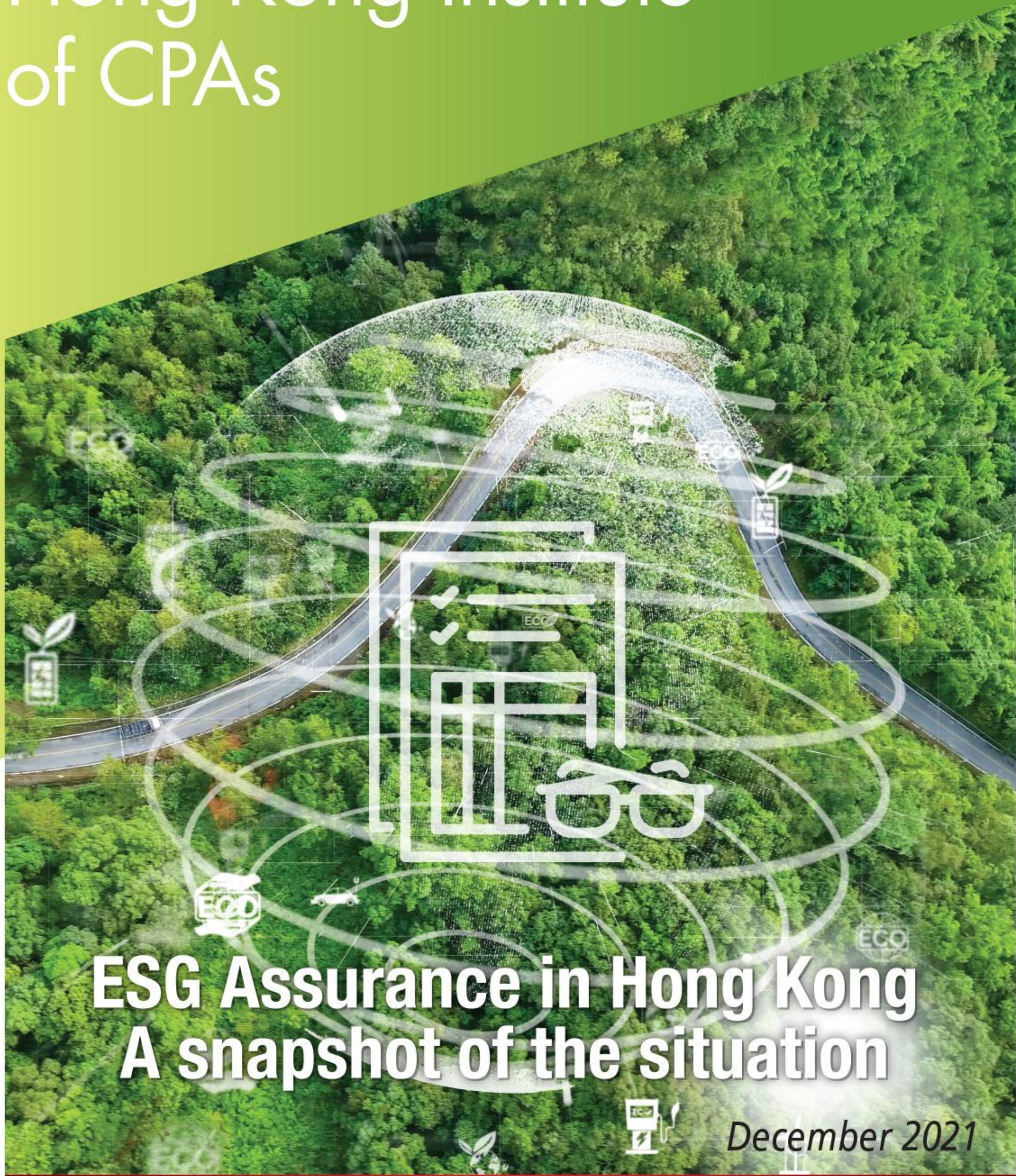
Hong Kong Institute of CPAs



ESG Assurance in Hong Kong
A snapshot of the situation

December 2021

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

The Hong Kong Institute of Certified Public Accountants is the only body authorized by law to register certified public accountants and grant practising certificates in Hong Kong. The Institute has more than 47,000 members and more than 17,500 students. Members of the Institute are entitled to the description "certified public accountant" and to the designation CPA.

Contents | *Page*

Message from the chair of the 2021 Best Corporate Governance and ESG Awards Judging Panel

Dear members,

It is pleasing to see more companies integrating their environmental, social and governance (ESG) vision, strategies and action plans into their corporate agenda, and disclosing quite extensive ESG information, enabling investors to make informed investment decisions and allocate capital more efficiently. Meanwhile, with the ESG information provided by companies, other stakeholders are also better able to judge whether those companies are genuinely committed to implementing good ESG practices and disclosures, and to making their own contribution towards long-term sustainable development.

Given that an increasing number of stakeholders are relying on good quality of ESG information, attention is also turning to the accuracy, reliability and integrity of such information in order to enhance the stakeholders' confidence in it. The need for some form of external validation or assurance of ESG reporting, akin to that provided by auditors in relation to financial information, is now the subject of discussion. However, at present there are no internationally agreed standards for ESG reporting as there are for financial reporting. Various different frameworks and sets of guidance for non-financial and ESG reporting, or specific aspects thereof, such as climate change, have been developed by different organizations, some of which have quite been widely adopted or used as benchmarks.

While there has been some consolidation over the past couple of years - in particular the International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB) merged in 2021 to form the Value Reporting Foundation (VRF) - the disparate and dispersed efforts to support ESG reporting have made it difficult for companies to know what benchmarks to report against, particularly for those seeking international investment. This, in turn, has also made it problematic for investors and other stakeholders to make comparisons between the ESG-related disclosures of different companies' and, where there is assurance, also the assurance provided on those disclosures.

Therefore, the announcement by the Trustees of International Financial Reporting Standards (IFRS) Foundation, at the 26th UN Climate Change Conference of the Parties (COP26), held in Glasgow, 31 October - 12 November 2021, of the formation of a new International Sustainability Standards Board (ISSB)[1] to develop, in the public interest, a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs, was very welcome; as was the commitment by the VRF and the Climate Disclosure Standards Board to consolidate into the new board by June 2022.

With these landmark developments, over time, we hope to see both ESG reporting, and assurance provided on it, coalesce into something that is extensive, reliable and credible, as well as being harmonized and comparable on a global level. We also believe that, by virtue of their training, experience and skill sets, as well as their professional ethics and the requirement for them to undertake continuous professional development, accountants are well placed to play a pivotal role in the further development of ESG reporting and assurance.

[1] https://www.ifrs.org/groups/international-sustainability-standards-board/

Message from the chair of the 2021 Best Corporate Governance and ESG Awards Judging Panel (cont'd)

This report reflects a snapshot of where Hong Kong listed companies stand at the present time with regard to ESG assurance. Currently, while it is encouraged to some extent, it is not a mandatory requirement under the local rules and regulations, and, in practice, only a relatively small percentage of the listed companies in Hong Kong opt to obtain any form of external assurance. Those that do tend to obtain limited scope engagements on specific information rather than the more extensive reasonable assurance across the broad spectrum of their ESG data and reporting.

While it may be some time before there is a consensus about regulation around assurance, given that ESG reporting standards themselves are still at a relatively early stage of evolution, obtaining a degree of assurance over a company's ESG information and data from a reputable, professional firm can help companies to build trust with investors and drive their competitive advantage. This may be why a number of CPA firms are increasing resources into developing and enhancing their ESG-related services to serve the needs of their existing and future clients. To support our members in practice, the Institute has published Auditing and Assurance Technical Bulletin (AATB) 5 *Environmental, Social and Governance (ESG) Assurance Reporting*[2], providing practical non-authoritative support material to assist practitioners in performing ESG assurance engagements, in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*.

Finally, in the context of seeking to strengthen ESG reporting, it is also important to stress that boards and managements, and preparers, should devote adequate and proper attention to ensuring the quality and reliability of their own ESG-related information and non-financial reporting generally.

Raymond Cheng FCPA (practising)
2021 Institute President
and Chair of the 2021 Best Corporate Governance and ESG Awards Judging Panel

[2] https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/03_Our-views/TB_-Cir/Auditing/aatb5_20.pdf

Background

In view of the accelerating demand for good quality ESG information, obtaining some assurance on ESG reports is also becoming important in helping to build stakeholders' trust in the quality of the information disclosed. The Hong Kong Stock Exchange's (HKEX) upgraded *Environmental, Social and Governance Reporting Guide* (ERG), which is under the Listing Rules (Appendix 27 of Main Board Listing Rules and Appendix 20 of the GEM Listing Rules), also notes that companies may seek independent assurance to strengthen the credibility of ESG information.

In some jurisdictions, the local equivalents of HKEX's ERG guidance go even further. As noted in the Asian Corporate Governance Association's (ACGA) recent update of its *CG Watch* comparative study[3] on corporate governance across Asia, the Singapore Exchange's sustainability reporting guide offers a succinct rationale for assurance and recommends phasing it in:

"Independent assurance increases stakeholder confidence in the accuracy and completeness of the sustainability information disclosed. An issuer whose sustainability reporting has already matured after several annual exercises would want to undertake external assurance by independent professional bodies to add credibility to the information disclosed and analysis undertaken. An issuer new to sustainability reporting may wish to start with internal assurance before progressing to external assurance for its benefits. The issuer should also consider whether it would be worthwhile to undertake independent external assurance on selected important aspects of its report even in its initial years, expanding coverage in succeeding years."

As reported in July, the Institute initiated a brief research exercise on the ESG assurance status of all 55 Hang Seng Index-constituent companies, investigating those that had published their sustainability/ESG report or incorporated a sustainability/ESG section in their annual reports for 2020/21, as at 28 June 2021. While 49 of them had published this ESG information by the cut-off date, only 23 out of 49 companies, i.e. around 47%, also sought external assurance on the information disclosed.

The situation of the Hang Seng Index-constituent companies, however, shows only a small part of the story. To further investigate the prevailing ESG assurance practices among listed companies more generally, the Institute has taken a broader look at listed companies with 31 December 2020 as their fiscal year-end date, scanning roughly 1,900 companies. These were allocated into the 89 categories identified by AASTOCKS.COM LIMITED.

In general, we were able to derive some useful statistics based on asking the questions set out below, and with the able support of a group of undergraduate students.

[3] CG Watch 2020, Future Promise - Aligning governance and ESG in Asia (ACGA & CLSA, May 2021), page 11.

Background (cont'd)

Regulatory requirements

- As mentioned above, the focus of this research was on listed companies with a financial year ended 31 December 2020. It seems that all of the companies included in the research published their ESG-related information either in their annual or ESG reports, generally, based on the ERG. At the time the companies were preparing their ESG reports, the relevant version of the ERG contained a mix of "comply-or-explain" provisions and recommended disclosures[4]. The "comply-or-explain" provisions covered general disclosures relating to policies and compliance with relevant law and regulations that had a significant impact on the company, in relation to each of the different aspects of ESG, and also additional disclosure of certain key performance indicators (KPIs) under the Environmental section. The recommended disclosures covered various KPIs in the Social section of the ERG.

- The ERG complements paragraph 28(2)(d) of Appendix 16 of the Main Board Listing Rules (and rule 18.07A(2)(d) of the GEM Rules), which states that an issuer's directors' report for a financial year must contain a business review in accordance with schedule 5 to the Companies Ordinance (Cap. 612). The business review must include, to the extent necessary for an understanding of the development, performance or position of the issuer's business:

    i. a discussion of the issuer's environmental policies and performance;

    ii. a discussion of the issuer's compliance with the relevant laws and regulations that have a significant impact on the issuer; and

    iii. an account of the issuer's key relationships with its employees, customers and suppliers and others that have a significant impact on the issuer and on which the issuer's success depends.

- So for quite a number of December 2020-year-end companies, their ESG disclosures were a combination of "comply-or-explain" requirements and voluntary disclosures. Looking ahead to next reporting cycle, these companies will now be subject to the upgraded version of the ERG, which includes a number of mandatory disclosure requirements relating to ESG governance structure, reporting principles and reporting boundary, as well as "comply-or-explain" requirements for all the KPIs in the both the Environmental and Social sections of the report[5]. These new provisions took effect for listed companies for financial years commencing on or after 1 July 2020.

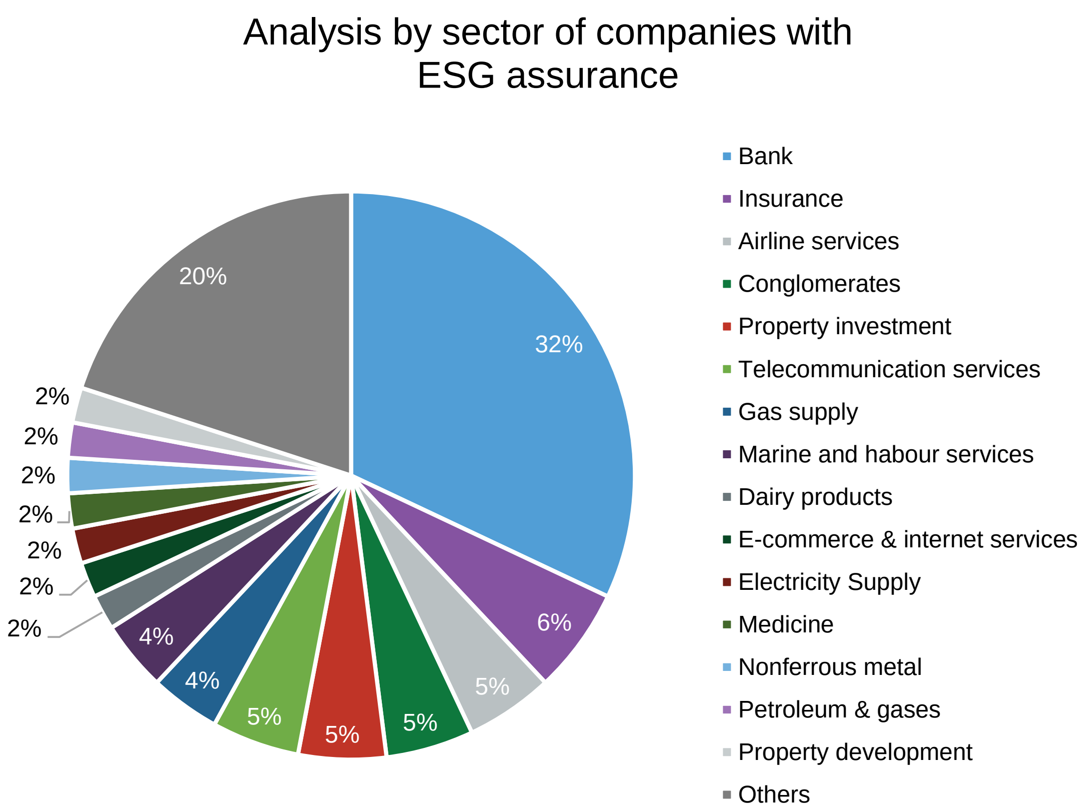
[4] See: https://en-rules.hkex.com.hk/node/3841/revisions/5218/view
[5] See: https://en-rules.hkex.com.hk/sites/default/files/net_file_store/HKEX4476_3841_VER20.pdf

1. What is the overall percentage of companies with ESG assurance?

The results show that only a very limited number of companies overall obtained assurance on their ESG reporting. Among the 1,897 companies included in the research, only 85 (4.5%) of them obtained external assurance. This figure includes 17 Hang Seng Index constituent companies. It suggests that at this stage, most listed companies in Hong Kong do not see the benefits of assurance. It may also be indicative of other factors – for example, that they see ESG reporting as primarily an issue of compliance and, currently, obtaining assurance is not a requirement, or that they are not entirely confident in the data and other information that they are reporting on. This merits further exploration.

Among the 85 companies with assurance, banks accounted for over 30%. This may be because banks are more attuned to ESG issues, given that the Hong Kong Monetary Authority (HKMA) has introduced various measures on sustainable banking and green finance and, at the international level, the recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) have been gaining increasing prominence.

The second highest number was among the insurance sector, albeit accounting for only 6%. This suggests that the financial services sector, more generally, views independent validation of ESG reporting as relatively more important. The rest of the companies with ESG assurance were almost evenly distributed across other industry categories, ranging from 1 to 5%. Industries where companies with assurance each represented only 1% of the total have been consolidated into "other" category for ease of presentation.



1. What is the overall percentage of companies with ESG assurance? (cont'd)

Earlier this year, the International Federation of Accountants, together with the American Institute of Certified Public Accountants and the Chartered Institute of Management Accountants embarked on a global benchmarking study[6] in partnership with Audit Analytics (IFAC study), *The State of Play in Sustainability Assurance* sought to better understand the extent to which companies were reporting and obtaining assurance over their sustainability disclosures, which assurance standards were being used, and which companies were providing the assurance service.

The IFAC study reviewed 1,400 companies across twenty-two jurisdictions, of which 51% reported sustainability information with some level of assurance on it. While, prima facie, this would indicate that the assurance rate of Hong Kong listed companies identified in our research of around 4.5% significantly lags behind the global benchmark, such a comparison may be imprecise. The IFAC study looked at, on average, 64 of the largest companies in each jurisdiction covered, while our study covered around 1,900 companies of all different sizes. As noted above, our earlier research on HSI-constituent companies which had published ESG reports by a cut-off date, found that around 47% also sought external assurance. This is not dissimilar to the figure in the IFAC study.

[6] https://www.ifac.org/system/files/publications/files/IFAC-Benchmarking-Global-Practice-Sustainability-Assurance.pdf

2. What are the percentages of companies by market capitalization with ESG assurance?

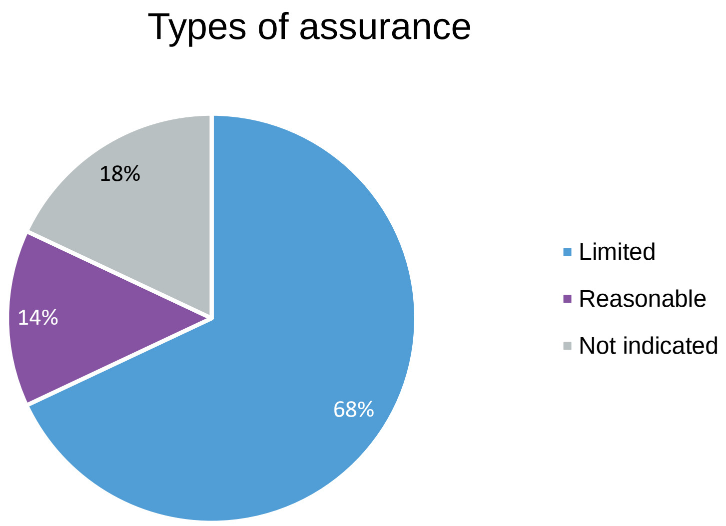
Our assurance research covered the 1,890 companies with 31 December 2020 as their financial year end. Applying the market capitalization adopted to classify different size companies under large (HK$54 billion and above), mid (over HK$9 billion and below HK$54 billion) and small (up to HK$9 billion) market capitalization (cap) categories in our Best Corporate Governance and ESG Awards 2021, we arrive at the numbers of companies in the large-, mid- and small-cap categories included in our study indicated below. The results are as follows:

Categories	Number of companies	Number of the companies with ESG assurance	Percentage B/A * 100%
Large	144	29	20.1%
Mid	309	36	11.6%
Small	1,437	20	1.4%

It is not a surprise to find that the companies in the large-cap category have a significantly higher percentage of ESG reports with some level of assurance, as already suggested by our earlier research on HSI-constituent companies, and that a very low percentage of the companies in small-cap category have any ESG assurance Large- and the bigger mid-cap companies would tend to have more resources to devote to their ESG. They would be more likely to be aiming to attract international investors, including institutional investors, whose expectations, generally, in terms of ESG reporting are increasing.

3. What types of assurance do companies use?

Nearly 70% of the sample that obtained assurance obtained limited assurance with 14% obtaining reasonable assurance.



This seems to be in line with the international trend. At present, KPMG note[7], due to the relative immaturity of ESG reporting and the associated cost/benefit, most opinions are limited assurance. Whilst the scope of financial statement audits and reviews covers the whole statement and disclosures, for ESG reporting, most of the time it will be selected KPIs or a specific section of the ESG report or annual report.

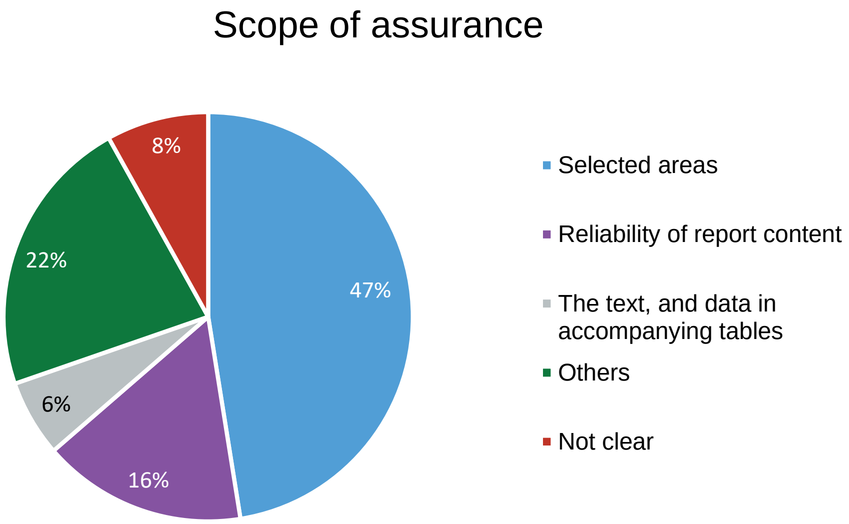
Reasonable assurance in general requires more effort than limited assurance. This is because it implies a similar level of assurance as for a financial statement audit and the need to obtain sufficient evidence.

Limited assurance engagements on the other hand are not as robust and, therefore, the cost is lower. This may be one reason why, at this stage, when assurance is voluntary, many companies prefer to opt for limited assurance. Other reasons may be the lack of common standards for ESG reporting, and that more attention and focus given to obtaining key data, such as data on greenhouse emissions, and having this assured, than to other information and data. They may, therefore, have less confidence in other data and so be more reluctant to subject it to assurance.

[7] See https://home.kpmg/uk/en/blogs/home/posts/2021/02/esg-reporting-do-you-need-assurance.html

4. What is the scope of assurance?

Nearly 50% of the companies in the sample indicated that only selected information/ data contained in the ESG reports was assured, while about 15% assured the reliability of their report content, which is considered a larger scope.

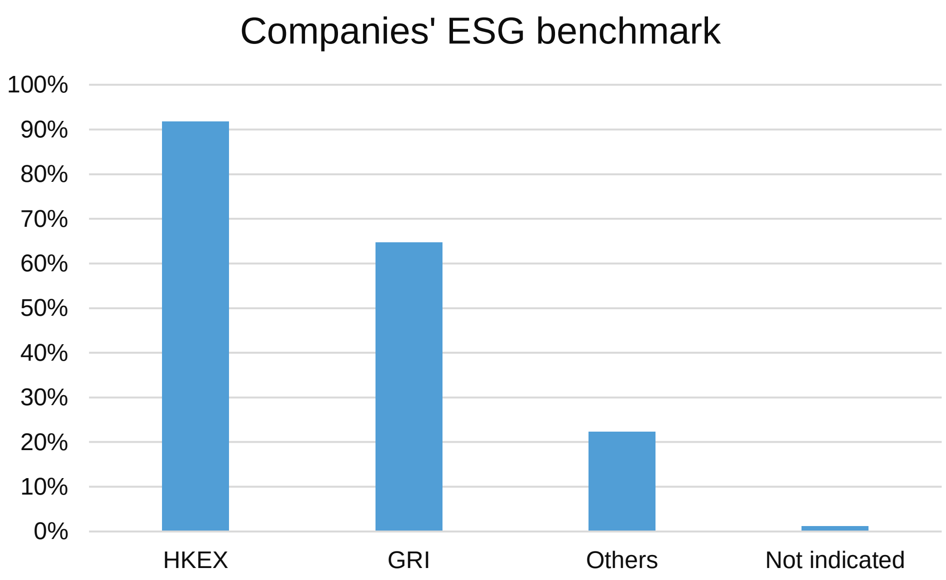


For 22% of the companies, the scope is classified as “others”. In most of the cases, the scope seemed to cover the entire report but then proceeded to mention a specific focus on certain activities/ areas, or to cover ESG performance data and information, without indicating whether this was equivalent to the reliability of the report content as a whole.




5. What benchmarks do companies use to prepare their reports?

The ERG was quoted by more than 90% of the companies as one of the sources for preparing their ESG report. There is also a growing awareness of international standards and some are quite widely adopted. Our research indicated that almost 65% of the companies referred to the standards issued by the Global Reporting Initiative (GRI) in preparing their reports.



Remarks:

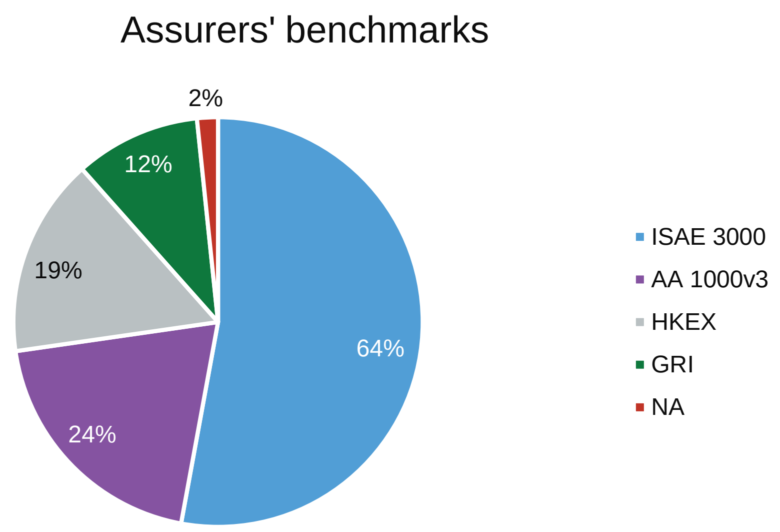
- These percentages do not add up to 100 as many of the companies prepared their reports with reference to two or more standards.

- Our focus was on standards referred to in ESG assurance reports, rather than other benchmarks that may also be mentioned in the body of ESG report, such as the 17 United Nations Sustainable Development Goals, TCFD recommendations, etc. By definition, those mentioned in the assurance report are more likely to be those standards and benchmarks most closely followed by the company concerned.

6. What standards do assurers use to assure ESG reports?

International Standard on Assurance Engagements (ISAE) 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* issued by the International Auditing and Assurance Standards Board (IAASB), was the most commonly adopted assurance standard with 64% of assurance reports in the study referring to this. The IAASB is an independent international standard-setting body that sets auditing and assurance standards.

The next most widely-referenced benchmark in our study was the AA1000 series of standards, which is applied by 24% of assurance reports. These are principles-based frameworks used by global businesses, private enterprises, governments, and other public and private organizations to reflect performance in accountability, responsibility, and sustainability. They are issued by AccountAbility, a global consulting and standards firm that works with businesses, investors, governments, and multilateral organizations on ESG matters.

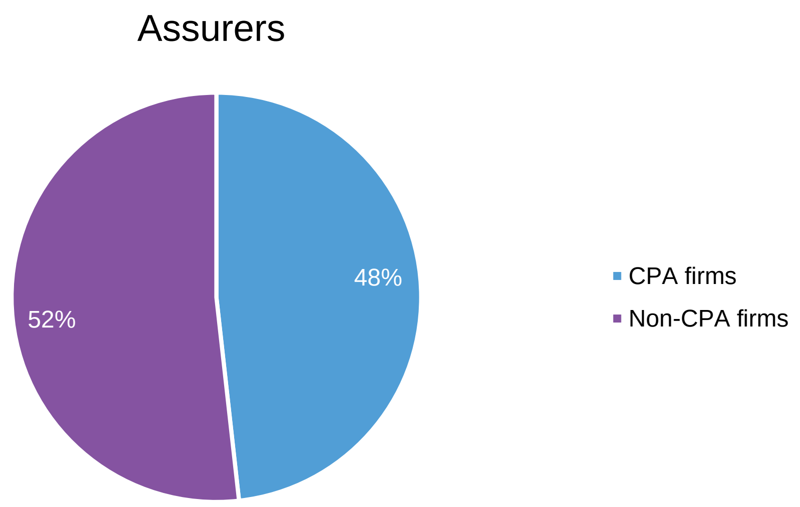


Language of "adoption"

In relation to questions 4 and 5 above, we noted that various different terminology was used to describe the way in which benchmarks were followed or taken into account, including "in accordance with", "pursuant to", "according to", "based on", "with reference to". It appears that the former three terms are more indicative of close compliance with a particular benchmark than the latter two. In particular, companies seemed consider that they had greater flexibility to make use of certain parts, rather than the whole, of the relevant standard or benchmark when they used either of the terms "based on" or "with reference to".

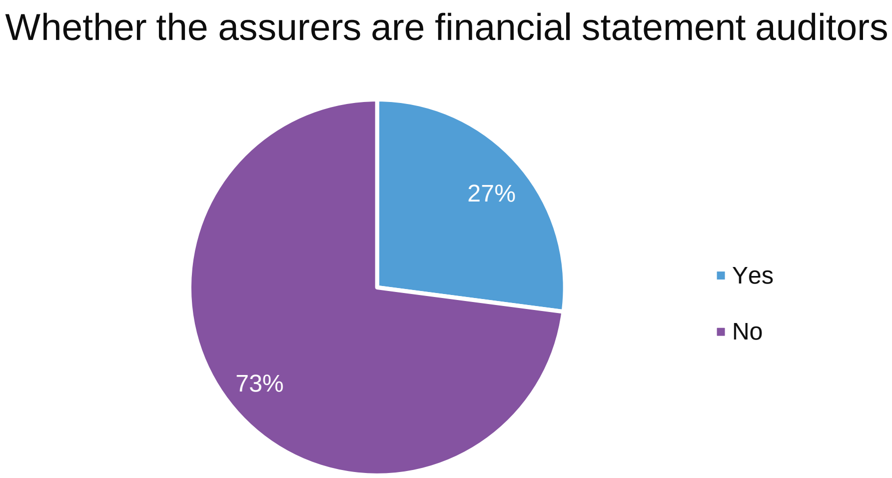
7. Who are the assurers of ESG reports?

Firms of certified public accountants assured 48% of the reports. Non-CPA firms assured the rest, among which an assurance agency established in 1989 as a non-profit-distributing organization by the Hong Kong Government, seems to play a dominant role.



8. Are the ESG assurers the same as the financial statement auditors?

In over 70% of the cases, the firm auditing the financial statements did not also assure the ESG report. This may be regarded as further enhancing the independence of ESG assurance but, on the other hand, there may be synergies where the financial statement auditors also perform the role of ESG assurers, particularly where ESG-related issues could have an impact on the financial statements, which may be increasingly the case in the future.



Findings, observations and recommendations

Findings

- Overall, the penetration of assurance on ESG reporting is the listed company sector in Hong Kong is still very low.

- Based on our findings for December 2020 year-end companies, a significantly higher proportion of large-cap companies, around 20%, obtained assurance than for other categories. Only a very small proportion of small-cap companies, less than 1.5%, obtained assurance. These findings are not surprising given the more limited resources of most small-cap companies and that large-cap and the bigger mid-cap companies are more likely to be looking for international investment, including from institutional investors, who will want to be able place reliance on the integrity of ESG-related information and data.

- Where there was assurance, the level of assurance was "limited" in over two thirds of the cases (68%) and "reasonable" in only 14% of cases, and it covered only selected areas of information in around half the cases (47%).

- As regards industry sectors, the financial services sector and banks, in particular, had a significantly higher proportion of assured ESG reports than other sectors (amounting to almost one third of the total in the case of banks). This is likely to be the outcome of the focus on promoting sustainable banking and green finance by the HKMA, as well as the increasing prominence internationally of the recommendations of the TCFD.

- The limited penetration of assurance on ESG reporting is believed to stem from several factors, including the following:

    - Under the current regulatory regime, assurance is not mandatory and, in fact, not even a recommended best practice.

    - Currently, there are no generally accepted ESG reporting standards (although some, like the GRI, are quite widely referred to) other than the ERG under the listing rules in Hong Kong, which is deliberately non-committal about specific reporting standards that companies may adopt.

    - In 2020, the ERG contained only limited "comply-or-explain" provisions applicable to December-year-end companies, which included some key performance indicators in the Environmental section only. For companies with financial years starting on or after 1 July 2020, the latest, upgraded version of the guide will apply. So this will be generally applicable in the next reporting cycle.

- Where assurance is obtained, in around 50% of cases, the assurer was a CPA firm. This is not surprising given that that main assurance benchmark referred to by all forms of assurers, in nearly two thirds of cases, was ISAE 3000, issued by the IAASB. Accountants will naturally be more experienced and adept at applying accounting-related standards.

- What may be more unexpected is that, where CPA firms undertook ESG assurance, it is generally not the company's auditor. While this separation of roles may add to the perception of independence and stronger checks and balances, it may also work against the aim of achieving a deeper integration between ESG and financial reporting.

Findings, observations and recommendations (cont'd)

Observations and recommendations

- With the establishment of the ISSB, it can be expected that fairly rigorous ESG reporting standards will be developed and promulgated quickly, starting with a standard on climate change. These standards are likely to be widely accepted and, around the world, regulatory frameworks may, over time, may be put in place to ensure the application of these standards, in a similar way to financial reporting standards. Companies should take the opportunity to adopt ESG reporting standards that can enhance the integrity, reliability and comparability of their reporting. As noted in the president's introductory message to this report, boards and managements should also devote adequate and proper attention to ensuring the quality and reliability of their ESG reporting.

- Against this background, companies can be more confident in starting to adopt, or to expand their assurance on their ESG information and data. This can help to validate and lend greater credibility to their ESG reporting. With the increased harmonization and comparability of standards that is likely to occur, investors will have more trust and confidence in companies' reported ESG performance, which will be enhanced by the added comfort provided by assurance.

- In addition, with the more extensive requirements of the revised ERG now in effect, this is an appropriate time for companies new to this journey to start considering what data and information should be a priority for assurance, if they do not feel comfortable seeking assurance on all of their ESG reporting. They should consider focusing initially on data that is most material to them and their stakeholders. Good stakeholder engagement processes and the development of a sound materiality matrix can help to identify the key information and data.

- Noting the very varied landscape alluded to in the president's message and the present lack of comparability in assurance, the ACGA makes two suggestions for moving the process forward[8]:

  "First, encourage the content of ESG reports to be independently reviewed for their breadth and depth of coverage, with recommendations made as to how they could improve and be made more useful for investors in particular. This does not envisage assuring all the data points, rather taking a more selective approach to addressing issues that are most material to a company's business.

  Secondly, if an ESG risk is material enough to have a major financial or business impact, it should be discussed in the annual report and assessed alongside the financial statements. The obvious candidate is climate change. Indeed, some global institutional investors are starting to call for auditors to look at climate risk disclosure, in particular TCFD reporting, when auditing the financial statements."

[8] CG Watch 2020, Future Promise - Aligning governance and ESG in Asia (ACGA & CLSA, May 2021), page 13.

Findings, observations and recommendations (cont'd)

- With the setting up of the ISSB, there is an opportunity for the accounting profession to play a larger role in supporting ESG reporting and assurance, which the profession should grasp. The accounting profession has the skill sets and understanding of key processes, including financial and data analysis, internal control and risk management, to take a leading role in ESG assurance, as well as reporting. Members of the profession are required to undertake continuous professional development, and are bound by, professional standards and a code of professional ethics.

- Most assurers refer to the framework under ISAE 3000 in conducting their ESG assurance engagement. In this regard, not only are accountants more familiar with the application of this standard, they are trained in applying professional standards generally and may, ultimately, be subject to investigation and disciplinary action if they fail to apply a standard appropriately. This is not the case for other assurers, for whom ISAE 3000 is just a point of reference. They may inadvertently or deliberately fail to apply aspects of it without any direct repercussions.

- There should be more discussion on the merits of a company's financial statement auditor, supported by specific expertise, where needed, also being engaged to provide assurance on the company's ESG report, as opposed to engaging a third party assurer, which could be a different CPA firm, to perform the latter function. Given the impact that ESG factors may have on the financial statements, having the same service provider perform both roles could help facilitate integration of financial and ESG considerations, as well as corporate governance and ESG, which is something, we believe, many regulators around the world, including HKEX, see as the goal.

- In this regard, Deloitte note[9] that ESG information may be highly interconnected with financial reporting. For example, knowledge obtained from financial statement audits, including internal controls, may be beneficial in planning the ESG assurance procedures (e.g., the auditors' understanding of the business holistically across all of an organization's functions, its industry, market forces, and why certain sustainability metrics are important financially as well as from a risk perspective).

[9] https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Audit/gx-audit-environment-social-and-governance-considerations-corporate-reporting-and-assurance-basics.pdf

Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East, Wanchai, Hong Kong
Tel: (852) 2287 7228
Fax: (852) 2865 6603
Email: hkicpa@hkicpa.org.hk
Website: www.hkicpa.org.hk