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MODULE 1 | DEC 25/JUNE 26

ESG

summary notes

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CHAPTER 19

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Ch 19 - Sustainability Audit; ESG Rating; Emerging Mandates from Government and Regulators

1] Sustainability :-
sustainability & sustainable development means practices adopted while using the resources that meets the needs of the present without compromising the ability of the future generations to meet their needs.

2] Thus, sustainable development focuses on three things:
(a) People (social concerns)
(b) Planet (environmental concerns)
(c) Profit (economic concerns)

3] Corporate sustainability means conducting business in a way that creates value for the present shareholders, while protecting the rights of the future stakeholders.

4] This above sustainability practices has resulted into businesses moving towards sustainability reporting.

5] Further, a new concept of sustainability audit evolved.

6] Sustainability audit is a comprehensive assesment of an organization's social, economic & environmental impacts., purpose of the same is to identify areas where the org. can improve. its sustainability performance & to minimize the negative impact on the environment, society & economy.

7] A sustainability audit is a look inside the co. & is targeted to evaluate the company's current sustainable practices allowing the co. to set out goals for improved sustainability performance.

8] In other words, sustainability audit identifies the strength & weaknesses which allows companies to develop a sustainability strategy & set goals.

Lastly,
9] The function of sustainability audit is to evaluate the performance of the company against these pre-set goals.

10] Evolution of sustainability audit

- As the society has evolved & has started following the modern approach by not just focusing on economic performance but also considering other sustainability parameters, it has led to more & more corporates adapting to sustainability audit.

- Initially, it focused only on environmental issues but over the time it has also included social & economic factors.

- Also, with technological advancements & new tools available audit has become comparatively easier & more rational data is available.

- Now companies are no longer evaluated on just their economic performance but are now seen on their ESG parameters as well, which has made sustainability audit all the more important.

11] Framework of sustainability audit

- A sustainability audit typically follows a structured framework which includes the following steps:-

(a) Planning & preparation - This is the first step which involves defining scope & object of the audit & preparing a plan for conducting the audit.

(b) Data collection & analysis - This involves gathering data of the organization's environmental, social, economic impacts & as well as analysing the policies & practices adopted by the organization towards sustainability.

(c) Assesment & Evaluation - In this step the collected data is analyzed & evaluated, so this step typically benchmarks the performance of the organization against the industry stds and best practices.

(d) Report generation - At this step the auditor summarizes the findings of audit & provides reccommendations.

(e) Implementation & monitoring - This step involves making action plan & implementing the same & monitoring the progress to ensure that the goals are met.

(f) Reporting & communication - Lastly, it includes communicating the results to stakeholders about material findings of sustainability audit.

2] Process of conducting sustainability audit

(1) While conducting sustainability audit it typically begins with assesing culture of co., for instance how open the employees are with regards to discussing their social responsibility practices, and if they have received any training for the same.

(2) After that the auditor checks the sustainability strategy which is generally in the form of a formal document which sets out the aims & objectives, apart from these they may also consider any other docs like their contracts with the suppliers.

(3) After review is conducted the auditor now checks as to how well the organization has performed its sustainability activities & also to check whether there has been any negative effects of their initiatives.

(4) The team also further evaluates co's policies and check as to whether it aligns with the company's sustainobility initiatives.

(5) Once the review is complete the audit team provides a detailed review about their findings as well as recommendations to improve the sustainability practices to the board of director. This results into sustainability audit scorecard.

(6) Sustainability audit can be done in following manner:-
(a) Planning & preparation
(b) Data collection & analysis
(c) Assesment & evaluation
(d) Report generation
(e) Implementation & monitoring
(f) Reporting & communication

13] Key elements / content / understanding sustainability audit report

- A sustainability audit includes the following key elements :
(a) It carries the scope of the report alongwith the objective behind the audit.

(b) Background - This section carries the info about the organisation, its sustainability goals which have been previously set, so basically this section provides the context of the audit.

(c) Methodology - Under this section the method adopted by the auditor to collect the data & tools & techniques used to analyse the data is disclosed.

(d) Key findings - Under this section the auditor presents the main findings including the detailed analysis of the organization's sustainability performance.

(e) Recommendations - This section provides the specific recommendations as to how the organization can improve its sustainability performance.

(f) Forming & implementing plan - This section outlines the plan containing the recommendations above & setting specific goals.

(g) Conclusion - In the end a summary is presented which contains the measure findings, recommendations & the action plan.

* Advantages of sustainability audit / importance:
1] Identifying areas for improvement
2] Measuring sustainability performance
3] Demonstrating commitment to sustainability
4] Enhancing reputation & Brand image
5] Fostering innovation & competitiveness
6] Valuable tool to understand sustainability performance.

PART B - ESG Rating

- It is a rating framework wherein an org assess the ESG performance of any org against the ESG issues

- Recently, the investors apart from assesing org's financial health have also started checking the ESG ratings of the org's in which they invest

- It is believed that organisations having lower ESG risk may create more value than those having high ESG risk score.

- The criteria revolves around the following:

(a) Environment

↳ while doing ESG rating environmental factors are considered which means how the org protects the natural resources.
Few ex could be - air & water quality / Biodiversity / Deforestation.

(b) Social

↳ Social factors address how an org treats people & community.
Few ex could be - customer satisfaction / Data protection.

(c) Governance

↳ Governance examines how corporation policies itself focusing on internal system controls & practices to maintain compliance.
Few ex could be - Co. leadership / Board composition incl. diversity / corruption & Bribery

*Meaning:-

- An ESG score is a measurement of co's performance against the ESG issues.

- It is not necessary that every rating platform follows same evaluation criteria, however, all the criterias fall within the ambit of ESG.

- These scoring systems either are industry specific i.e. material to only a particular industry or are industry agnostic which are relevent for all industries.

- These ESG rating platforms finds the material issues which then becomes the criteria & further assign weights to these criterias, then further, it assesses the organization's performance against these criterias

- The sum total of the product of the above becomes the ESG score based on which an ESG rating is assigned.

- These ESG ratings shows the co's performance against the ESG issues & risk wherein a better ESG rating means the co. is managing its ESG risk relatively better against its peers & a lesser ESG rating shows the opposite.

ESG KPI

- ESG KPI are trackable figures to understand the ESG impact of an org & is integral to understand the impact of the companies, which alerts the investors about the impact of their investment.

- For the top 1000 listed entities BRSR has been made mandatory to report upon their ESG performance.

- Recently, assurance is required ~~by~~ from the corporations & it further could be of 2 types i.e. - limited assurance
  - reasonable assurance

- Limited assurance has lesser confidence of people as against reasonable assurance & for that reason SEBI introduced BRSR core for 3rd party assurance on selected KPIs under ESG areas.

- The BRSR core shall be mandatory for the top 250 cos from year 2025 & is currently applicable on comply/explain basis & where assurance is not mandatory.

ESG Rating Organisations & methodology used

- ESG rating agencies are organisations that examine an organisation's ESG performance to issue an ESG score and rating.

- This rating helps an investor in deciding where to invest & with whom to do business.

- In the current times investors have been proactive in watching the ESG performance of corporates which in turn promotes the companies to perform well in the ESG sphere & this has led to the promotion of ESG rating.

- Some of the widely known ESG rating org:

1] DUN & BRADSTREET

- It is an international rating agency & is one of the largest rating agency which provides ESG scores & ratings at the company level & also sector level analysis.

- It focuses on tracking & analysing the ESG performance of all the targeted cos & provide an easy to understand rankings as well as comparisons so a person can make an informed decision.

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2] MSCI (Morgan Stanley Capital International)
↳ same intro as above.
- The MSCI ESG rating model answers four key questions about any company:
(a) What is the most significant ESG risk & opportunity for the company?

(b) How exposed is the company to these risks & opportunities?

(c) How well the co. is managing these risks?

(d) The overall assessment of how ~~co~~ well co. is managing its ESG risk & comparison with its global peers?

- Based on the above an overall ESG score is assigned (0-10) & an ESG rating is assigned (AAA - CCC).

- The criteria covered by MSCI is under following 3 pillars:-
(a) Environment
↳ Environmental opportunities
↳ Pollution & waste
↳ Climate change.

(b) Social
↳ Human capital
↳ Social opportunities.

(c) Governance
↳ Corporate gov.
↳ Corporate behaviour.

Bloomberg
(a) Env:- Waste disposal.
- renewable
(b) social:
Discrimination
diversity
(c) Governance
Shareholder's rights
IDs.

Understanding MSCI rating:-
(Illustration)

- The MSCI while considering E/S/G focuses on two aspects:
  (a) The risk associated with it
  (b) Opportunities

- Environmental Issues:-

In environmental issues they consider Climate change / pollution & waste generation

In climate change issues they consider:-
(a) carbon emissions
(b) GHG emission
(c) Product carbon footprint

In pollution & waste generation:-
(a) Amount of toxic emissions & waste generated
(b) Electronic waste generated.

Apart from the risk they also consider env. opportunities:
(a) Clean Technology
(b) Green Buildings
(c) Renewable energy.

- Social Issues:-

Human Capital issues:
(a) How well the labour is managed?
(b) Workers training
(c) Health & safety protocols.

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Product Liability issues:
(a) Product safety & quality
(b) Privacy & data security

Social opportunities are:
(a) Better access to finance
(b) Access to healthcare

Governance Issues:-
(a) Corporate governance issues which includes:
- Board diversity & independence
- Accounting practices

(b) corporate behaviour:
- corporate culture
- Ethical performance.

How these scores are given?
- The ESG rating agency identifies all the key issues of which some are industry specific & some are universal.

- For instance, packaging material & waste generation may be a key issue for soft drink industry but might not be relevent for technology industry.

- MSCI after analysing all these issues & the performance of the co. issues an ESG score (a lower score signifies that the co. is not managing the risk effectively & a higher score indicates aggressive efforts of the co. to mitigate the risk.

- These scores are then converted into ratings which move between AAA (leaders) to BBB (Average) to CCC (laggard)

- A good case study of ESG rating is of amazon wherein the co. maybe performing remarkably in the fin. sphere but has been rated average in their ESG sphere because of their laggard score in labour management & average score in product carbon footprint.

- The above allows an investor to consider more factors before making an inv decision.

* Advantages of ESG rating

- While there are several advantages of ESG rating few of them are as follows:

(a) Competitive advantage -
• Having an ESG programme shows the consumers about the corporation's commitment towards sustainability which inturn promotes Brand loyalty.

• Better brand loyalty attracts more consumers which allows more business profits thereby giving competitive advantage to the corporate against other business.

(b) Cost Reduction :-

• By doing what is more relevent to sustainability businesses improve upon their key metrix like energy consumption, water consumption, waste generation & raw material usage.

• By improving on the above parameters a business can drastically reduce the cost associated with this making it more efficient.

(c) More attractive to investors & lenders -

• The better a co. performs in the ESG sphere the more attractive it becomes in-front of investors as the recent studies shows that more the co. is ESG compliant the more value it creates.

• The above has led more investors & lenders started considering ESG rating.

(d) Attraction & Retention of talent -

• Although pay is ~~so~~ one of the most imp factor but the new generation wants to enjoy their job & make a positive impact.

• So, these ppl prefer cos with strong ESG goals.

• Another problem that employers face is 'great resignation' which shows that employees who have other option shift. Research has shown that satisfied employees work harder & stay longer

& produce better results.

(e) Supply chain prospects -

• Now, investors have started giving attention in company's supply chain partners as well.

• Beause of the above reason cos have started considering shifting from the suppliers who have poor ESG performance to those having better, so, the ESG rating is improving the supply chain as well.

• Because of all the above benefits it promotes the cos. overall growth & improves the fin. performance.

Part C : Emerging Mandates:

1] ESG Reporting in India

- The first time India started reporting upon ESG matters was from the year 2009 where the MCA issued the voluntary guidelines on CSR.

- Since then the reporting framework has been strengthened day by day, for instance, CSR reporting, BRR, NGRBC mandated sustainability reporting.

- The Companies Act, 2013 madates companies to include a report in their annual financial statements about the conservation of energy.

- Apart from the above it is the duty of the directors to include a disclosure on opportunities, threats and risks in their annual report under SEBI (LODR) Regulations, 2015.

[Such disclosure does not require the matrix adopted by the company to identify the same]

- Since, reporting on co's performance on sustainability has become a very important reporting, SEBI further introduced 'Disclosure requirement for issuance & listing of green debt securities' which allowed issuance of green debt securities & enhance investor confidence.

- Further, additional disclosures in the offer document were mandated as well as after disclosures were also mandated for projects financed by green debt.

- These disclosures have been prescribed to attract finances for ESG compliant projects.

- Lastly, BRSR was made mandatory which seeks compulsory disclosure from all the listed entities to report their performance against the 9 principles of NGRBC.

- In BRSR there are 2 indicators -
- Essential indicators (these are mandatory)
- leadership indicators (voluntary)

- Further, BRSR core has been made mandator to enhance the ESG disclosures & provide reasonable assurance.
[It is being applied in phases upon top 1000 listed entities, wherein currently Top 500 are required to report upon it].

Note For above functions to happen smoothly the following has to be done:
(a) Appoint cheif sustainability executive:-
- Above transition will require businesses to ma teams which clearly allocate sustainability roles
- Since, many employees would be slow to adop new policies as well as unaware as to how to deal with the transition, a CSO would have to make efforts for a smoother change which changes destructive mindset to reduce/recycle process.

(b) Create an ESG policy budget:-
- Since, ESG regs will require the orgs to appoin teams & hire people, the first prob to faced co. would be lack of budget, hence co. shou make an ESG budget.
- It would be CFO's duty to do the same as well as provide justification for spending of money.