LEVERAGING ESG AND INTEGRATED REPORTING FRAMEWORK FOR SPURRING SUSTAINABLE INVESTMENTS

Abstract

The changing dimensions of business and economic world are leading to ever increasing focus on aspects like environment, society and governance with change in reporting architecture so as to provide the much needed information to the stakeholders with regard to the activities of a company. This trend has hastened the adoption of ESG metrics and integrated reporting the world over including India. This article discusses the concept of ESG, global initiatives towards reporting framework and its role in promoting sustainable finance.

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THE PERSPECTIVE

A society can survive and thrive only if the environment is taken care of and duly protected sustainably. In the past, world has witnessed how economic and environmental crises have affected the society at large. COVID-19 pandemic with which the world is still coping, has demonstrated the economic vulnerabilities and disparities, health care system gaps and healthcare facilities access issues around the world. To recall, US subprime crises in 2007 had ultimately hit the tax payers and the common man. Similarly, corporate frauds and bankruptcy due to misutilization of scarce resources also hit the economy.

With the shift from the shareholder to stakeholder perspective, society and environment are also part of the stakeholder architecture and are concerned and interested in the operations of any economic entity. Value creation is now a holistic concept and not mere increase in financial value. Corporates are the backbone of any society or economy. Therefore, despite government efforts, the goals cannot be achieved if the corporates are not sensitive enough to modify their actions in line with the environmental and societal needs and aspirations. It is thus important to direct the actions of companies towards sustainability actions and reporting.

EVOLUTION OF ESG CONCEPT

Sensitization and actions related to ESG issues for corporates date back to 1960s in the form of socially responsible investing in the United States of America, by electric and mine workers, where they began to invest pension capital in affordable housing and health facilities. Post that a series of events kept on strengthening the importance of ESG concept resulting in a declaration of

The Earth Day on 22nd April 1970. Further the initiatives led to the forming of MSCI KLD 400 Social Index in 1990.

The Earth summit took place in 1992, where India was also one of the 152 countries to sign the International Environment Treaty. Following this, another major event in the form of Kyoto Protocol was signed by 192 countries pledging to reduce Green House gas effect. In the same year, that is 1997, Global Reporting Initiative was founded in Boston. In the year 2000, United Nations Global Compact was launched wherein the aim was to motivate companies to align their strategies with universal principles; 30 Indian business organisations are currently participants to the compact. In 2004-05, United Nations, through a report, provided guidelines to corporates regarding incorporation of ESG into their operations.

In 2011, with the core objective of establishing and improving the industry specific disclosure standards and to standardize sustainability accounting and measurement across 77 countries, the Sustainability Accounting Standards Board (SASB) was launched. In the year 2015, the United Nations announced 17 Sustainable Development Goals (SDG's) of the 2030 Agenda for Sustainable Development wherein the Paris Agreement tied all the nations towards sustainable development.

EVOLUTION OF SUSTAINABILITY REPORTING IN INDIA

The initial efforts in India towards ESG reporting can be traced back to the issuance of National Voluntary Guidelines on Corporate Social Responsibility (NVGs) in 2009 by Ministry of Corporate Affairs (MCA), GOI. The next step came from SEBI (Securities and Exchange Board of India) which made it compulsory for top 100 listed companies, by market capitalization, to file Business Sustainability Report (BSR) along with annual report. BSR had to be separately filed and they are based on NVG's. This was later, in 2015, extended to 500 listed companies.

In between, in the year 2014, it was made compulsory for certain companies, based on turnover, to spend at least 2 per cent of their average past three-year profits on CSR activities. SEBI initiated its first step towards adoption of Integrated Reporting (IR) by top 500 listed companies in 2017, though it is still voluntary. It was followed by introduction of National Guidelines on Responsible Business Conduct (NGRBC) in 2019. The same year, SEBI extended the BRR to the top 1,000 listed companies by market capitalisation. In 2021 SEBI has published the format which the top 1,000 listed entities by market cap will be required to use for sustainability disclosures.

The BSBR will contain following disclosures relating to the listed entities:

- material ESG risks and opportunities, approach to mitigate or adapt to the risks, along with the financial implications of the same
- sustainability-related goals, targets and performance
- environment-related disclosures, covering aspects such as resource usage (energy and water), air pollutant emissions, GHG emissions, efforts to transition to a circular economy, waste generated and waste management practices, bio-diversity
- social-related disclosures, covering its workforce (covering gender and social diversity, median wages, welfare benefits, etc.); communities (covering social impact assessments, corporate social responsibility, etc.); and consumers (covering product labelling, product recalls, and consumer complaints in respect of data privacy and cyber security)

ESG REPORTING AND EVALUATION

A group of Standard setters, disclosure reporting facilitators and credit rating agencies are organisations/ institutions linked with ESG reporting and evaluation. The main purpose of these organisations is to motivate and direct the efforts of various entities reporting for ESG. For example: Climate Disclosure Standards Board (CDSB), Global Reporting Initiative (GRI) International Integrated Reporting Council (IIRC), Sustainable Accounting Standards Board (SASB, now merged with IIRC), International Sustainability Standards Board. (ISSB) are few organisations aggressively involved in Standard setting in the domain of ESG reporting.

CDP, apart from various accounting firms like big 4's, facilitates disclosure reporting by organisations and yet other organisations such as Morgan Stanley Capital International (MSCI), S&P Global ratings and Sustainalytics , to name a few, are rating agencies providing evaluation criteria for giving ratings or providing ESG score.

MSCI uses a rule-based methodology, employing publicly available data and then using an ESG lens to account for the risks and opportunities facing the industry/company. The methodology together with peer comparison for company's bottom line, also looks at the risk management and balancing plan of the company. After assessing each ESG risk on threshold of impact and time horizon, they assign a percentage weight to each of the risk. In order to derive the overall ESG ratings, the combined and normalised scores are compared with the industry peers.

S&P Global provides ESG profiles and preparedness opinions. The profiles give 30 per cent weightage to environment, 30 per cent to social and remaining 40 per cent to governance. Apart from this 40 per cent of the profile is driven by sectoral and regional analysis, applied to an entity. Sustainalytics enables investors to identify and understand financially material ESG risks at the security and portfolio level and their impact on the long-term performance for equity and fixed income investments.

The ESG risk ratings, combined with qualitative analyses, provide clients with a differentiated risk signal and deeper insights into the materiality of certain ESG issues for a company and what the company is or is not doing to manage them effectively.

In India ESGRisk.ai claims to be the first rating agency to provide an India specific assessment framework. ESGRisk.ai covers a company's ESG performance across three categories with 19 themes and 35 key issues. The scores are based on a comprehensive assessment of 1000 indicators. Figure 1 below shows the ESG rating process at ESGRisk.ai.

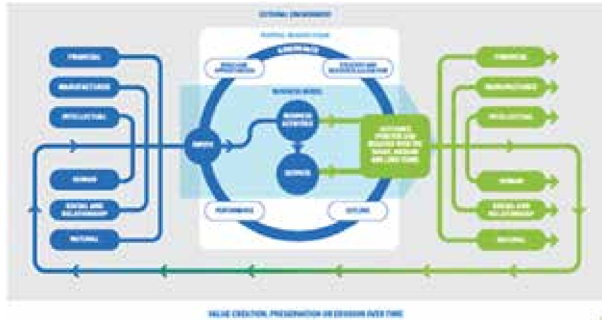
FIGURE 1: ESGRISK.AI WEBSITE, EXTRACTED ON 24TH JULY 2022.

A PEEK INTO INTEGRATED REPORTING

The Prince of Wales' Accounting for Sustainability Project, the Global Reporting Initiative and the International Federation of Accountants jointly initiated the formation of International Integrated Reporting Council (IIRC) in the year 2010. The central theme of Integrated Reporting is a broader explanation of performance. Its role is to create a unique value creating proposition story. It makes visible an organisation's use of and dependence on various resources and relationships and an organisations' access to and impact on them. Capital, here, refers to "any store of value, that an organisation can use for the production of goods and services." Hence these resources and relationships have been explicitly termed as "capital". As defined by IIRC, IR is a "concise communication as to how an organisation's strategy, governance, performance and prospects, in the external environment, leads to the creation of value in the short, medium and long term."

Integrated report proposes to bring modification to the current reporting practice, and proposes and promotes both financial and non-financial reporting. The three important areas where there is a deviation of integrated reporting from the financial reporting is, the reporting on financial and non-financial capitals against reporting on only financial capital, short-term, mid-term and long-term view in place of short-term and long-term view and triple bottom line of people, planet and profit in place of only profits.

FIGURE 2*: PROCESS THROUGH WHICH VALUE IS CREATED, PRESERVED OR ERODED



*Source: International Integrated Reporting Framework (January 2021 Report)

Integrated reporting has introduced the concept of six capitals namely financial capital, manufactured capital, intellectual capital, human capital, social and relationship capital, and natural capital. Organisations may not own all the capitals. IR moves away from the concept of capital maintenance. It rather talks about the availability, quality and affordability. These capitals are not independent and their inter linkage depends upon the goals and objectives of an organisation. For example, a retail company may not have much to report on intellectual capital or on manufactured capital. Figure 2 depicts the interlinkage between various capitals and hence the process in which value may be created, remain preserved or may erode.

These capitals continuously interact and hence each may increase, decrease and they may get transformed. For example, when an organisation earns profit, its financial capital increases. There is a change within a financial capital. When an employee is trained, human capital increases, but financial capital decreases because it comes at a cost to the organisation. Ultimately this training would lead to increased efficiency and hence gradually it would increase the financial capital. Hence over a period of time all these interactions between the capitals can be understood in the form of net value added.

Sometimes, IR and sustainability reporting are used and understood inter changeably. But IIRC explains how sustainability reporting and integrated reporting are different. The focus of sustainability reporting is on the impact on environment, society and economy rather than the strategic role of various capitals in value creation and secondly the prominent audience for sustainability reporting is larger society vis- a -vis IR, that targets the providers of financial capital.

ADOPTION OF IR IN INDIA

Companies in India, produce multiple reports that serve different needs, including Annual Reports, Corporate Social Responsibility Reports, Business Responsibility Reports

(BRR), Sustainability Reports (GRI guidelines and BRR guidelines) and reports showing compliance with emission and effluent standards. This approach confuses readers of both financial and non-financial information of the business. Over the years, India has made significant progress in adopting integrated reporting, driven by a 2017 circular of the Securities and Exchange Board of India (SEBI) recommending that the top 500 listed companies, which are required to prepare a BRR, consider using integrated reporting framework for annual reporting.

Kirloskar Brothers and Tata Steel were the two pioneer companies to participate in the pilot program of IIRC for adoption of integrated reporting. Tata Steel adopted integrated reporting practice from the year 2014-2015 onwards. As per the latest available data, around 80 Indian companies have included integrated formats in their annual reports. There has been a 3.5x increase in the number of companies using the International Framework in their annual reports between 2018 and 2020.

SUSTAINABLE FINANCIAL PRACTICES

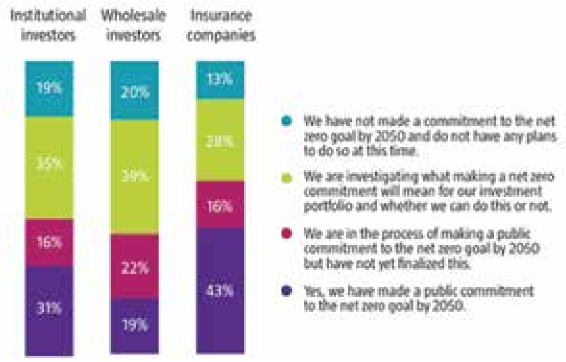
The World Bank defines sustainable finance as the 'process of taking **environmental, social and governance (ESG) considerations** into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects. As per European Commission (EC), sustainable finance also, involves transparency related to risks and ESG factors, which may impact the financial system. EC suggests that appropriate governance can mitigate these risks.

In just a decade's time, sustainable finance has witnessed a huge jump and is practiced globally today. Despite COVID-19 pandemic, when many investment avenues halted, sustainable finance investments witnessed 23 per cent increase in comparison to last year wherein around $732 billion worth of sustainable debt was issued.

Since, there is a huge demand for sustainable investments, many banks like for example, Standard Chartered and Barclays are in the process of developing frameworks to assess investment opportunities in sustainability-based projects. Banks and other issuers are preparing themselves to exploit the opportunity by considering ESG considerations in product development, pricing and underwriting. These considerations are also guiding the portfolio decisions and risk management to protect against ESG-related risks.

Most of the insurance companies are also engaged in practicing sustainability. They are investing maximum funds in related sectors. These companies are investing huge amounts in R&D activities to create sustainable finance products. Figure 3 shows the result of the survey by Robeco, clearly showing the highest number of investments being made by insurance companies in comparison to Institutional and wholesale investors.

FIGURE 3: COMPARATIVE ANALYSIS OF INVESTMENTS BY INSTITUTIONAL, WHOLESALE AND INSURANCE COMPANIES AS INVESTORS*



*Investors by survey participants amount to around USD 23.7 million dollars in AUM

Source: Sustainable investing for insurers, article published online on us.milliman.com

A letter, prominently highlighting the importance of ESG, was written by CEO of Black Rock Company in 2021. This shows the sensitivity of investment decisions by investment companies towards ESG and sustainable practices by firms. Bloomberg is predicting around USD 53 trillion worth of investments in high- performing ESG metrics i.e. around 35-40 per cent of the projected total assets under management (AUM).

ESG ADOPTION- OPINION, OPPORTUNITIES AND CHALLENGES

ESG or IR agenda encompasses business transformation, strategy and an integrated way of thinking. According to PWC, the focus and drive of the senior officials will pay a very critical role in creating a ESG supporting culture.

Koushik Chatterjee, CFO, Tata Steel stated on the recent panel discussion conducted by money control: "Purpose of the corporation needs to be decided'; he pointed out that Tata 's founder's vision was that "what comes from the society must go back to the society and ESG is reframing the statement…, business organisations must realize that they cannot only profit out of planet, ESG identifies the soul of the corporation",

Paul Druckman, CEO of IIRC (2011-2016) suggests a three-step model in the adoption of IR. Beginning from stakeholder mapping exercise which involves alignment of strategy with stakeholder's expectations, based on their perception of risks and opportunities. In the second step, a consideration of the resources is required to implement the changes and integration of various departments to achieve the delivery of a coherent strategy and communicating the strategy clearly using multiple resources and enhancing stability. The PWC report further mentions that in addition,

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a critical priority for leaders is to back up their ESG initiatives and aspirations with actual investments. The motivation for business to address ESG issues will continue to be prompted by all the stakeholders and the possibility of identifying new avenues for value creation.

CONCLUSION

Businesses need to show their stakeholders that they create value and report on not just financial capital but also intellectual, environmental, manufactured and human capitals to name a few. The regulators, various concerned institutions (facilitators) and companies, at large, the world over are becoming sensitized towards ESG , integrated reporting and investing in sustainable projects. This would motivate companies to adopt sustainable business practices, thus contributing towards the achievement of Sustainable Development Goals of the United Nations. By being more transparent in their practices and culture, organisations gain the trust of their many different stakeholders, which in turn contributes to sustainable development and responsible capitalism. India is now prepared to move on the next step of mandating ESG reporting. MA

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OBITUARY

CMA Sasadhar Paul, Member of the Institute, passed away on July 30, 2022 at the age of 85 years.

In the year 1965, he was elected as the Councillor of the Bhatpara Municipality as an Independent Candidate. He worked as an Accounts Manager in The Gouripur Jute Mill, Nadia Jute Mill and lastly he retired from Anglo-India Jute Mill, Jagaddal, North 24 Parganas and West Bengal as Head of Costing. He was the Pioneer Member and Secretary & Chairman of Naihati-Ichapur Chapter of Cost Accountants.

May his departed soul rest in peace.