Preparedness of Indian Public Equities for Business Sustainability (Environmental, Social and Governance) Disclosure and Reporting

Issue briefing in context of SEBI mandating Business Responsibility reporting

cKinetics
Accelerating Sustainability

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Snapshot

Through its board resolution passed on November 24th, 2011, the Securities and Exchange Board of India (SEBI), has mandated listed companies to report on Environmental, Social and Governance (ESG) initiatives undertaken by them through a Business Responsibility (BR) report which would form part of a company's annual reports/filings. As per SEBI's directive the business responsibility reports should describe measures taken by companies covering the key principles of the 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business' framed by the Ministry of Corporate Affairs (MCA). This SEBI directive will be immediately applicable to the top 100 companies (by market capitalization) and remaining companies will come under its ambit in a phased manner.

This briefing presents an insight into the current policy framework in India related to Business Responsibility reporting, especially the National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business and elucidates the need and drivers for business sustainability reporting.

The brief also describes the state of Business Responsibility reporting of large Indian public equities based on findings of a study on the disclosure levels of Sensex companies with respect to National Voluntary Guidelines on Responsible Business.

Finally the brief discusses the way forward for Business Responsibility reporting by the companies and the opportunities and challenges associated with it. With the new regulation, adoption of Business Responsibility reporting will see a sharp uptake which in turn might also sensitize the remaining companies about the benefits of enhanced disclosure of non-financial performance, such as that related to environmental, social and governance metrics.

National Voluntary Guidelines for the Social, Environmental and Economic Responsibilities of Business (NVG-SEE)

The National Voluntary Guidelines for Social, Environmental and Economic Responsibilities of Business were released by the Ministry of Corporate Affairs[1], Government of India, in July 2011. They outline principles for responsible business action and provide guidance for the implementation of the same.

These guidelines have been formulated to encourage adoption of sustainability reporting and mainstream disclosure on environmental, social and governance metrics in India. NVG-SEE provides businesses a framework which enables them to move towards responsible decision making and urges them to adopt the "triple bottom-line" approach.

SEBI has, in the recent years, laid increasing significance on disclosure of non-financial measures and has lent support to ESG disclosure and standard setting initiatives. As per SEBI's requirement under clause 49 of the listing agreement all public equities are required to comply with certain disclosure norms related to corporate governance. SEBI's decision to get the largest businesses to adopt the NVG-SEE is a reaffirmation to continue to raise the bar for disclosure and drive transparency in the marketplace.

The national voluntary guidelines consist of 9 core principles, namely:
Principle 1: Businesses should conduct and govern themselves with Ethics, Transparency and Accountability

Principle 2: Businesses should provide goods and services that are safe and contribute to sustainability throughout their life cycle

Principle 3: Businesses should promote the well-being of all employees

Principle 4: Businesses should respect the interests of, and be responsive towards all stakeholders, especially those who are disadvantaged, vulnerable and marginalized

Principle 5: Businesses should respect and promote human rights
Principle 6: Business should respect, protect, and make efforts to restore the environment

Principle 7: Businesses, when engaged in influencing public and regulatory policy, should do so in a responsible manner

Principle 8: Businesses should support inclusive growth and equitable development

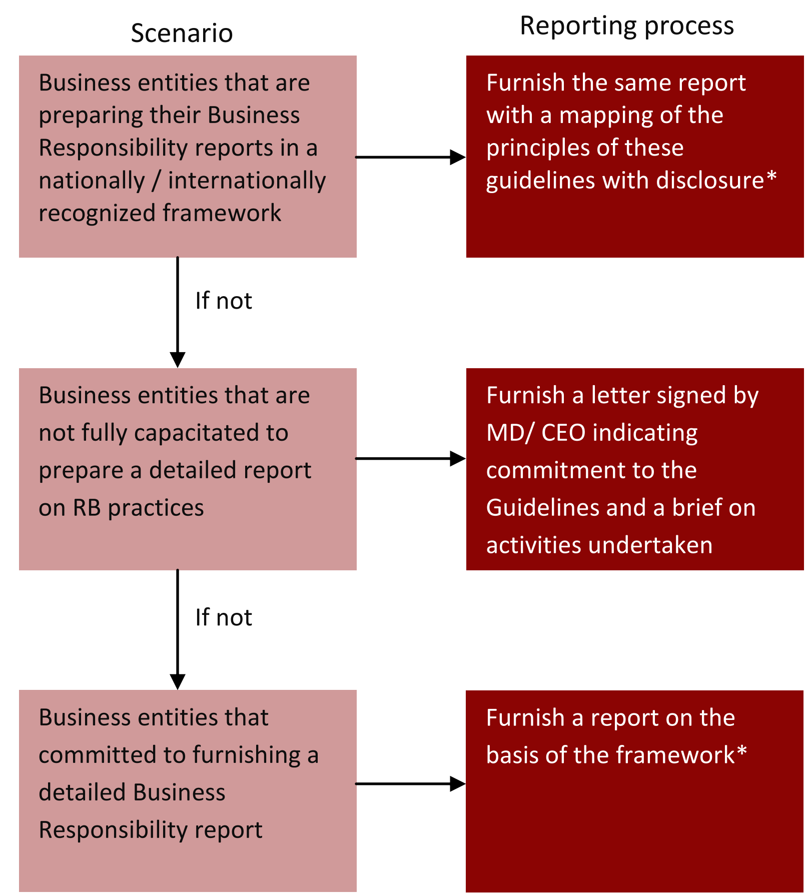
Principle 9: Businesses should engage with and provide value to their customers and consumers in a responsible manner

[1] National Voluntary Guidelines on Social, Environmental & Economic Responsibilities of Business 2011, http://www.mca.gov.in/Ministry/latestnews/National_Voluntary_Guidelines_2011_12jul2011.pdf

Reporting process under NVG-SEE

NVG-SEE is flexible in its reporting approach. If companies are already following an accepted sustainability reporting framework then they may continue to do so *(see flow chart in the right column).* Such companies are not required to publish a separate report, but can map the 9 core principles of NVG to the disclosures made in their existing sustainability/business responsibility reports. Companies who have decided to adopt the NVG but don't have the necessary capacity to furnish a full-fledged report can provide a statement of commitment to adoption of NVG to their stakeholders and furnish primary details on activities undertaken in relation to these guidelines. Companies who would like to adopt NVG to the full extent can furnish reports detailing their performance on environmental, social and governance factors based on the suggested framework (which is outlined in the Appendix to this brief).

Which reporting process and framework to follow?



* The SEBI directive mandating the largest companies to follow a reporting framework will fall into these options

Need and drivers for Business Responsibility reporting

All stakeholders including investors, government and consumers are putting pressure on companies and demanding a performance report of companies' activities to ensure they are not detrimental to environment, society or employees. Business valuations are likely to differ if they reflected all the environmental, social and governance (ESG) risks along with economic performance. Business Responsibility reporting seeks to fill this gap between corporate financial performance and a company's true performance which takes into account non-financial metrics as well. It enables measurement, tracking and reporting of a company's performance on non-financial metrics such as environmental, social and governance (ESG) parameters.

The need for Business Responsibility reporting is not only for external shareholders but also for management and the board to better understand the true drivers shaping long term stakeholder value and to gain more insight into their company's strengths and weaknesses. It helps the company identify its operational shortcomings and inefficiencies so that appropriate steps to improve its internal systems and processes can be taken up. Peter Drucker's axiom, "what gets measured, gets managed" aptly summarizes this point. Sustainability reporting is needed to instill confidence in a company's stakeholders about its long term sustenance and ensure a continued social license to operate.

Drivers for adoption of Business Responsibility reporting comprise of both pull and push factors. Stakeholder groups such as investors, customers, etc. are increasingly demanding greater level of disclosure and encouraging companies to adopt non-financial reporting. On the other hand, regulations and compliance standards such as those by stock exchanges, government regulatory bodies etc are other drivers for adoption of sustainability reporting.

International drivers for Indian businesses

- **Global presence**: Indian companies which aspire to expand their footprint into new markets and compete globally have to address the risks and competition in the international arena. For flagship sectors such as the Information Technology, already many global customers are seeking the Business Responsibility or Sustainability Reports as a qualifier to do business.

- **Attract capital:** Another major international driver for domestic businesses to adopt Business Responsibility reporting is to attract the interest of foreign investors who are looking to invest in Indian companies which fare well on non-financial metrics as well. Also, a desire to list on a leading international stock exchange can greatly influence a company's disclosure levels on sustainability.

Moreover, with the dialogue on climate change getting focused on emerging economies such as India and China, domestic companies will come under increasing pressure to report on non-financial parameters especially related to environmental impact. [2]

[2] International Finance Corporation and World Resources Institute, "Undisclosed Risk: Corporate Environmental and Social Reporting in Emerging Asia", April 2009, http://pdf.wri.org/undisclosed_risk_emerging_asia.pdf

Domestic drivers

Other drivers which will significantly enhance the adoption of Business Responsibility reporting include[3,2]:

- **Regulatory framework** - regulation either from a government body or from stock exchanges mandating disclosure of non-financial metrics is one of the biggest drivers for Business Responsibility reporting such as the recent SEBI regulation.

- **Competitive advantage** – By driving reporting, a company can use it to integrate sustainability into its core operating strategy which in turn can help build a competitive advantage through resource conservation, employee retention, better risk management, etc.

- **Reputation -** Extensive media coverage and increased NGO activism has awakened businesses to the need of incorporating sustainability practices and systems. A positive brand image with regards to sustainability can help companies attract premiums for their products and services and foster brand loyalty.

Value addition of ESG programs for corporate performance

%age of respondents

Respondents included CFOs, investment professionals, institutional investors, and corporate social responsibility professionals

Source: 'Valuing corporate social responsibility,' The McKinsey Quarterly, February 2009.

[3] WBCSD and UNEP FI, "Translating environmental, social and governance factors into sustainable business value", http://www.unepfi.org/fileadmin/documents/translatingESG.pdf

Status on Business Responsibility reporting of Indian public equities

Business Responsibility reporting is still in its infancy in India. Traditionally, the disclosure levels of Indian companies have been poor compared to their western counterparts. One reason for slow pace of adoption of responsibility reporting has also been the lack of demand from Indian investors regarding disclosure of non-financial performance. Many Indian investors have been primarily focused on financial returns and have not laid so much emphasis on non-financial risk factors such as environmental, social and governance performance. However, the awareness regarding ESG issues has increased over the last few years and so has investor interest in increased disclosure.

Current disclosure levels of BSE Sensex

Recently (in July 2011) cKinetics conducted a strategic assessment of the current disclosure levels of India's leading companies across multiple sectors to gauge the current level of preparedness of India Inc on Business Responsibility reporting.

As part of the work, the companies comprising the Bombay Stock Exchange Sensex (BSE 30) were reviewed for their current disclosure levels viz. the reporting framework suggested by the NVG-SEE. These 30 companies account for INR 28,218 billion market capitalization(as on July 22, 2011) representing almost 42% of the total market capitalization of companies listed on the Bombay Stock Exchange.

The study calculated the disclosure score for all the 30 companies which constitute the BSE Sensex. The NVG-SEE was used as the framework to map the disclosure levels of Indian companies. The NVG-SEE framework has 36 parameters reflecting nine key principles related to responsible business practices.

Disclosure Score =

$$\frac{\text{No. of parameters on which company discloses information}}{\text{Total no. of parameters}}$$

The data was collated from publically available information through company annual reports, sustainability reports and company websites.

(It should be noted that the study has adopted the NVG-SEE framework ***as- is*** *and has not considered materiality of parameters with respect to different sectors. This implies that some parameters may not be relevant for all sector and disclosure score of companies in certain sectors may not be accurately reflected.)*

The disclosure score varied across a wide range for these 30 companies, from 19% to as high as 78%. (It should be noted that till the most recent annual disclosure, companies were not required to provide this data and that the responsible business guidelines were announced only in July 2011)

Disclosure score follows a sectoral trend

Industry	No. of companies	Range of disclosure score
Banking and finance	4	19%-28%
Automobile	5	31%-78%
Construction & Engineering	2	33%
Metals	4	39%-50%
Electric Utilities	3	39%-61%
Oil & Gas	2	67%-72%
Heavy Electrical Equipment	1	39%
IT Consulting & Software	3	61%-78%
FMCG	2	72%-75%
Telecom services	2	22%-25%
Realty	1	36%
Pharmaceuticals	1	31%

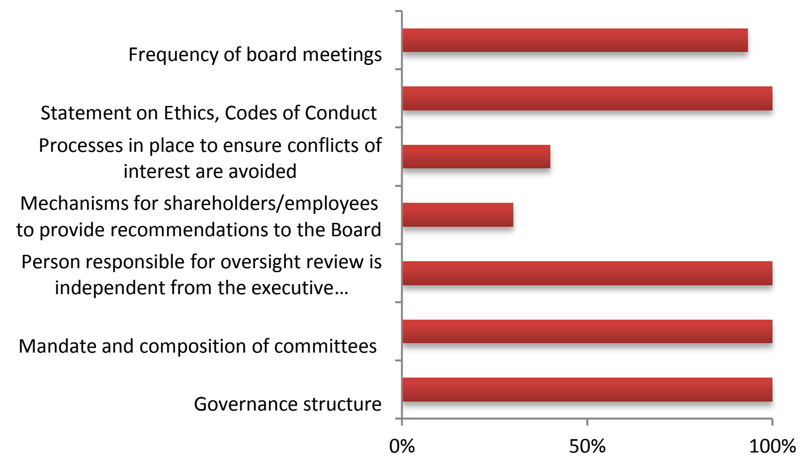
Source: cKinetics analysis

It has been observed that companies in Banking and Telecom Services industry have the lowest disclosure score and those in the FMCG industry (personal products, cigarettes and tobacco products) have the highest disclosure score. The IT Consulting & Software companies also have a reasonably high score. In the Automobile Industry, there is a clear distinction between disclosure scores of 2/3 wheeler companies and those of car and commercial vehicle companies with latter having a much higher score.

Governance

The study found that typically these companies have a high disclosure level regarding governance issues. Almost all the 30 companies disclosed information about the governance structure, constitution of the board of directors, responsibilities of the board members as well as the sub-committees, internally developed code of conduct and ethics etc. However, while the frequency of the boards meetings seem to be of a high order, it is not clear as to the extent the board reviews sustainability performance and / or sets guidelines for formulating sustainability strategies. Furthermore, no information exists on mechanisms available to shareholders and employees to provide recommendations to the board/ Chief Executive.

Disclosure on governance parameters



Source: cKinetics analysis

Employee welfare and stakeholder engagement

With regards to parameters related to employee well-being, the study determined that the disclosure levels are not very high. . Though almost all companies report their total employee strength, hardly any mention is made of the split between permanent and contractual employees. Additionally, only 8 companies were found to report the break- up of employees by gender and only 4 disclose the number of persons with disability, who form a part of their workforce. More than 50% of the companies have provided details of training programs carried out during the year but a standard metric is not used for disclosing such information. A little over 50% of the companies studied make explicit mention of observance of human rights in their operations. There is very poor disclosure w.r.t. wages and salaries of skilled and unskilled employees..

Stakeholder engagement is a mixed bag with half of the companies providing insight into their stakeholders and the nature of engagement with them. However, there is almost no disclosure about issues on which formal dialogue has taken place between the company and its stakeholders.

Community engagement and customer value

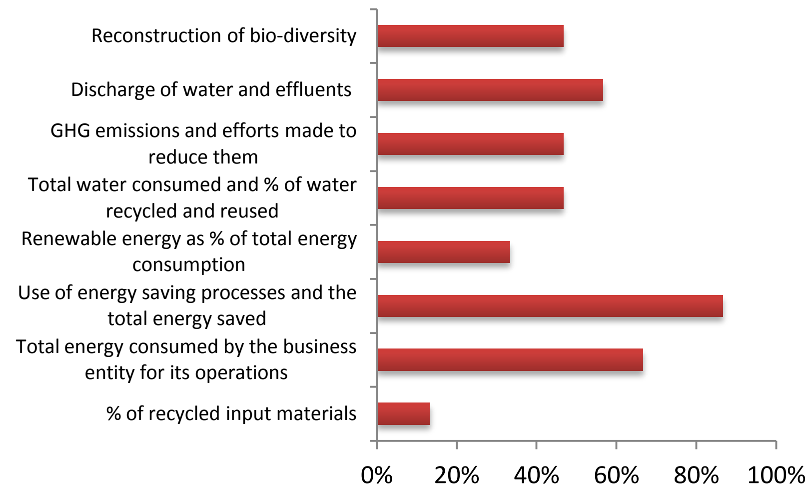
All 30 companies in the Sensex do believe in inclusive growth and make adequate disclosures about community investment and development work undertaken by them on account of fulfilling their corporate social responsibility. Amongst the various principles elucidated in the NVG-SEE, inclusive growth is the only one for which there is 100% disclosure amongst the BSE-30 companies.

On the other hand, there is almost negligible disclosure on product labeling effort including information regarding customer health and safety, method of use and disposal etc. Although one needs to keep in mind that this parameter may not be material for all the companies.

Environment

Till the current SEBI directive, India has not had a mandatory environmental reporting for listed companies though the Companies Act (1956) requires companies to disclose details regarding energy conservation measures undertaken by them in their annual reports. 26 out of 30 companies surveyed have listed energy conservation measures adopted by them and the remaining 4 have explicitly stated in their annual reports that this parameter is not material to their business. Though many companies report their total energy consumption, very few disclose the percentage of renewable energy used, if any. As is evident from the chart below, very few companies disclose the percentage of recycled materials used as input raw materials. Just about 50% of the sample companies typically provide details of efforts undertaken on reconstruction of bio-diversity and mitigation of adverse impacts of GHG emissions arising from their business operations and total water consumption.

Disclosure on environmental parameters



Source: cKinetics analysis

Other aspects covered by the NVG-SEE

Disclosure levels are generally poor with regards to the other aspects of the NVG-SEE, namely on product life-cycle impacts, and with regards to policy advocacy efforts undertaken.

The way forward for Business Responsibility reporting

As outlined earlier, disclosure regarding the environmental, social and economic responsibilities of business has multiple benefits in terms of enhanced revenue growth and market access, cost savings, increased access to capital, better risk management and improved brand value and reputation.

For ESG disclosure to become useful in the main-stream, it needs to be accepted by the multiple stakeholders involved: businesses (of course), investors, policy makers and non-government actors. A few key parameters that need to be addressed are outlined below.

- **Format standardization** - A standard set of metrics accepted by all stakeholders for presentation of sustainability performance will allow for the disclosure process to become more meaningful.
    - *Comparability* - Metrics which define ESG performance need to be comparable across companies which will help determine the relative standing of a company amongst its peers. Like performance can be compared across companies in the case of financial reporting, Business Responsibility reporting also needs to incorporate metrics which lend themselves to comparison.
    - *Complexity* – Financial reporting is much more mature and, thus comparatively easier to capture. ESG related issues are complex, which makes their quantification, assessment and integration into decision making a difficult process. However by having standardization within sectors, a lot of the complexity can be avoided.
- **Materiality** – Another area to be addressed in the measurement of non-financial performance is creating an objective process of determining which of the ESG issues are material. Materiality may vary across industries and to some extent even across companies within the same industry.

- **Reliability** - Third party assurance for Business Responsibility is needed to ensure veracity of data disclosed by the management. This will particularly be important to increase investor interest.

- **Management systems** – Unlike financial reporting for which tracking and measurement systems are in place; data collection with respect to performance on sustainability issues is challenging and requires capacity building and coordination amongst various departments of the organization. Data sources for Business Responsibility reporting are diverse, inconsistent and systems for consolidation and reporting are less automated.

Though uptake of Business Responsibility Reporting by Indian companies has been slow in the past, the new SEBI regulation is likely to provide the necessary impetus and increase adoption of the National Voluntary Guidelines of business responsibility. This would hopefully be the beginning of a trend with companies realizing the importance of integrating sustainability into their core business philosophy and enhanced disclosure of the extra financial metrics related to environmental, social and governance performance.

Appendix: Business Responsibility Report - Suggested Framework[4]

Part -A

Part A of the report includes basic information and data about the operations of the business entity so that the reading of the report becomes more contextual and comparable with other similarly placed businesses. It may be written in a free format incorporating at least the following:

A-1

- Basic details of the business – Name; nature of ownership; details of the people in top management; location of its operations - national and international; products and services offered; markets served;
- Economic and Financial Data – Sales; Net Profit; Tax Paid; Total Assets; Market Capitalization(for listed companies); number of employees;

A-2

- Management's Commitment Statement to the ESG Guidelines
- Priorities in terms of Principle and Core Elements
- Reporting Period/Cycle
- Whether the report s based on this framework or any other framework
- Any Significant Risk that the business would like its stakeholders to know
- Any Goals and Targets that were set by the top management for improving their performance during the Reporting Period

Part B

Part-B of the report incorporates the basic parameters on which the business may report their performance. Efforts have been made to keep the reporting simple keeping in view the fact that this framework is equally applicable to the small businesses as well. The report may be prepared in a free format with the basic performance indicators being included in the same. In case the business entity has chosen not to adopt or report on any of the Principles, the same may be stated along with, if possible, the reasons for not doing so.

B-1

Principle 1 – Ethics, Transparency and Accountability

- Governance structure of the business, including committees under the Board responsible for organizational oversight. In case no committee is constituted, then the details of the individual responsible for the oversight
- Mandate and composition (including number of independent members and/or non-executive members) of such committee with the number of oversight review meetings held.
- State whether the person/committee head responsible for oversight review is independent from the executive authority or not. If yes, how.
- Mechanisms for shareholders and employees to provide recommendations or direction to the Board/ Chief Executive.
- Processes in place for the Board/ Chief Executive to ensure conflicts of interest are avoided.
- Internally developed statement on Ethics, Codes of Conduct and details of the process followed to ensure that the same are followed
- Frequency with which the Board/ Chief Executive assess BR performance.

Principle 2 – Products Life Cycle Sustainability

- Statement on the use of recyclable raw materials used
- Statement on use of energy-efficient technologies, designs and manufacturing/ service-delivery processes
- Statement on copyrights issues in case of the products that involve use of traditional knowledge and geographical indicators
- Statement on use of sustainable practices used in the value chain

Principle 3 – Employees' well-being

- Total number of employees with percentage of employees that are engaged through contractors
- Statement on non-discriminatory employment policy of the business entity
- Percentage of employees who are women
- Number of persons with disabilities hired
- Amount of the least monthly wage paid to any skilled and unskilled employee

[4] Suggested framework from the NVG-SEE 2011

- Number of training and skill up-gradation programs organized during the reporting period for skilled and unskilled employees
- Number of incidents of delay in payment of wages during the reporting period
- Number of grievances submitted by the employees

Principle 4 – Stakeholder Engagement

- Statement on the process of identification of stakeholders and engaging with them
- Statement on significant issues on which formal dialogue has been undertaken with any of the stakeholder groups

Principle 5 – Human Rights

- Statement on the policy of the business entity on observance of human rights in their operation
- Statement on complaints of human rights violations filed during the reporting period

Principle 6 – Environment

- Percentage of materials used that are recycled input materials
- Total energy consumed by the business entity for its operations
- Statement on use of energy saving processes and the total energy saved due to use of such processes
- Use of renewable energy as percentage of total energy consumption
- Total water consumed and the percentage of water that is recycled and reused
- Statement on quantum of emissions of greenhouse gases and efforts made to reduce the same
- Statement on discharge of water and effluents indicating the treatment done before discharge and the destination of disposal
- Details of efforts made for reconstruction of bio-diversity

Principle 7 – Policy Advocacy

- Statement on significant policy advocacy efforts undertaken with details of the platforms used

Principle 8 – Inclusive Growth

- Details of community investment and development work undertaken indicating the financial resources deployed and the impact of this work with a longer term perspective
- Details of innovative practices, products and services that particularly enhance access and allocation of resources to the poor and the marginalized groups of the society

Principle 9 – Customer Value

- Statement on whether the labeling of their products has adequate information regarding product-related customer health and safety, method of use and disposal, product and process standards observed,
- Details of the customer complaints on safety, labeling and safe disposal of the products received during the reporting period

Part C

Part C of the report incorporates two important aspects on BR reporting. Part C-1 is a disclosure on by the business entity on any negative consequences of its operations on the social, environmental and economic fronts. The objective is to encourage the business to report on this aspect in a transparent manner so that it can channelize its efforts to mitigate the same. Part C-2 is aimed at encouraging the business to continuously improve its performance in the area of BR.

C-1

- Brief Report on any material/significant negative consequences of the operations of the business entity

C-2

- Brief on Goals and Targets in the area of social, environmental and economic responsibilities that the business entity has set for itself for the next Reporting Period.

About cKinetics

cKinetics is an operational consulting and strategic services firm exclusively focused on shaping scalable sustainability solutions with businesses and investors.

With operations in India and in the United States, the firm has 3 focus areas: (a) resource efficiency on the fronts of carbon, energy, water and waste; (b) renewable energy and (c) smart infrastructure.

Offerings

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