Nangia Andersen LLP

# RESEARCH PAPER

## ESG - PROPONENT OF RESPONSIBLE BUSINESSES

# ESG- PROPONENT OF RESPONSIBLE BUSINESSES

Business performance that was formerly linked to profits and returns, is now also taking cognizance of the potential environmental and social impairment that it may lead to. It is now being universally acknowledged that good governance practices by companies demonstrate stronger corporate performance.

Environment, Social and Governance (ESG) are matters associated with corporate responsibility and sustainability, material to long-term enterprise value creation. It is based on the idea that companies must be conscious of the impact of their activities on the environment/ society and emphasises on the obligation of the corporates beyond returns and profits. ESG, a part of stakeholder capitalism, involves serving the needs of all the stakeholders, as opposed to only shareholders, for the long term health and success of the business. ESG considerations have gained traction in the past decade, since millennial investors are being mindful of the environmental and social impact of their potential target investments.

**Environment**
Refers to the use of clean energy, waste management and conservation of natural resources

**Social**
Includes corporate social responsibility and what a company gives back to the society from its earnings and profitability

**Governance**
Refers to internal system of practices, controls, and procedures that a company adopts to govern itself, make effective decisions, comply with the law and meet the needs of stakeholders

## Examples of ESG risks[1]

**Environment**
- Environmental Policy
- Carbon Intensity Trend
- Renewable Energy Use
- Effluent Management

**Social**
- Health and safety systems
- Data Privacy programs
- Employee turnover rate
- Community Development

**Governance**
- Management quality
- Board structure
- Board diversity
- Financial Reporting

## I. Why is ESG gaining traction?

The purpose of ESG is to reflect how ethical a company's practices are, putting sustainability and moral principles above profit. ESG issues have become vital for businesses that give precedence to sustainability, and for investors looking for socially responsible investment opportunities.

### The world is transforming

Climate changes, natural disasters, data privacy/security issues and pandemics are a threat to business. Now that one of these threats has become reality, companies, leaders, investors are focussing on corporate responsibility and sustainable development. Apparently, the COVID 19 pandemic has amplified the transition to a more purposeful and inclusive stakeholder capitalism. Companies that helped their staff and suppliers during the testing times have gained reputation and resultantly, business. Such businesses proved to be more irrepressible during the pandemic.

### The new-age investors

ESG metrics are being used by potential investors, who now, not only observe how a potential target company is doing financially, but also monitor the societal and environmental impact of the target company. The 'Who cares wins'[2] terminology is increasingly gaining importance. Investors and stakeholders now expect companies to report on non-financial issues, risks and opportunities with the same discipline and rigour as financial information. As per research conducted by Edelman Trust Barometer 84% of the respondents agree that maximising shareholder returns can no longer be the primary goal and that business leaders must commit to balancing the needs of shareholders with those of customers, employees, suppliers and local communities.[3]

In fact, purchasing decisions are increasingly being made keeping in mind social issues. Customers are willing to pay more for sustainable products. Consequently, companies have to focus not only on the quality and cost of their products and services, but also on establishing sustainable, socially responsible, environmentally aware business practices in order to win and retain customers.

### The Link between ESG and Financial Performance

Studies have revealed that good ESG initiatives drive up financial performance, which then provides the monetary resources to invest to be an even better-ESG firm, which then drives up performance again, and so on. A recent research conducted by Harvard Law School Forum on Corporate Governance[4] suggested that *"people may choose not to invest in a firm that has poor ESG, thereby limiting its access to capital and raising its cost of capital. Firms that get in trouble on the environment may be distracted by the regulatory headache (higher costs) and customers may avoid the firm (lowering revenue). If one does not treat employees right, this could lower morale, increase turnover, and therefore lower productivity."*

Further, the MSCI report on emerging markets ESG leaders' performance[5], is suggestive of the fact that their decline in value was lower during the pandemic as compared to the others. In fact their recovery was also comparatively faster.

The Economic Times in an article dated July 5, 2021[6] reported that *"According to a study, following ESG Practises in an organisation resulted in better operational performance in 88% of companies, and better stock performance in 80% of the companies. It lowered the cost of capital for 90% of companies. Companies with high suitability scores showed better operational performance, less investment risk and higher resilience."*

## II. How ESG proposition leads to value creation?

Tap new markets and expand into existing ones: More sustainable products attract more B2B and B2C customers. Strong community and government relations helps companies achieve better access to resources.

Cost Reductions: ESG can also reduce costs substantially, through lower energy consumption and reduced water intake. Among other advantages, executing ESG effectively can help combat rising operating expenses (such as raw-material costs and the true cost of water or carbon).

Reduced Regulatory and legal interventions: A stronger external-value proposition can enable companies to achieve greater strategic freedom, easing regulatory pressure. In fact ESG focussed companies also earn subsidies and government support.

Uplift Employee Productivity: A strong ESG proposition can help companies attract and retain quality employees, enhance employee motivation by inculcating a sense of purpose, and increase productivity overall. Enhanced social credibility attracts best talent.

Thinking and acting on ESG has become more pressing in the recent times. Magnitude of investment flow and data from across the globe suggests that ESG is more than a feel-good exercise. The Global Sustainable Investment Alliance (GSIA) that brings together regional data from across United States of America (USA), Canada, Japan, Australia and Europe, has reported that together, sustainable investment in these markets has reached USD 35.3 trillion in assets under management (AUM), having grown 15% in two years.[7]

ESG has become an inextricable part of businesses today and notably, all its elements are entwined. While the 'climate first approach or the 'E' in ESG is of growing importance considering the global climate crisis, social issues from diversity and inclusion to wage equality have also become important for all stakeholders - governments, regulators, investors, customers and employees. Similarly, governance is also of key importance and promotes ethical and effective action across an organisation which in turn yields better profits and higher returns.

## III. Using the ESG Advantage

To reap the benefits from ESG, a corporate structure must communicate with the sceptical observers and convince them of their contribution to ESG goals. ESG reporting must have both qualitative disclosures and quantitative metrics to measure a company's performance against ESG risks, opportunities and related strategies. ESG reporting is an ideal and effective means of enabling companies to answer in a single document a wide variety of questions that stakeholders may raise.

However, ESG reporting may be challenging and must fulfil the requirements of the reporting methodology. An ESG report must have the right and balanced information to meet stakeholder's information criteria. It is vital to know HOW to communicate relevant information that is comparable and standardised and WHAT ESG indicators and information to report.

## GLOBAL ESG FRAMEWORKS[8]

### Global Reporting Index (GRI)

GRI is an independent international organisation whose framework is widely used by businesses and stakeholders to understand and communicate their impact on sustainability issues such as climate change, human rights, governance, and social well-being. The standards provide for qualitative and quantitative information disclosures under universal and specific standards. The universal standards seek information on general management parameters, and specific standards enable reporting as per relevance to business operations

## The Sustainability Accounting Standards Board (SASB)

SASB is an independent non-profit organisation which provides 77 industry-specific standards. It assists public corporations in disclosing material, decision-useful information to investors. They are designed for voluntary use in disclosures required by existing US regulations in filings with the Securities and Exchange Commission (SEC).

## Task Force on Climate-related Financial Disclosures (TCFD)

In 2017, the TCFD released climate-related financial disclosure recommendations,structured around four thematic areas that represent core elements of how organizations operate: governance, strategy, risk management, and metrics and targets.

## International Integrated Reporting Framework

The International Integrated Reporting Council (IIRC), established in the UK in 2010, has developed the framework which is a principle-based guidance for preparing an Integrated Report (IR). It is different from the other sustainability reports in terms of structure and expectations. The IR does not prescribe standardised indicators, and companies are to develop their own standards. An IR provides insight on the resources and relationships used and affected by an organisation, which are referred to as “the capitals”.

## CDP (Formerly Carbon Disclosure Project)

Based in the UK, CDP represents a network of investors and purchasers that runs a disclosure system enabling companies, cities, states, and regions to measure and manage their climate change impacts . It collects data on water, climate, and forests, analyses it, ranks the same, and publishes the data online. It is an online dashboard where stakeholders may report and view impacts of entities.

## ISO 26000

The International Organization for Standardization launched ISO 26000 Guidance on social responsibility in November 2010. It offers voluntary guidance, and not certification or standards, on social responsibility. It is based on seven principles and provides 37 issues that companies may choose to report on as per materiality.

## IV. ESG Reporting – The India Story

**2009** – National Voluntary Guidelines (NVGs) on Corporate Social Responsibility issued

**2012** – SEBI mandated top 100 listed compnaies by market capitalization to file Business Responsibility Report (BRR) based on NVGs along with their annual report

**2014** – Corporate Social Responsibility Rules come into force**

**2015** – The requirement of filing BRR was extended to top 500 listed companies by market capitalisation^

**2017** – SEBI advised the use of Integrated Reporting (IR) from FY 2017-18, on voluntary basis by top 500 companies required to file BRR^^

**2019** – National Guidelines on Responsible Business Conduct (NGRBC) released&

**2019** – Requirement to file BRR extended to top 1000 listed companies by market capitalization from FY 2019-20&& market capitalization from FY 2019-20&&

**2021** – Business Responsibility and Sustainability Report (BRSR) introduced in May 2021$


## V. Business Responsibility and Sustainability Report

By way of notification dated May 10, 2021, SEBI re-characterized BRR into BRSR, which seeks disclosures from listed entities on their performance **against the nine principles of the NGBRC**. Reporting under each principle is divided into essential and leadership indicators.

The BRSR is intended towards having quantitative and standardized disclosures on ESG parameters to enable comparability across companies, sectors and time. Such disclosures will be helpful for **investors to make better investment decisions.** The BRSR shall also enable companies to engage more meaningfully with their stakeholders, by encouraging them to **look beyond financials and towards social and environmental impacts.**

With effect from the **financial year 2022-2023,** filing of BRSR shall be **mandatory for the top 1000 listed companies (by market capitalization)** and shall replace the existing BRR. Filing of BRSR is voluntary for the financial year 2021-22. Listed entities already preparing and disclosing sustainability reports based on internationally accepted reporting frameworks (such as GRI, SASB, TCFD or Integrated Reporting) may **cross-reference** the disclosures made under such framework to the disclosures sought under the BRSR.

The growing trend of sustainability reporting trend has resulted in the standardisation of frameworks into a globally accepted frameworks. BRSR incorporates several performance indicators of the international frameworks in an attempt to bring it on par with global ESG reporting trends.

## VI. WHAT THE BOARD OF DIRECTORS SHOULD CONSIDER

1. Have compelling sustainability targets been set that appeal the marketplace?

2. What accountabilities has the company set for ESG-related performance?

3. How the company's message compares to the peers? How ESG initiatives make a difference?

4. Is the ESG Report satisfying the information needs of the investors and other stakeholders?

5. Can ESG reporting be integrated with Financial Reporting?

6. How is the Board managing ESG risks?

7. What Reporting standards are being used and why? Are ESG efforts being overstated or understated?

8. How does the Board ensure that ESG disclosures are reliable? Are internal controls in place?

9. Does the Board have an audit plan to ensure fair presentation of underlying data? Is audit independence ensured?

BRSR is more a comprehensive disclosure framework than BRR. As compliance is mandatory from FY 2022–23, it is imperative for companies to prepare themselves for the change.

**Explore**

Identify information to be pursued

**Improve**

Continuously improve data compilation method for correct reporting

**Declare**

Declare  complete qualitative and quantitative information, while maintaining data trail

## Sources


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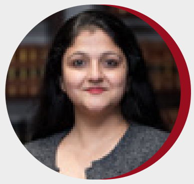

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