ESG matters

Driving change through Financial Reporting

Contents

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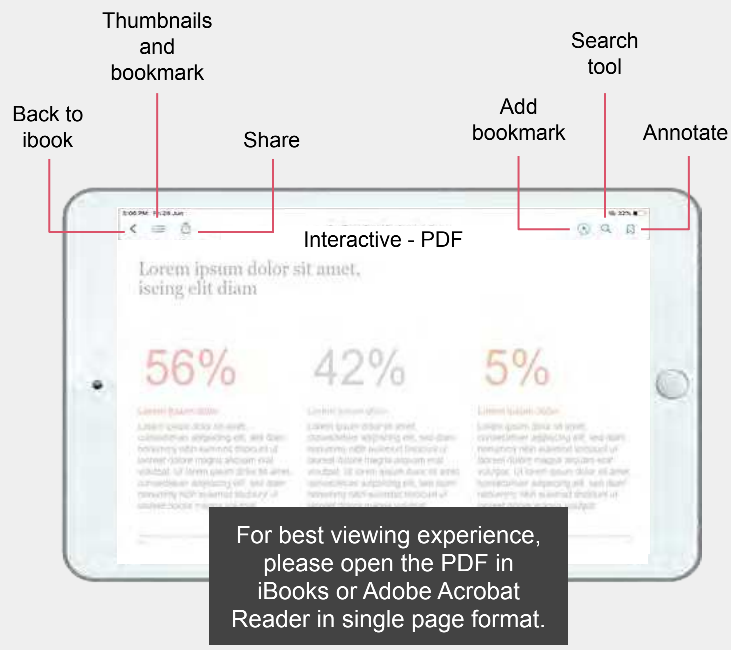


Introduction

In an era where good corporate citizenship is becoming a norm, reporting on environmental, social and governance (ESG) related issues is fast becoming a common practice among major listed companies. For these companies, the annual report is a key communication tool to disclose sustainable practices to stakeholders.

Companies that are not proactive in communicating their ESG practices will miss an opportunity to craft their own sustainability narrative. They will then lose their competitive advantage as investors may turn to unverified public and third party information.

Of the world's largest 250 companies, about 95% publish sustainability reports - an impressive figure! However, these reports are prepared using an overwhelming variety of ESG reporting frameworks, unlike the more uniform accounting principles used in financial reporting.

There are more than 1,700 ESG-related metrics and more than 360 different ESG guidelines available for companies to use. Four standards dominate the ESG's reporting ecosystem - Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), Task Force on Climate-related Financial Disclosures (TCFD) and Carbon Disclosure Project (CDP). The proliferation of guidelines adds to confusion, hinders comparability and allows companies to cherry-pick flattering results and indulge in 'greenwashing'.

Mervyn King, chairman emeritus of the Amsterdam-based GRI, once said "From a societal point of view, it is almost an outrage that you have competition between framework providers on a public interest issue like sustainability."

The urgency for simplification and consistency is sorely needed to address this confusion of standards. This has spurred a few global bodies into action. In the last three months alone, the actions include:

Recommendation of a set of universal ESG metrics and disclosures

- By the World Economic Forum (WEF) in collaboration with Big Four accounting firms, to measure stakeholder capitalism that companies can report on regardless of their industry or region.
- The metrics are organised around four pillars:
  - principles of governance
  - planet
  - people
  - prosperity

A consultation paper to assess demand for consistent global sustainability standards

- Issued in September 2020 by the International Financial Reporting Standards (IFRS) Foundation, with the aim to provide the global governance for non-financial standard-setting.

Merger of global bodies

- In November 2020, the International Integrated Reporting Council (IIRC) and SASB have announced their intentions to merge into the Value Reporting Foundation, a unified organisation intended to provide investors and corporates with a comprehensive corporate reporting framework across the full range of enterprise value drivers and standards.

Sustainability landscape in Malaysia

The landscape in Malaysia is not too different from the global arena, with regulators such as Bursa Malaysia, Securities Commission of Malaysia and the Central Bank of Malaysia playing an active role in driving the sustainability agenda. Ever since the establishment of the Corporate Social Responsibility framework in 2006, there have been numerous initiatives over the years to align our practices towards global standards.

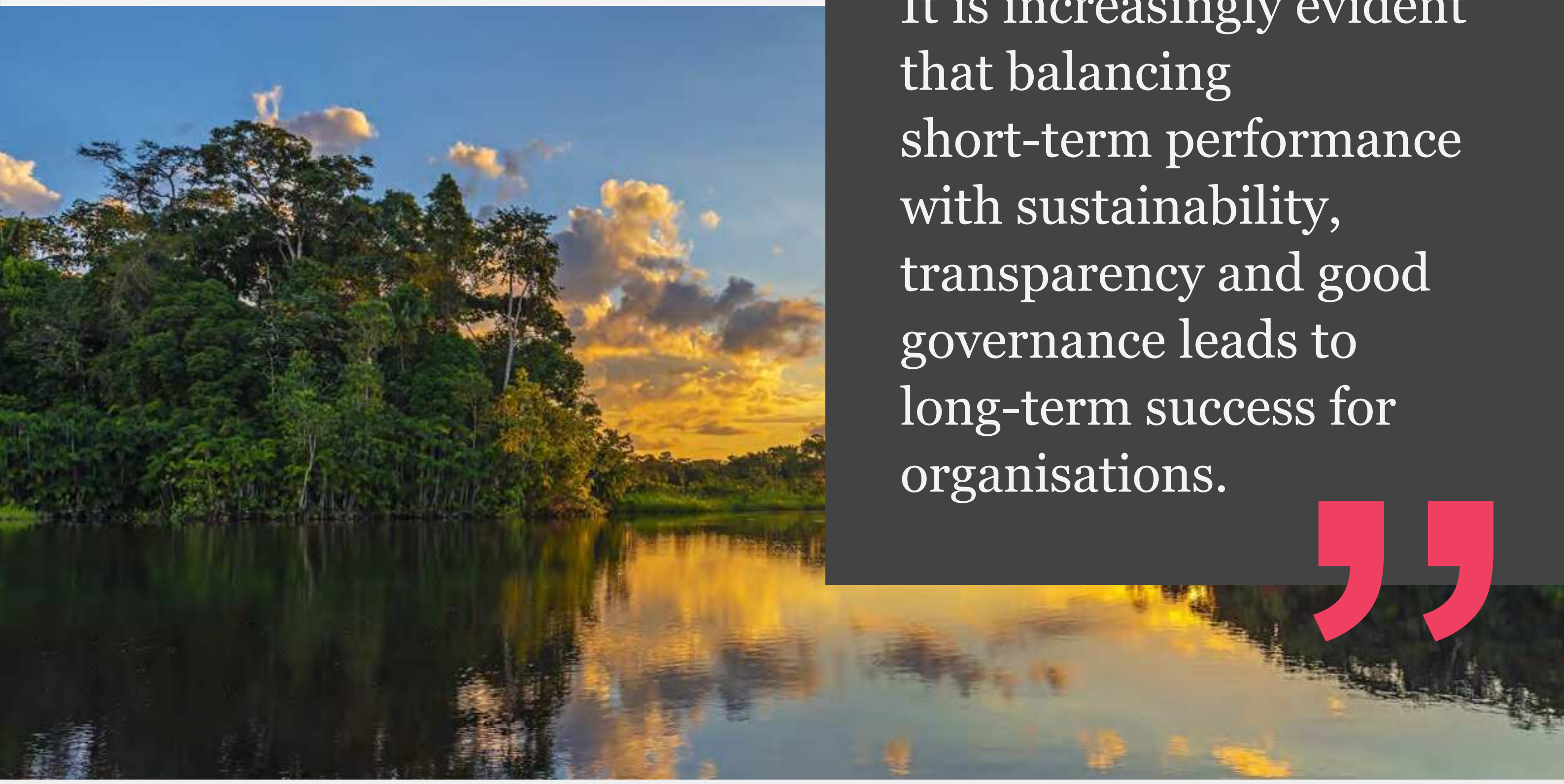
Recent efforts include a push for adoption of TCFD reporting recommendations by financial regulators, creating a comprehensive online sustainability portal (BURSASUSTAIN), releasing the Sustainable and Responsible Investment Roadmap (SRI Roadmap) for the Malaysian capital market and developing the “Climate Change and Principles-based Taxonomy”.

It is currently mandatory for Bursa-listed companies to disclose their management of material economic, environmental and social risks and opportunities via the Sustainability Statement in their annual reports. However, similar to the global landscape, there is no one consistent ESG framework mandated by Bursa, although GRI remains the most popular. According to Bursa, there are currently 73 companies[1] listed on Bursa Malaysia that have met the globally benchmarked ESG criteria.

It is undeniable that we are living in unprecedented times: geopolitical tensions are increasingly acute and the global political, economic and financial system that has worked for more than a century is being tested.

Malaysian corporates are not shielded from these challenges, and they are now expected to stay on the front foot, working closely with policymakers and regulators to confront far-reaching global and local challenges.

It is increasingly evident that balancing short-term performance with sustainability, transparency and good governance leads to long-term success for organisations. This makes delivery on ESG measures no longer merely a “nice to do” or a “box-ticking exercise”. It has become essential for business and societal prosperity, it is demanded by investors, and it is considered critical for long-term business success.



“It is increasingly evident that balancing short-term performance with sustainability, transparency and good governance leads to long-term success for organisations.”

[1]As of June 2020

Consideration of climate change in financial reporting

One of the key aspects of ESG, and probably its most pressing concern, is climate-related risk. Climate change is driving some of the most profound changes to businesses. Companies can no longer treat climate-related risks as a mere matter of corporate social responsibility.

As the world targets a move to a 2°C economy, an increasing number of key stakeholder groups are emphasising the importance of climate change in financial reporting:

Investors are becoming more active in demanding for companies to disclose the impacts of climate change on the resilience of their business strategies.

Banks have indicated that they need to understand the impact of climate-related risks on their clients and are increasingly pricing these risks into the cost of borrowings.

Global rating agencies have highlighted how climate change could affect credit ratings and are incorporating this into their analyses.

Regulatory bodies (for example in the European Union) are expected to further pressure companies and organisations to follow the frameworks for financial disclosures related to climate change.

In 2011, Thailand's worst floods in 50 years[1] have affected hundreds of manufacturers and disrupted the supply chains for the country's top automakers including Toyota, Honda and Nissan. This is a clear example of how changing temperatures and weather patterns around the globe could pose significant risks for businesses. The downsides may well have a financial statement impact, for example, through impairments to goodwill, or reductions in the useful economic lives of assets. Costs may increase due to effects on supply chains, and revenues may fall as consumer demand for goods and services changes over time in response to climate change.

With growing pressure from investors, emerging focus from regulators, and continued social pressure globally, it is increasingly expected that companies provide meaningful and useful disclosure about climate-related risks that could impact the business and how management are responding to these risks.

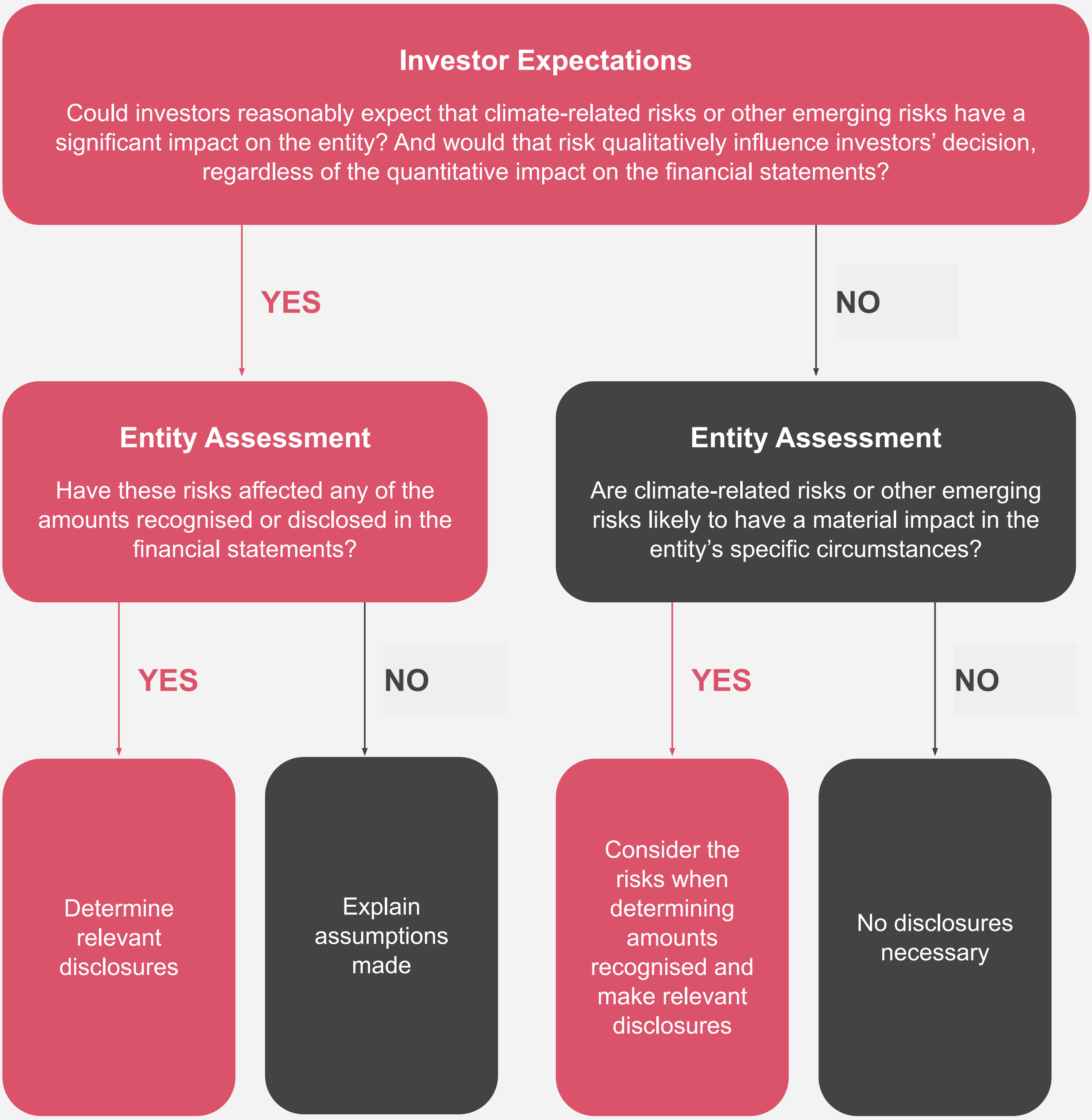
Whilst there are no explicit accounting standards dealing with sustainability issues, IFRS via its principle-based approaches do address issues that relate to climate-change and other emerging risks. To reinforce this implicit requirement within IFRS, in November 2019, the International Accounting Standards Board (IASB) published a briefing document containing guidance on how the impacts of climate change are dealt with, albeit not explicitly, in existing IFRS'. This is followed by an IFRS educational material released in November 2020 that shows how existing IFRS requirements require companies to consider climate-related matters when their effect is material to the financial statements.

In other words, companies need to consider user needs and expectations while preparing financial statements. If this information can affect users' decision-making, then this information should be deemed as 'material' and should be considered and disclosed. As the effects of climate change become more prominent, they will become more and more visible in the financial statements.

[1]Chang-ran Kim (2011, October 27). Thai flooding impact spreads across world for Toyota. *Reuters*

Consideration of climate change in financial reporting (cont'd)

The flowchart below provides guidance for companies to consider in assessing climate-related and other emerging risks in the preparation of their financial statements:



Role of Boards in driving ESG

Globally, the directors of public companies are increasingly facing challenges from investors and other stakeholders to be proactive in evaluating competitive threats and understanding disruptive market trends, which include environmental concerns.

Without a doubt, ESG measures are considered critical for long-term business success, and as primary stewards of risk and guardians of long-term enterprise value, Boards should step up in driving the ESG agenda of their companies, which includes climate change considerations.

Kenneth Hayne, a former High Court judge in Australia, effectively summed up the role of Boards - *Directors have a fiduciary duty to act on climate change risk, include it in corporate strategies and report on it to shareholders.* This warning is raising the real prospect that Boards failing to act could end up in court.

Boards should gain enough knowledge and experience on climate-related risks, have access to sufficient information about the financial impact of these risks, robustly challenge their management team in evaluating the impact of climate-related risks on the financial statements, and encourage adequate disclosures to be made.

In collaboration with PwC, the World Economic Forum (WEF) developed a set of climate governance principles for corporate boards to effectively steer climate risks and opportunities in their business. To access this guide, please visit this site or scan:

How does the Board oversee ESG?

Strategy

Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?

Messaging

Do ESG messaging and activities align with the company's purpose and stakeholder interests?

Risk assessment

Have material ESG risks been identified and incorporated into the ERM? Has the board allocated the oversight of these risks to the full board or individual committees?

Reporting

What is the best communication platform to use for the company's ESG disclosures?

Role of Boards in driving ESG (cont'd)

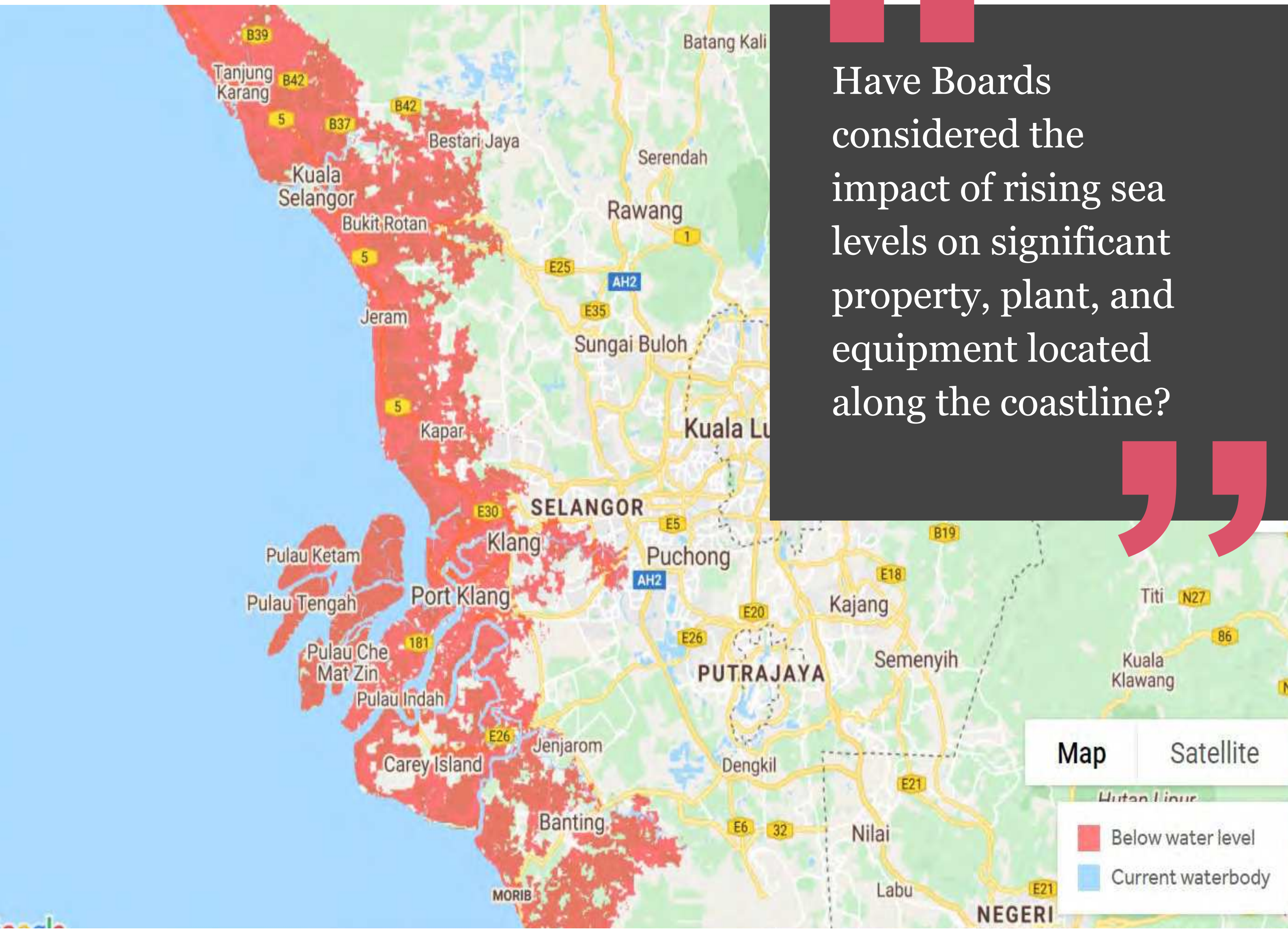
The following are examples of potential financial reporting implications arising from climate-related risks, **together with questions that Boards should consider** as part of their climate change consideration:

Financial line Items affected	Relevant accounting standards	Examples of questions to consider
ASSETS		
Non-financial assets carried at cost • Property, plant and equipment • Right-of-use assets • Intangible assets	• IAS 36 *Impairment of Assets* • IAS 16 *Property, Plant and Equipment* • IFRS 16 *Leases* • IAS 38 *Intangible Assets*	• What is the impact of rising sea levels on the operating efficiency, the expected useful lives and the related carrying amount of your significant property, plant and equipment located along the coastline which is susceptible to flooding? • What is the impact of changing temperature pattern on the future yield of the fruit crops and therefore the carrying amount of the plantation assets? • What is the impact of the shift in government policy towards renewable energy on the expected useful lives of oil and gas exploration assets?
Non-financial assets carried at fair value • Biological assets • Investment properties • Non-financial assets fair valued during a business combination	• IFRS 13 *Fair Value Measurement*	• Are changing weather patterns considered in the key assumptions used in the fair valuation of agricultural produce (biological assets)? • How is the fair value of a recently purchased coal-fired power plant affected by increasing lobby for the government to move towards renewable energy source, and what is the resultant impact on goodwill arising from this business combination?

Role of Boards in driving ESG (cont'd)

Financial line Items affected	Relevant accounting standards	Examples of questions to consider
ASSETS		
Financial assets • Receivables	• IFRS 9 *Financial Instruments*	• If a bank's loan portfolio has significant exposure to fossil-fuel-intensive projects, how does climate-related risks affect the expected credit losses of these loans and investments? • What is the impact on the recoverability of the debts of a company whose customers are susceptible to the disruption of business as a result of potential coastal flooding?
LIABILITIES		
Liabilities • Provisions • Contingent liabilities	• IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	• What is the impact of the push towards full electric vehicles on the accounting for provision for onerous contract or decommissioning a manufacturing plant for petrol cars? • Will the stricter environmental regulations on oil spillage result in recognition of provision or disclosure of contingent liabilities arising from potential litigation?
DISCLOSURES		
Disclosures	• IAS 1 *Presentation of Financial Statements* • IFRS 7 *Financial Instruments: Disclosures*	• Are key assumptions and major sources of estimation uncertainty used in the impairment assessment of the oil and gas assets adequately disclosed in the financial statements? • Did management consider disclosing the sensitivity of the fair value of the biological assets to the climate change assumptions underlying its computation?

Role of Boards in driving ESG (cont’d)



> Have Boards considered the impact of rising sea levels on significant property, plant, and equipment located along the coastline?

A map in the website of Coastal Climate Central, a non-profit news organisation that reports on climate science, predicts that a good part of coastal Selangor including Banting, Klang and Kapar will be submerged below water by 2050 as a result of rising sea water. Have Boards considered the impact of this climate-related risk on their organisations?

Role of Regulators in driving ESG

Regulators also play a critical role in driving this agenda in the following ways:

1) Harmonisation of the ESG standards

Regulators should be at the forefront of encouraging global initiatives towards a single sustainability framework - an equivalent to the IFRS used in financial reporting. As an example, regulators in New Zealand are the first to require the financial sector to report on climate risks using the comply-or-explain approach based on the TCFD framework.

Currently, there is no globally consistent sustainability standard in the market today. Four (4) standards dominate the ESG reporting realm:

- Global Reporting Initiative (GRI) - *most popular standard*
- Sustainability Accounting Standards Board (SASB)
- Task Force on Climate-related Financial Disclosures (TCFD)
- Carbon Disclosure Project (CDP)

2) Facilitating the calibration of reliable ESG data sets

Regulators could play a part in facilitating the development and calibration of reliable ESG data sets, which could be used by Boards and other stakeholders to drive the deliberation of climate-related issues.

At present, ESG data varies widely from one category to another. Data sets are also beset by poor quality, inconsistency, and lack of coverage across companies and industries.

Environment Data
- *Annual carbon emissions*
- *Water consumption*

Social Data
- *Workforce diversity*
- *Gender equity*

Governance Topics
- *Corruption*
- *Labour practices*
- *Gender composition of the Board*

3) Mandating external assurance to build trust

Regulators should consider mandating external assurance on sustainability data for public companies in Malaysia. At present, many organisations have adopted a 'check-box' boilerplate approach to disclosures, with questionable data sets.

Practicing robust independent external assurance will promote trust and confidence with stakeholders as it is widely-accepted to:

- Strengthen the quality of a sustainability report by instituting discipline over data governance
- Promote the correct application of the adopted sustainability framework

Conclusion

We are at a turning point. Fundamental shifts are transforming what it takes to be commercially successful. Sustainability and climate change are the global challenges of our time, raising the importance of ESG factors.

Financial factors are no longer viewed as the pre-eminent drivers of value. To succeed, a business has to address the most important issues facing the world today. And therefore, **companies need to demonstrate how they create value, for shareholders and for society, through insightful, rounded and trusted reporting.**

In essence:

1. **Companies need to reshape their corporate reporting to meet stakeholder needs**
2. **We need globally aligned standards to drive consistency and trust**
3. **Boards play a critical role in developing strategies and ensuring follow through**
4. **ESG information needs to be audited to be trusted**

Conclusion (cont'd)

1 Corporate reporting needs to change

Stakeholders are demanding greater focus on sustainable practices. As a result, the corporate strategy of a company is now pushed to reflect the significance of ESG, which includes climate-related risks..

This transformational shift makes it vital for corporate reporting to demonstrate values beyond financial statements. Companies need proper KPI definition (financial and non-financial) and trusted data to succeed in preparing meaningful reports. A range of skills are also essential to transform strategies into measurable KPIs and then to collect the necessary data.

2 Globally aligned standards are imperative

The numerous standards currently available are set with different focus and consequently different metrics. Varying requirements under these standards make it hard for stakeholders to compare across organisations and understand what is reported.

Ongoing global initiatives, including those of regulators, to harmonise these standards will help provide greater comparability, reduce fragmentation and complexity in approaches, and reinforce trust within the ESG ecosystem.

3 Boards play a critical role

Boards set the tone in driving the ESG agenda in their organisations. They are in a position to connect sustainability with corporate strategy, oversee how the strategy and risk management practices meet the needs of broader stakeholders as a means to driving shareholder value.

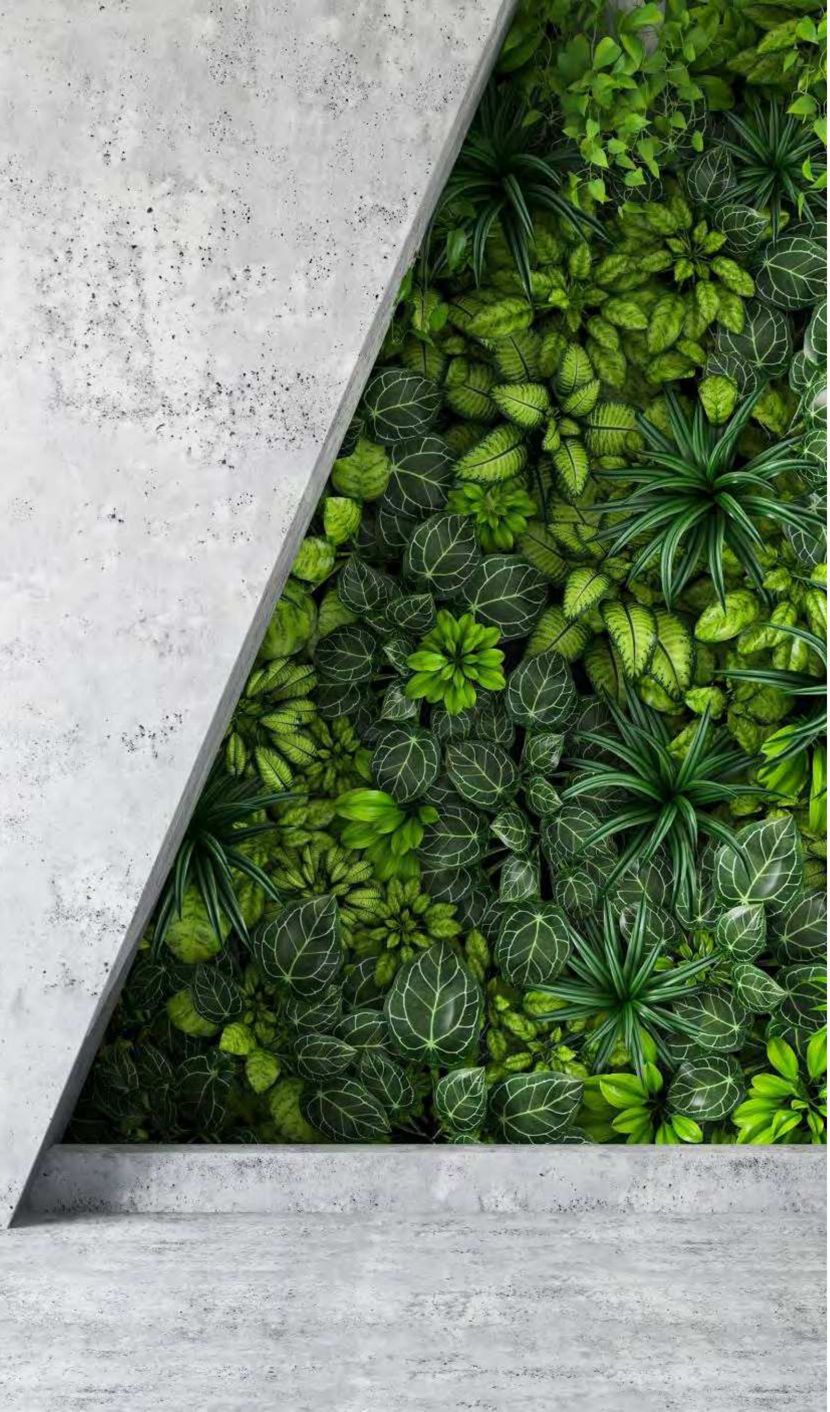
Climate change risks continue to receive increased focus from investors, regulators, media and non-government organisations. In this regard, Boards have a critical role to play in robustly challenging management's evaluation of the impact of climate-related risks on the financial statements and encouraging adequate disclosures to be made.

4 ESG data audit - crucial for trust

Ensuring robust information across the ecosystem via high levels of personal accountability is key. And this involves having quality information, a well-built system of requirements, knowledge on application, processes, controls and reporting, and a requirement that information is independently assured.

As with financial reporting, external assurance can enhance the credibility of sustainability reporting and provide both report readers and internal management with increased confidence in these reports.

Overall, companies should engage with their stakeholders on data and disclosure expectations. This is a collaborative process and requires multi-stakeholders' responses, but it needs to happen at pace. It took a century for global standards for financial reporting to emerge. We do not have the luxury of time. ESG factors are shaping business success now. Reporting has to change fast. **It's time to take ESG standards and practices to new levels. Investors, regulators and other stakeholders will expect nothing less.**



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