materiality assessment for the selection of material ESG factors, as well as set reporting boundary on specific entities or operations that are included in the ESG report. Fundamentally, reporting should reflect both what the company is doing now and where it is going, with accompanying metrics and goals.

Are there established targets for material ESG issues?

To effectively measure, monitor and evaluate ESG performance of companies, quantitative targets and key performance indicators (KPI) should be set by companies for material ESG factors. In particular, HKEX requires companies to disclose targets set regarding climate-related and social related issues and the steps taken to achieve them.

Boards and/ or audit committees should monitor the progress of target implementation and the performance of the KPIs. Companies should take rectifications when the progress falls short of expectations.

Are there established processes and controls in place for the data collection and reporting?

Collecting data in a consistent method is important, especially for businesses with global operations and multiple product lines. In some cases, there is an established standard that is accepted by almost all investor groups. For example, the Greenhouse Gas Protocol is widely recognised as a way to report on emissions.

Still, tracking greenhouse gas emissions means companies need to have all those responsible for collecting data to gather it in the same way. Every level of the business should understand the metric, and how often if should be reported among other criteria. The audit committee line of inquiry should focus on understanding the procedures and controls in place.

What level of assurance is the company getting on ESG metrics? What is being assured, by whom, and what is the value of the assurance?

HKEX encourages companies to seek independent assurance to strengthen the credibility of EGS information disclosed in their ESG reports, there're two levels, i.e. "reasonable assurance" and "limited assurance", available. Also, it may be distinct for every industry and company, it's critical for companies to begin to identify their priorities before pressure from customers, shareholders, and others push to accelerate the company's timeline. Carbon (GHG, greenhouse gas, emission), as described above, is a common and oft-recommended first place to start because standards are well-known.

Audit committees are best positioned to understand which metrics merit independent assurance as well as what level of independent assurance to be sought. For example, labour in the supply chain could be a key area where a retail company's customers may appreciate independent assurance. Or a consumer goods company's shareholders may consider seeking independent assurance on their claims of sustainable sourcing.

Given its understanding of the rigor required to get the numbers right, the audit committee can help the company decide how far the journey goes, even potentially working toward assurance on their full ESG report.

How should audit committees think about value creation and competitors when engaging on ESG?

Audit committees should take steps to understand the business and competitive environment regarding ESG strategy and reporting. What are competitors measuring and reporting? Are there emerging regulatory requirements that a company should be aware of?

Understanding the current landscape and the company's way forward, coupled with strategic investment in data collection and integrity, not only responds to stakeholder demands, but also may expand an organisation's perspective, exposing new risks to its business model along with opportunities for growth and transformation. This is the true significance of bringing standardisation and rigor to ESG the measurement and reporting.

Developing a clear ESG strategy, along with a standardised reporting process can set a company apart from its competition, as investors, customers, and other stakeholders increase their scrutiny. Regardless of whether a company is still developing goals and policies, focusing on metrics and reporting, or working to push the limits – effectively addressing ESG strategy and reporting should be a long-term objective aligned with the company's core business.

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