November 2018

HOW TO PREPARE AN ESG REPORT?

A STEP-BY-STEP GUIDE TO ESG REPORTING

CONTENTS

Introduction

The landscape for ESG reporting is rapidly changing. Regulators, investors and other stakeholders are increasingly focusing on corporate disclosure on climate-related and certain social issues.

There is a need for constant transition in our thinking and actions in this area. In this document, we provide guidance to issuers on: (i) how to provide a more decision-useful report to investors, especially in light of the recommendations of the Taskforce on Climate-related Financial Disclosures ("**TCFD Recommendations**")[1]; and (ii) draw issuers' attention to common pitfalls in preparing ESG reports. We will amend this document from time to time to ensure that it remains up to date.

Increasing demand for ESG information

An "informed market" calls for disclosure of all information that might have a significant impact on the company or its business. Investors are becoming increasingly aware that corporate financial statements alone are not necessarily sufficient in determining the company's access to capital, cost of capital, the likely environmental and social risks that it may face, and the way in which these risks are managed. Whilst in the past investors may have made decisions based largely on a company's track record, they are increasingly looking to the future. ESG reporting reflects management strength and engenders investor confidence in the long-term prospects of the company.

The Exchange's role

We play a key role in fostering market confidence and promoting good governance and disclosure. ESG disclosure is crucial in ensuring that investors are given sufficient information to make properly informed investment decisions. We also have a statutory duty to continuously review and develop our regulatory framework, to make sure that it is up to date and is aligned with international best practice.

Over time, we hope that these efforts will facilitate the development of a corporate culture in which ESG practices and reporting are fully integrated into daily business operations, leading to greater transparency, more resilient risk management processes and sustainable value creation.

Importance of ESG strategy

The impact of financial risks from ESG issues can be minimised if there is a strategic approach that is forward-looking and grounded in the long-term interests of the company.

Therefore, it is important for companies to develop an ESG strategy to respond to and manage such risks. In particular, the board of directors should have oversight of and assume the overall responsibility for an issuer's ESG governance.

[1] See Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures (June 2017), Task Force on Climate-related Financial Disclosures (https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf)

Understanding environmental risks

Although this section of the document emphasises climate-related risks, issuers should bear in mind that these are not all of the environmental risks. For some issuers, other environmental risks such as pollution or shortage of natural resources may present themselves as more pressing issues.

Today it is widely recognised that environmental (especially climate change-related) risks present financial risks to many, if not all sectors, in which our issuers operate. As such, companies need to consider actions today in light of how financial risks from climate change may evolve in the future. Financial risks from climate change can arise from two primary channels or "risk factors": physical and transition[2].

Physical risks

Physical risks resulting from climate change can be event driven (acute) or longer-term shifts (chronic) in climate patterns. Physical risks may have financial implications for companies, such as direct damage to assets and indirect impacts from supply chain disruption.

Companies' financial performance may also be affected by changes in water availability, sourcing, and quality; food security; and extreme temperature changes affecting company's premises, operations, supply chain, transport needs, and employee safety.

Acute Risk

Acute physical risks refer to those that are event-driven, including increased severity of extreme weather events, such as super typhoons, floods, extreme temperature fluctuations.

Chronic Risk

Chronic physical risks refer to longer-term shifts in climate patterns (e.g., sustained higher temperatures) that may cause sea level rise or chronic heat waves.

Transition risks

Transitioning to a lower-carbon economy may entail extensive policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed, and focus of these changes, transition risks may pose varying levels of financial and reputational risk to companies.

[2] Source:
(i) Transition in thinking: The impact of climate change on the UK banking sector (September 2018), Bank of England
(ii) Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures (June 2017), Task Force on Climate-related Financial Disclosures (https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf)

Policy and legal risk: Risks associated with and financial impact of policy changes such as the adoption of energy-efficiency solutions, or potential litigation as the value of loss and damage arising from climate change grows.

Technology risk: Development and use of emerging technologies may increase production and distribution costs, and reduce the company's competitiveness.

Market risk: Supply and demand for certain commodities, products, and services may change as climate-related risks and opportunities are increasingly taken into account.

Reputation risk: Impact on company's reputation due to changing customer or community perceptions of a company's contribution to or detraction from the transition to a lower-carbon economy.

TCFD Recommendations

Companies may refer to the TCFD Recommendations for guidance on identifying and disclosing the potential financial impacts of climate-related risks and opportunities on their businesses.

What are the TCFD Recommendations?

The TCFD Recommendations focus on helping companies to identify and disclose the potential financial impacts of climate-related risks and opportunities on their businesses under four thematic areas:

- Governance - the company's governance around climate-related risks and opportunities.
- Strategy - the actual and potential impacts of climate-related risks and opportunities on the company's businesses, strategy, and financial planning where such information is material.
- Risk Management - how the company identifies, assesses, and manages climate-related risks.
- Metrics and Targets - the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

In particular, one of the TCFD's key recommended disclosures focuses on the resilience of a company's strategy, taking into consideration different climate-related scenarios, including a 2° Celsius or lower scenario.

A company's disclosure of how its strategies might change to address potential climate-related risks and opportunities is a key step to better understanding the potential implications of climate change on the company. Such analysis will be important for improving the disclosure of decision-useful, climate-related financial information.

Step-by-step guide to ESG reporting

We have identified the following steps for the preparation of an ESG report, which will be further explained in the next chapters:

- Board and ESG working group
- Understanding the requirements of the ESG Reporting Guide (Appendix 27 to the Main Board Listing Rules or Appendix 20 to the GEM Listing Rules) (the "**Guide**")
- Reporting boundary
- Stakeholder engagement
- Materiality assessment
- Writing the ESG report

It is not mandatory for issuers to follow the steps and procedures set out in this document and its appendices (*Toolkit* and *Reporting Guidance on Environmental KPIs*), as they are for general reference and guidance only. Each issuer is unique and, as such, should develop its own steps and procedures for ESG reporting in view of its specific circumstances.

Issuers may also refer to HKEX's dedicated ESG webpage for further resources and materials on ESG reporting.

Step 1 Board and ESG working group

Establish an ESG working group (that reports to the board) comprising senior management and staff who have sufficient knowledge in both ESG matters and the issuer's operations.

The ESG working group should have clear terms of reference setting out:

- ✓ Powers delegated to it by the board
- ✓ Authority to carry out various tasks (including internal and external materiality assessments)
- ✓ Scope of its work (e.g. implementing the board's strategy and policies, preparing the ESG report)
- ✓ Cost and resource commitment from the issuer

Notwithstanding the ESG working group, the board retains overall responsibility for an issuer's ESG governance, which includes[3]:

- evaluating and determining the issuers' ESG-related risks and opportunities;
- ensuring that appropriate and effective ESG risk management and internal control systems are in place;
- setting the issuer's ESG management approach, strategy, priorities and objectives; and
- reviewing the issuer's performance periodically; and
- approving disclosures in the issuer's ESG report.

[3] See paragraphs 8 to 10 of the Guide.

Step 2 Understanding the requirements of the Guide

The ESG working group should first understand the reporting requirements of the Guide, the issuer's ESG risks determined by the board and the board's ESG strategy.

The issuer may also consider adopting international ESG reporting guidance for its relevant industry or sector, so long as it includes comparable disclosure provisions to the "comply or explain" provisions set out in the Guide[4].

Please visit: http://www.hkex.com.hk/eng/rulesreg/listrules/listsptop/esg/index.htm for links to international reporting guidance.

Preliminary materiality assessment by the board

Not all General Disclosures and KPIs need to be assessed for materiality through a full-blown stakeholder engagement exercise. If the board determines that a disclosure requirement (whether disclosure of a policy or a KPI) is obviously immaterial to an issuer's business (e.g. an investment company may find disclosure of packaging materials used to be immaterial) or material to an issuer's business (e.g. an airline company should find disclosing data on greenhouse gas emissions to be material), it may decide to report or not report on such disclosure without conducting a stakeholder engagement and materiality assessment exercise.

Identifying information gaps

In respect of each disclosure requirement, the ESG working group should work with relevant staff to identify sources of data, or to develop a process by which such data could be collected in future.

For policies, ask the following questions:

- Do we have any existing policies in the specific area? If not, is it necessary to develop such policies?
- Who in the company are responsible for determining the policies and oversight of implementing them?

[4] See paragraph 7 of the Guide.

For KPIs, ask the following questions:

- What information or data do we need to report for this KPI?
- Are there any gaps in the data and, if so, what do we need to do to generate the required data?

> ✧ Use *Toolkit – Identifying Information Gaps* to identifying information gaps.
>
> ✧ *Reporting Guidance on Environmental KPIs* contains useful data collection methodologies and practical guidance on how to collect the information and calculate the data called for under each of the KPIs in "Subject Area A. Environmental" of the Guide.

Step 3 Reporting boundary

Determine the reporting boundary (i.e. parts of business that the issuer intends to report on) based on ESG risks identified by the board. This could include geographical scope (e.g. operations in Hong Kong, but not those in Mainland China or elsewhere) or business scope (e.g. only covering certain aspects of the business, but not others).

Step 4 Stakeholder engagement

What is stakeholder engagement?

Stakeholder engagement is the process by which an issuer involves parties who may be affected by the decisions it makes or can influence the implementation of its decisions.

To achieve long term success and sustainability, the issuer and its directors need to build and maintain successful relationships with their stakeholders, and maintain this engagement on an on-going basis.

> Stakeholder engagement helps issuers to:
>
> ✓ understand stakeholders' expectations, interests and information needs
>
> ✓ be aware of the impact of the company's business on the environment and society and vice versa
>
> ✓ identify material ESG issues so as to mitigate risks and maximise opportunities

How to conduct a stakeholder engagement exercise?

The ESG working group may consider undertaking the following:

4.1 Generate a full and complete list of stakeholders by consulting various departments within the issuer (e.g. corporate communications/public relations, human resources, investor relations, sales and marketing, procurement, legal, government relations, etc.).

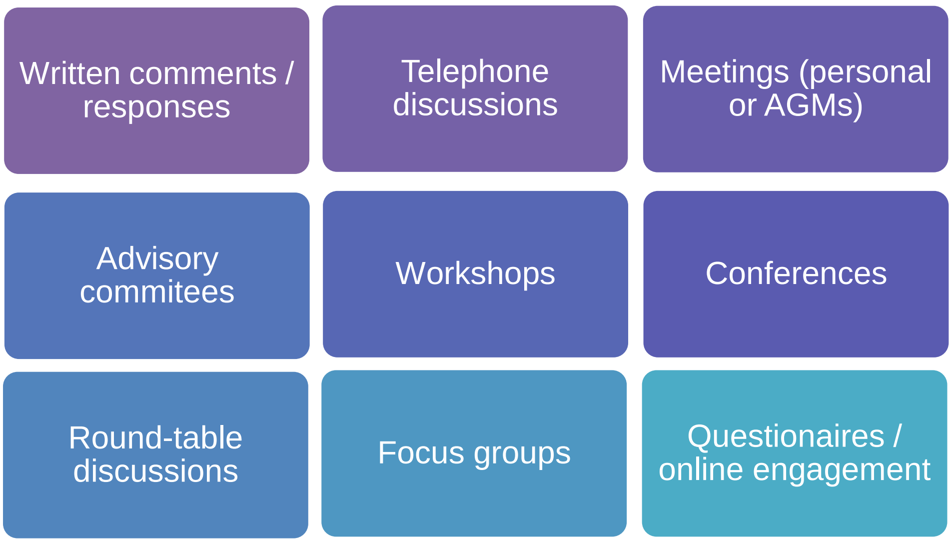
Depending on the issuer's business, industry and other factors, external stakeholders may include but are not limited to:

- Investors/ shareholders/ members
- Customers and potential customers
- Suppliers/business partners
- Employees (e.g. in the context of the human resources department, employees would be their external stakeholders)
- Government and regulators
- NGOs and lobby groups
- Local communities
- Competitors/ peers
- Experts and specialists

4.2 Reduce the list of stakeholders into a workable size (as the ESG working group may not have the resources to contact each and every stakeholder) to a list of key stakeholders.

> ✧ Use *Toolkit – Stakeholder Influence – Dependency Matrix* to work out a list of key stakeholders (i.e. those in the top right-hand quadrant).

4.3 Decide on the most effective engagement methods, which may include:



4.4 Engage with the key stakeholders identified in 4.2 through the engagement methods determined in 4.3, to seek their views on material issues identified in Step 2.

- ✧ Use *Toolkit – Stakeholder Profile* template and *Toolkit – Stakeholder Engagement Plan* to help with the stakeholder engagement process.

4.5 Following stakeholder engagement, the issuer should create an action plan to address the most important and relevant stakeholder concerns.

- ✧ Use *Toolkit – Post Stakeholder Engagement Action Plan* to help create the action plan.

Step 5 Materiality assessment

Why is materiality assessment important?

ESG standards / guidance (such as the GRI standards, the TCFD Recommendations, the Guide) tend to cover most of the current environmental and social issues. Not all of these issues are relevant to all types of companies. Depending on the industry, the geographical locations of the issuer's operations and other factors, an issuer may consider certain Aspects material whilst others are not.

It is important for an issuer to ascertain ESG issues that are material and relevant to its business and operations, and prioritise such issues accordingly.

Determination of material issues should be stakeholder-driven.

Internal materiality assessment

Internal materiality assessment should be conducted by senior managers and/or key employees of the issuer.

We encourage issuers not to outsource the internal materiality assessment, as members of staff have a better understanding of the issuer's structure, business and operations, and as a result may be in a better position to identify the material issues.

- Use *Toolkit – Materiality and Relevance* to assess and determine the materiality of each provision of the Guide by each selected stakeholder with reference to the issuer's business and operations.

External materiality assessment

External materiality assessment should be conducted with key stakeholders identified in Step 4.

Assessing materiality

Having obtained a list of material issues from the issuer (internally) and from key stakeholders (externally), the ESG working group can merge these two sets of data to assess their materiality.

- Use *Toolkit – Materiality Matrix* to merge these two sets of data.

General Disclosures and KPIs that fall within the top right-hand quadrant are identified as critical for disclosure, and should thus be covered by the ESG report.

Partially material

It is noted that General Disclosures under each Aspect may call for information on various matters (e.g. Aspect B6 calls for information on "health and safety, advertising, labelling and privacy matters relating to products and services provided and methods of redress").

Therefore, an issuer may find a "comply or explain" provision to be partially material to its business only (e.g. in respect of Aspect B6, "labelling" is not considered to be material as the issuer's operation does not involve any packaged products).

If a "comply or explain" provision is found to be material (i.e. if it falls within the top right-hand quadrant of the [Toolkit – Materiality Matrix]), the issuer may:

- Disclose the required information; or

- Decide not to disclose the information and give considered reasons for this decision in the ESG report.

If a "comply or explain" provision (or any part thereof) is found to be immaterial (i.e. if it falls within the bottom left-hand quadrant of the [Toolkit – Materiality Matrix]), the issuer may:

- Continue to disclose the required information; or

- Opt not to disclose the information and explain its non-disclosure on the basis of materiality/relevance in the ESG report.

Step 6 Writing the ESG report

The ESG report should include the following:

A. A description of the issuer's ESG governance;

B. Set out the reporting boundary;

C. A description on how it applied the Reporting Principles;

D. Report on each of the "Comply or Explain" provisions; and

E. Key messages that the issuer aims to convey to investors and other stakeholders.

A. ESG Governance

The ESG report should start by stating the issuer's ESG management approach, strategy, priorities and objectives and explain how they relate to its business. It would be useful to discuss the issuer's management, measurement and monitoring system employed to implement its ESG strategy *(paragraph 10 of the Guide)*.

Investors and other stakeholders place considerable weight on board-level interest in ESG issues, as that could help ensure that ESG considerations are factored into decisions.

This envisages a statement from the board containing the following elements:

- How the board (or relevant board committee) is informed of ESG-related risks
- How are ESG risks (including climate change related-risks) and opportunities embedded into, or how have these impacted on, the company's strategy (including risk management, policies, financial planning etc.).
- How the board reviews progress against goals and targets.

B. Set out the Reporting Boundary

An ESG report should also state which entities in the issuer's group and/or which operations have been included in the report. If there is a change in the scope, the issuer should explain the difference and reason for the change *(paragraph 10 of the Guide)*.

Investors would also expect the company to identify and disclose any entities included in the company's consolidated financial statements that are not covered by the ESG report.

C. Application of the Reporting Principles

The Reporting Principles in the Guide underpin the preparation of every ESG report and as such, they should be followed without exception. The issuer is expected to explain how it applied each of the Reporting Principles. This envisages disclosure of:

(a) <u>"Materiality" reporting principle</u>

- *Process of stakeholder engagement:* Details of who and how often the issuer engaged its stakeholders, as well as the insights gained from the exercise.
- *Process of materiality assessment:* How the issuer decided on the material issues.
- *Step-by-step assessment process:* Disclosure of the issuer's materiality matrix which demonstrates engagements of internal and external stakeholders on each issue.
- *Application of materiality assessment:* Identification of the "comply or explain" provisions (if any) that will not be disclosed as they are considered to be immaterial to the issuer, and an explanation of how the issuer arrived at this determination.

(b) <u>"Quantitative" reporting principle</u>

- Narratives explaining the purpose and impacts of KPIs.
- Information on the standards, methodologies, assumptions and/or calculation tools used, or source of conversion factors used.
- Comparative data, where available.

(c) <u>"Balance" reporting principle</u>

- Both positive news (e.g. awards and achievements) and negative news (e.g. accidents, challenges or failures).

(d) <u>"Consistency" reporting principle</u>

- Confirmation that the methodology for preparing the ESG report is consistent with previous years, or a description of any changes to the methods used or any other relevant factors affecting a meaningful comparison.

D. Report on each of the "Comply or Explain" provisions

An issuer must either report on a "comply or explain" provision, or give considered explanation on why not. Failure to comply (i.e. disclose the required information) without explanation is a breach of the Listing Rules.

The following sets out what the Exchange expects for disclosure on (i) policy; (ii) compliance with relevant laws and regulations that have a significant impact on the issuer; and (iii) KPIs (if any):

(i) Policy

Provide a summary of the policy or embed links to the relevant documents.

Caution:
Do NOT use generic statements such as "we have an anti-corruption policy" without further elaboration.

(ii) Information on compliance with relevant laws and regulations that have a significant impact on the issuer

Consider whether there are laws and regulations in respect of that Aspect which may have a significant impact on the issuer.

- Yes: (i) Specify the relevant laws and regulations; (ii) disclose their potential impact on the issuer; and (iii) disclose ways in which the issuer has ensured compliance with such laws and regulations.

- No: State that there are no laws and regulations that have a significant impact on the issuer.

Example of the law / regulation that have a significant impact on an issuer:

Starting from 1 January 2018, China has implemented the "Environmental Protection Tax Law", which is aimed at strengthening pollution control, protecting the environment, and regulating new tax targets enterprises and public institutions that discharge certain pollutants directly into the environment. The law requires these entities to pay tax for producing air and water pollutants, noise and solid wastes. This tax is likely to have a significant impact on, for instance, issuers in the manufacturing industry.

Caution:

- Do NOT use blanket statements of compliance (e.g. "we have complied with all laws and regulations") or absence of non-compliance (e.g. "we are not in breach of any applicable laws and regulations").

- Disclosure of certifications awarded by standard-setting organisations such as International Organization for Standardization does NOT suffice as disclosure of compliance with laws and regulations

(iii) Information on KPIs

Disclose the information called for under the relevant KPI. The following KPIs are often overlooked:

KPI	Description	Common pitfalls
Aspect A1 - Emissions		
A.1.4	Total non-hazardous waste produced (in tonnes) and, where appropriate, intensity (e.g. per unit of production volume, per facility).	Omitted to disclose total non-hazardous waste (or an explanation for absence of such disclosure).
Aspect A2 - Use of Resources		
A.2.4	Description of whether there is any issue in sourcing water that is fit for purpose, water efficiency initiatives and results achieved.	Omitted to disclose water efficiency initiatives and results achieved (or an explanation for absence of such disclosure).
A.2.5	Total packaging material used for finished products (in tonnes) and, if applicable, with reference to per unit produced.	Omitted to disclose total packaging material used (or an explanation for absence of such disclosure).
Aspect A3 - The Environment and Natural Resources		
A.3.1	Description of the significant impacts of activities on the environment and natural resources and the actions taken to manage them.	Confused KPI A.3.1 with “Policies on minimising the issuer's significant impact on the environment and natural resources” and only disclosed energy saving policies such as “turning off lights to reduce electricity usage”. For KPI A.3.1, issuers should disclose (i) the significant impact of its business activities on the environmental and natural resources; and (ii) targeted actions taken to manage them.

E. Key messages that the issuer aims to convey to investors and other stakeholders

Through preparing an ESG report, issuers would be in a better position to identify both risks and opportunities arising from ESG issues relating to their operations.

The ESG report is a channel for an issuer to demonstrate its resilience and readiness to achieve sustainable development for its business activities. Issuers should use this means to showcase their ability to look beyond the risks, and realise opportunities through innovation and value creation.

Other writing tips:

- Keep text of report simple, concise and to the point.
- Give explanations for data presented in graphs or charts.
- Use pictures to emphasise or clarify points made in the text.
- Include short case studies to highlight how the issuer has implemented ESG policies or practices.

ESG Reporting Flowchart

Set up an ESG group

- Understand ESG reporting requirements, ESG risks and board's ESG strategy
- Set reporting boundary

Stakeholder engagement

- Compile a workable list of stakeholders
- Engage with key stakeholders using the most effective methods
- Create action plan to address relevant stakeholder concerns

- *Toolkit – Stakeholder Influence – Dependency Matrix*
- *Toolkit – Stakeholder Profile*
- *Toolkit – Stakeholder Engagement Plan*
- *Toolkit – Post Stakeholder Engagement Action Plan*

Materiality assessment

- Conduct internal and external materiality assessments to decide whether to disclose certain information

- *Toolkit – Materiality and Relevance (to be completed for each stakeholder)*
- *Toolkit – Materiality Matrix (overall)*

Writing the ESG report

- Statement on ESG governance
- Disclosure of reporting boundary
- Application of Reporting Principles
- Reporting on each Aspect

Material	**Not material**
"Comply or explain" provisions • Either report or give considered reasons for deciding not to report	"Comply or explain" provisions • If decide not to report, could consider using materiality/relevance as an explanation
Recommended disclosures • Consider reporting, but if decide not to report, no need to give reasons	Recommended disclosures • No need to report or give reasons for deciding not to report

Key message to investors and stakeholders

- *Toolkit – Identify Information gaps*