

A Cat and Mouse Game for Investors

Assessing ESG Disclosure of Supply Chain Listings in Hong Kong

August, 2006



Executive Summary

Introduction

Gaps in ESG Disclosure - A Barrier to Informed Assessment

One Dimensional Disclosures Leave Investors Guessing

Disclosures Defined in Legalistic Terms Provide Little on ESG Themes

Disclosures Suggest Poor Intermediary Understanding of ESG Issues

Simple Metrics Provide Insights into ESG Risks

Red Flags to Watch and Questions to Ask

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Project sponsored by the Sigrid Rausing Trust

ASrIA wishes to thank the Sigrid Rausing Trust for its sponsorship of the project and the report ***A Cat & Mouse Game for Investors: Assessing ESG Disclosure of Supply Chain Listings in Hong Kong***. The Sigrid Rausing Trust is a philanthropic foundation based in Britain. It was set up ten years ago by Sigrid Rausing as a grant giving trust. It takes as its guiding framework the United Nations' Universal Declaration of Human Rights. The Trust's funding categories are all human rights orientated and aim to form a coherent framework for the work of the Trust

Editorial team: This report was authored by Sophie le Clue with editing and review by Melissa Brown, David St Maur Sheil and Sweeta Motwani. The layout and design of the report was managed by Sky Koon-chow Ng. We wish to thank Julie Craddock for her review of the report.

Disclaimer: ASrIA does not guarantee that the report is a comprehensive survey of disclosure issues in relation to supply chain listings. With the resources available, however, the report makes every effort to focus on key areas of relevance and to deliver data that is accurate and opinions that are objective and balanced.

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EXECUTIVE SUMMARY

Environmental, social and governance (ESG) issues are now recognised by leading financial institutions as material to investment decisions. These issues are highly visible in the fast-growing supply chains of Southern Asia, where companies from a range of sectors increasingly provide services to prominent global brands. As the global trend of outsourcing from the developed markets of Europe and the United States to less developed markets such as Asia looks set to continue, we are also seeing an increasing trend of these supply chain companies listing on the Hong Kong stock exchange (HKEx). The question for investors is, how are Asia's listed supply chain companies managing these and other ESG risks in an extremely dynamic and competitive environment?

IPO documents provide a rare opportunity for investors to assess the materiality of ESG risks

Through the issuance of public offering (IPO) documents, these listings provide a rare opportunity for investors to assess the materiality of ESG risks. Indeed, IPO documents such as the company prospectus are often the only means by which ESG issues are publicly disclosed, making them an increasingly valuable resource for investors. In early 2006, ASRIA undertook a review of IPO documents as a means of assessing critical disclosure and operational trends on ESG issues from a representative cross section of supply chain companies operating in China and listing on the HKEx.

Our findings indicate that whilst the environment in which these companies operate is rapidly changing, disclosure is generally at a standstill, both in terms of coverage and content. The scope of disclosures does not sufficiently cover potential material risks and in many instances the manner in which ESG issues are disclosed quite simply does not facilitate investor analysis. Increasingly critical issues for companies operating in China such as cost of labour, sustainable supplies of water and energy are not given sufficient attention and we find that substantive information is often missing, rendering the disclosure one dimensional in nature.

There is consistent failure to map ESG risks to proposed new and expanded facilities

One of the more perplexing aspects encountered in our research is the consistent failure to map potential ESG risks to proposed new and expanded facilities for which the listing proceeds are most frequently required. Indeed in a changing regulatory environment such as China, it is the new facilities and increased production capacities that are likely to capture the attention of regulatory authorities charged with administering higher standards.

For investment-oriented users one of the challenges of using prospectuses is the legalistic orientation meant to protect issuers and sponsors, a practice that we found often obscures clear disclosure of ESG risks. Indeed the limited scope and manner of presentation suggest that intermediaries are not always conversant with the issues of concern and indeed repetitive statements across the prospectuses indicate information may be derived from inappropriate sources. The superficial nature of disclosures also suggests that relevant information related to ESG performance is quite simply not available, leading us to further conclude that these companies may not be systematically addressing ESG risks in their operations. This is all the more surprising given that 46% of the companies claim to implement an ISO 14001 certified environmental management system.

Perhaps most worryingly, the commonplace failure to disclose potentially material ESG risks effectively, suggests a weakness in the stock exchange listing requirements.

We do however see some improvement in both coverage and clarity of issues in markets such as the apparel trade, where public scandals or legal issues have played a part in driving more candid disclosures on social issues. The disclosure of standard metrics such as costs of labour/turnover, capital expenditure on pollution control equipment, environmental fees and gross margins, to name a few, can also yield useful information for the assessment of materiality. Investors may further identify potential ESG risks through recognition of issues and terminology that may serve as red flags and thus may be the impetus for more detailed analysis.

Nonetheless, for the time being it appears that the process surrounding ESG disclosures looks set to remain a cat and mouse game, where unsubstantiated, incomplete and often unclear disclosure requires continuous follow-up in order that investors may have a fighting chance of determining the materiality of ESG risks.

ESG disclosure looks set to remain a cat & mouse game

INTRODUCTION

As the global trend of outsourcing from Europe and the United States to low cost markets such as Asia looks set to continue, we are seeing an increasing trend of Asian supply chain companies listing on the Hong Kong stock exchange (HKEx), in order to finance expansion to meet growing global as well as domestic demand. At the same time three key trends are redefining disclosure norms for HKEx listings of Chinese supply chain companies. These include:-

- the increasing number of global brands evaluating environmental, social and governance (ESG) risks associated with supply chain performance and subsequently imposing stringent performance requirements on their suppliers;
- China increasing its enforcement of relevant legal requirements while at the same time introducing new rules and standards; and
- international ESG laws and regulations becoming more material to Asia's supply chain, as non-compliance effectively bars market access.

In Asia, disclosure at the time of the IPO is often the only occasion that a company will disclose ESG data relevant to investors. Although some such disclosures can be found in annual reports and to a lesser extent in sustainability reports, typically these channels are not sufficiently informative for investor analysis. Indeed sustainability reports are a rare commodity in Asia's listed universe.

Listing documents, notably prospectuses, are thus the critical window for Asian investors interested in analyzing the materiality of ESG risks and similarly identifying and assessing ESG opportunities. The Hong Kong listing rules present a principled based approach to disclosure such that inclusion of material ESG issues relies on individual interpretations of materiality and thus relevant experience and knowledge of those drafting the documents as well as interpretation/requirements of the stock exchange. The language used is drafted through a process of negotiation between the various stakeholders, broadly including the corporate entity to be listed, lawyers, underwriters and accountants.

According to HKEx listing rules, listing documents which include the company prospectus issued by a new applicant ***must, as an overriding principle, contain such particulars and information which, according to the particular nature of the issuer and the securities for which listing is sought, is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities, financial position, management and prospects of the issuer and of its profits and losses and of the rights attaching to such securities***

Source : Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd.,
Volume 1 Equity Securities, Chapter 11 Listing Documents
http://www.hkex.com.hk/rule/listrules/vol1_2.htm

On presentation of information, the listing rules require that preparation of listing documents must have regard to the following principles:

- (1) the information contained in the document must be clearly presented and in the plain language format specified or recommended by the Exchange and/or the Commission from time to time; and**
- (2) the information contained in the document must be accurate and complete in all material respects and not be misleading or deceptive. In complying with this requirement, the issuer must not, among other things:-**
 - (a) omit material facts of an unfavourable nature or fail to accord them with appropriate significance;**
 - (b) present favourable possibilities as certain or as more probable than is likely to be the case;**
 - (c) present projections without sufficient qualification or explanation; or**
 - (d) present risk factors in a misleading way.**

Source : Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd.,
Volume 1 General, Chapter 1 Introduction
http://www.hkex.com.hk/rule/listrules/vol1_1.htm

In early 2006, ASrIA undertook a review of IPO documents as a means of assessing critical disclosure and operational trends on ESG issues from a representative cross section of supply chain companies operating in China and listing on the HKEx. Successful supply chain companies capable of listing are typically in high growth sectors and reflect critical supply chain trends. This report examines the issue of ESG disclosure by Asian supply chain companies through a review of the IPO prospectuses of 24 companies which listed in Hong Kong during 2005 (see Table 1).

Table 1 Selected Supply China Companies Listing in 2005

Company Name		Market Cap.* USD (mn)	Operations
Auto Parts	Minth Group Ltd.	614.5	Design, manufacture and sale of body structural parts, decorative parts and trim for passenger cars
	Xinyi Glass Holdings Ltd.	576.1	Producer of automobile glass
	New Focus Auto Tech Holdings Ltd.	124.9	Manufacture and sale of electronic and power related automotive parts for leisure and safety purposes:- i) inverters, ii) multi-functional power packs, iii) automotive lights, iv) cooler/warmer boxes, v) chargers/converters
	China Glass Holdings Ltd	93.9	Producer of float glass
Textile & Apparel	Shenzhou International Group Holdings Ltd	496.9	Vertically integrated knitwear manufacturer
	China Ting Group Holdings Ltd.	481.2	Vertically integrated and large scale garment manufacturer, exporter and retailer
	Addchance Holdings Ltd	56.7	Production and sales of dyed yarn and knitted sweaters
	Bauhaus International (Holdings) Ltd.	39.7	Manufacture, wholesale and retail sales of apparel, bags and sacs and accessories under its own brand names as well as retail sales of apparel under other third-party brand names in the fashion industry
Electrical, Electronics	Foxconn International Holdings Ltd.	14,199.9	Vertically integrated manufacturing service provider for the handset industry, including design and manufacture of precision tooling molds, product development, manufacture of components, modules and systems, assembly and integration, after sales.
	AAC Acoustic Technologies Holding Inc.	1,108.7	Design and manufacture of miniature acoustic components
	SIM Technology Group Ltd.	688.2	Development of mobile handset and wireless communications module and manufacturer of LCD modules.
	Fittec International Group Ltd	283.7	EMS providers in the PRC's PCB assembly industry, offering one-stop production solutions from procurement of raw materials to after-sales services to customers.
	Ju Teng International Holdings Ltd	217.6	Manufacture and sale of notebook computer casings and also casings for LCD PCs, digital cameras and game consoles
	EVA Precision Industrial Holdings Ltd	135.2	Vertically integrated precision metal moulding and stamping products manufacturing services
	Global Flex Holdings Ltd.	128.8	Provision of FPC solutions including the design, manufacture and sale of FPC and the sale of FCP. The Group also manufactures PCB and sells assembled PCB
	Sandmartin International Holdings Ltd.	117.9	Design, manufacture, and distribution of satellite TV reception products and communication related products.
	Alltronics Holdings Ltd	39.0	Research and development, manufacture and sales of electronic products – including home improvement electronic products and electronic product components
	Shinhint Acoustic Link Holdings Ltd	31.3	Vertically integrated manufacturing services provider for some of the leading consumer electronics brands.
	Kenford Group Holdings Ltd.	11.6	Design, manufacture and sale of electrical hair care products, electrical health care products and small household electrical appliances
Furniture	Samson Holding Ltd	1252.7	Production and marketing of a wide range of high quality residential furniture at mid to high price points for the U.S. wholesale market under own brand names.
	Kasen International Holdings Ltd.	176.3	Manufacturer of upholstered furniture and leather products
Pulp & Paper	Huali Holdings (Group) Ltd.	30.8	Design and manufacture paper based packaging containers and materials for customers in PRC.
Food & Beverage	Xiwang Sugar Holdings Ltd	439.7	Crystallised glucose producer - products broadly divided into corn refined products and corn based biochemical products
	China Haisheng Juice Holdings Co., Ltd.	144.8	Manufacture and distribution of fruit juice concentrate products and fruit juice concentrate related products

*Market Capitalization figures as at 29/06/06; source Hong Kong Exchanges and Clearing Ltd. <http://www.hkex.com.hk>

In assessing ESG risks and opportunities documented in prospectuses, investors may turn to a number of key sections. Typically these include the 'Risk Factors' and the 'Business' or 'Particulars of the Group' sections which usually contain the main ESG reference points. The 'Directors, Senior Management and Staff' section can also provide useful insights into both labour issues and governance through reference to staff turnover, compensation, as well as structure and experience of the board. In addition, the 'Industry Overview' section which details the operational requirements of the industry, yields useful information that can expose potential ESG risk areas and in some cases outlines relevant environmental protection laws.

Our main findings relate to both the nature and extent of disclosures and are discussed according to the following themes:

- **A pattern of non-disclosure** - significant gaps in disclosure are clearly a barrier to informed assessment of potential ESG risks and opportunities. In particular, disclosures relating to environmental risks are often limited in scope and those on social risk in particular, namely health, safety and labour issues, are frequently omitted altogether. Disclosures also tend to be fairly one dimensional in nature, often highlighting a potentially material ESG risk, without providing substantive information to enable effective analysis.
- **Legal orientation obscures rather than enlightens** - disclosures are consistently defined in highly legal terms at the expense of clearly defining ESG risks and opportunities, which seems inappropriate to the needs of investors.
- **Poor intermediary understanding of ESG issues** - the inaccurate use of language and presentation of issues leaves the reader to ponder whether the authors have sufficient technical understanding of ESG risks and opportunities. Equivalent gaps in the presentation of financial accounts would never be accepted.
- **Standard metrics providing insights into ESG risks** - although the prospectuses are generally uninformative on ESG risks, the disclosure of standard metrics such as costs of labour/turnover, capital expenditure on pollution control equipment, environmental fees, gross margin trends for continuing business lines, to name a few, can yield useful information for the assessment of materiality.

Table 2 ESG Disclosures

Type of Disclosure	% disclosing	Comment
Environment		
Legislative compliance	95.8	The majority of companies were definitive in assuring legal compliance within the track record period, 16.7% were less authoritative 'believing' that the company was in compliance. 25% indicated some non-compliance.
Electricity shortages	54.2	Recognized instability of electricity supply as a potential risk.
	33.3	Acknowledged being a large consumer of energy.
Environmental management certification ISO 14001	45.8	Often referred to as a quality standard suggesting some misunderstanding of ISO 14001 as an environmental management system standard.
		Scope of the certification lacking, 46% of those companies with ISO 14001 certification did not disclose which companies or operations were certified.
Water	25.0	Indicating water consumption and on occasion water shortages as a concern.
	25.0	Providing information on waste water treatment facilities.
Customer requirements	16.7	Disclosure related to the EU Directive on the Restriction of Hazardous Substances (ROHS), otherwise environmental requirements from customers not cited.
Social		
Payment of social insurance	100.0	Two companies disclosed non-payment of social insurance.
Relationship with employees	75.0	In all cases standard terminology referred to good relations maintained with employees.
Importance of low labour costs	58.3	Recognised the importance of low labour costs.
Labour shortages	20.8	Recognised as potential risks, but no direct experience of these issues during the track record period.
Labour unrest	12.5	
Recognition of social responsibility	12.5	Social responsibility cited by companies in the apparel sector.
Legislative compliance (health and safety)	16.7	Limited disclosure on compliance with health/safety and labour laws.
Governance		
Connected Transactions	79.2	Numerous transactions cited, often without sufficient explanation as to why and future arrangements.
Board structure and experience	62.5	Indicate family connections at the board level.
	62.5	CFO recently appointed (in the two years prior to listing).
	45.8	Independent Non-Executive Directors on the board of four or more other companies, often little disclosure provided to establish suitability/qualifications.
	20.8	CEO and Board Chair noted as the same individual.

GAPS IN ESG DISCLOSURE - A BARRIER TO INFORMED ASSESSMENT

Rising wages, tightening labour markets and greater awareness of the need for tougher enforcement of environmental regulations in Asia is resulting in increased materiality of ESG risks and also new opportunities. In support of this, we are beginning to see tougher regulation in China, both in the form of new regulations and standards as well as heightened enforcement. The growing relevance of international legislation to China's supply chain companies is further evident, as is the increasing number of global brands introducing strict ESG criteria into their supplier requirements. The penalty for non-compliance can and does result in the cancellation of contracts that suppliers can ill afford to lose. Nonetheless, based on our research, these issues are more often than not omitted or inadequately addressed in the listing documents disclosed prior to public offering.

Figure 1 Changing Dynamics - Increasing Enforcement and Regulation in China

During the period 2000-2001, China's State Council Central Office released 184 rules, regulations and related documents on OHS. Departments and Ministries of the State Council published another 135. Relevant departments in provinces, municipalities and autonomous regions issued a further 107.

Source: Stephen Frost, CSR Asia, September 2005, cited in Taking Stock: Adding Sustainability Variables to Asian Sectoral Analysis, ASRIA 2006.

The government of Guangdong has recently started publicly naming companies that defaulted on wages or failed to comply with other aspects of Chinese labour law. In September 2005, it publicly announced for the first time a list of 20 companies (see *CSR Asia Weekly*, vol. 1, Week 40) regarding a range of legal non-compliance. In January 2006, the government in Shenzhen listed another 30 companies for a variety of labour violations. It also charged the legal representatives of eight factories that owed some 1,200 workers 7 million RMB (US\$867,711) in wages with economic crimes (see *CSR Asia Weekly*, Vol. 2, Week 3). In June 2006, the Guangdong government released another list of 30 companies.

Source: CSR Asia Weekly Vol 2 week 26, June 2006

Comprehensive disclosure of material ESG themes was found to be lacking in almost all of the prospectuses reviewed. Typically, the most common disclosure in the Risk Factors section relates to the environment, which generally consists of broad statements concerning the potential financial risk of as yet unknown future environmental legislation in China.

Reference to social risks are rare, despite the fact that labour issues are recognised as being at the core of sustainability risks in the supply chain¹. Only three companies, all from the apparel sector, provided substantive disclosure of material social issues, despite the materiality of such issues to both the day-to-day operations and the strategic outlook of supply chain companies operating in China.

References to social risks are rare, yet labour issues are at the core of sustainability risks in the supply chain

With a few notable exceptions cited in Figure 2, less tangible risks, such as those concerning reputation and brand are almost entirely omitted, despite reliance on reputation sensitive global brands as key customers.

Figure 2 Rare Disclosure of Intangible Risks

Furniture manufacturer **Samson Holdings Ltd.** on compliance with environmental regulations:

Any failure or any claim that we have failed to comply with these regulations could cause delays in our production and capacity expansion and affect our Company's public image, any of which could harm our business.

Garment manufacturer **China Ting Group Holdings Ltd.** on fulfilling the social responsibility requirements of its customers:

Should the Group fail to fulfill the social responsibility standards required by its customers, be publicly perceived to fail to fulfill such standards or otherwise be publicly associated with poor social responsibility standards, its customers may decide not to use its services and its business may be harmed.

Garment manufacturer **Shenzhou International Group Holdings Ltd.** Holdings Ltd. on fulfilling the social responsibility requirements of its customers:

Certain of its customers are sensitive about social responsibility standards and if the Group is perceived to fail to meet standards, certain customers might choose not to do business with the Group.

Environmental disclosures are frequently limited in scope

Whilst all but one of the companies in our sample provided a designated section on environmental protection in the Risk Factors and/or Business Section of the prospectus, review of the scope and content generally reveals limited acknowledgment of somewhat standard environmental themes, such as the emission of waste water discharges which may require treatment and to a lesser extent air emissions and solid waste. In most cases the 'Business Section' does provide some additional information, mainly the status of compliance with existing environmental legislationⁱⁱ. In several cases confirmatory documentation provided by the local regulatory authority is cited as evidence of compliance. The applicability of the legislation however often remains unclear, as does the respective authority and legal standing of the regulatory body and the documentation provided. The issue of local authority jurisdiction is of particular relevance given reports of the central government's recent moves to crack down on local government entities which allow polluters to continue pollutingⁱⁱⁱ. Local policies and regulations formulated by such authorities and which violate the country's national environment laws are coming under increasing central government scrutiny.

Few prospectuses clearly define significant ESG issues and management practices associated with the industries' operations

The second main reference point on the environmental side relates to implementation of an ISO 14001 certified environmental management system. However as discussed below, the nature and extent of such disclosures often leave the reader questioning the authors' understanding of the intent and purpose of the ISO standard.

The generic statements which constitute disclosure on environmental risks are thus distinctly uninformative, often serving only to state the obvious, while failing to address implications at the operational level. Very few prospectuses were found to clearly define the significant ESG issues and management practices which are commonly associated with the industries' operations.

Figure 3 Typical Disclosure of Potential Environmental Impacts

Huali	<i>In general, smoke, noise, waste water and solid waste materials are produced during our manufacturing and printing process.</i>
Shenzhou	<i>The Group’s production facilities in China emit waste water, solid waste and waste gas.</i>
EVA	<i>Due to the nature of the Group’s business, effluents and solid wastes are produced in the course of the production process.</i>
Sandmartin	<i>Due to the nature of the Group’s business, certain amounts of effluents and solid wastes are produced in the production processes.</i>
SIM Technology	<i>The Group’s business operations do not result in the production of harmful pollutants.</i>

Only two companies, Alltronics and China Haisheng, provide relatively detailed disclosure on the specific environmental requirements or control measures adopted. Alltronics outlines requirements, but stops short of disclosing how it complies. China Haisheng is more explicit outlining environmental protection measures adopted. The latter is likely driven by recent legal claims against the company concerning water pollution (see section ‘Public Scandals, and Legal Breaches Driving Disclosure’, below).

The prospectuses are by no means comprehensive in citing potential ESG risks, with some issues notably absent. Land contamination for example is a risk area currently not evident in the disclosures, but is nevertheless an issue which if it follows the trends in Europe and the USA, will emerge as a potential financial risk, largely as a result of liability for clean up costs.

Whilst not specifically cited as an environmental issue, just over half of the companies in our sample refer to unstable energy supplies, mainly electricity, as a risk factor. In addition, one quarter refer to the business implications of China’s emerging water supply problem. Whilst most of these disclosures tend to be one dimensional and still represent a disclosure gap, we are seeing evidence that at least some companies have a more strategic understanding of these issues, given the increasing materiality of water and energy risk management for China’s supply chain companies.

Over half of the companies refer to unstable energy supplies as a risk factor

Figure 4 Water Risk Management in China - An Emerging Issue

...., facing severe water shortages, Beijing authorities have announced plans to severely limit development of new water-intensive businesses in the region. They explicitly will be focusing on constraining the location of new textile, leather, metal smelting and chemical industries according to reports in the China Daily. Makers of beverages, plastics and pharmaceuticals may have to meet water conservation restrictions to gain approval.

Cited in CLSA, "Remaining Drops, Freshwater Resources: A Global Issues" and cited from Environmental News Network, 11 March 2004 (www.enn.com)

The chemical spill into the Songhua River in November last year sounded an alarm over the seriousness of the country's worsening environment, prompting the central government to take a series of measures against polluters. "For a long time it was difficult to tackle polluters due to the lack of regulations targeting officials who are behind the polluters," said Sun Huaixin, (a Ministry of Supervision (MOS) official). Now that much needed regulations are in place, "Our law enforcement work will be greatly enhanced," he said adding that the MOS and the State Environmental Protection Agency (SEPA) will soon announce other pollution cases that they will jointly investigate.

The above quote is cited as part of media reports early in 2006 showing that for the first time two central government departments, SEPA and MOS jointly handled a pollution incident and shut down a distillery causing water pollution after the local authority failed to do so. The agencies were reportedly handling three other pollution incidents. This action by such government agencies took place shortly after the central government introduced a set of regulations aimed at punishing government officials responsible for environmental damage in February 2006.

Source of quote and information: <http://www.china-embassy.org/eng/xw/t237218.htm>
February 2006

Gansu [province] has planned to invest nearly 5 billion RMB (US\$620 million) by 2010 to treat water pollution of the section of the Yellow River that runs through the province. The government has mapped out a five-year plan for water pollution prevention and treatment, and will carry out 199 projects with a total investment of 4.97 billion RMB, involving treatment of industrial and domestic sewage, and the enhancement of environmental monitoring (Xinhua, 26 February).

Source: CSR Asia Weekly Vol 2 week 26, June 2006

Market access represents a fundamental business risk

Market access is increasingly a significant issue for supply chain companies operating in Asia, with customer requirements and international legislation being two key drivers. Over 80% of the prospectuses reviewed included disclosure of the importance of maintaining good customer relations and at the same time the inherent risk of relying on a narrow customer base. For these companies this means reliance on a small number of large customers, without the security of long term-contracts. Of the 21 companies that disclosed customer names, two-thirds are first and/or second tier suppliers to global brands^{iv} such as adidas, Kyocera, Nike, Philips, Sony Ericsson, Motorola, HP, all of which are known to include specific ESG criteria in their supplier requirements. These criteria typically reference labour issues including treatment of the workforce and workplace conditions, health, safety, and environmental protection issues. The details of these criteria and commentary on China-specific issues are easily accessible on the website of many of these global brands for verification by sponsors.

Customer requirements and international legislation are two key issues in market access

In recent years the introduction of numerous codes and standards by global brands, eager to keep pace with market peers, has created a competitive dynamic affecting both ends of the supply chain^v. HP as an example has introduced its supplier code of conduct covering environmental and social issues to 98% of its purchasing expenditures. On the supply side, this has inevitably created immense pressure for supply chain companies to comply with numerous standards imposed by different customers. Yet less than one fifth of disclosures acknowledged such requirements, leaving investors quite literally in the dark as to whether companies are in a position to meet the ESG demands of customers in an environment where non-compliance can mean the loss of business. Notably, most relevant disclosures from this perspective concerned the social responsibility requirements of apparel companies (see 'the Apparel Sector Leads on Social Disclosure'). Those companies not disclosing customer names inevitably leave investors further in the dark as to meeting customers' increasing ESG expectations.

Investors are left in the dark as to whether companies are in a position to meet the ESG demands of customers.

Figure 5 Global Brands' Supplier Requirements

Motorola on Supplier Requirements

- *Environmentally Preferred Product (EPP) efforts have become a priority as a result of legislation enacted by the European Union (EU), as well as pending legislation in other countries, on the restriction of certain hazardous substances in electrical and electronic equipment. Non-compliance to the legislation will prevent products from shipping within these countries. Motorola is requiring its supply base to fully disclose material, substances of concern, and recycled material content of each part we are supplied.*
- *Motorola's Supplier Global Corporate Citizenship (GCC) expectations include issues regarding Compliance, Discrimination, Forced Labor, Child Labor, Wages and Hours, Safe Working and Living Conditions, Freedom of Association and the Environment. A supplier's performance is also subject to periodic assessment.*
- *Over the past two years Motorola has developed and continues to refine its company-wide system for ensuring that our product's meet the ROHS Directive requirements. The Directive's requirements are incorporated to product design. A comprehensive system for obtaining supplier declarations and material disclosures concerning the chemical composition of components and products utilized by Motorola in developing products for the EU has been implemented.*
- *If the supplier does not take appropriate corrective action we will terminate business relations with that supplier.*

Source: <http://www.motorola.com/>

Sony Ericsson Mobile Communication's (SEMC) on Supplier Social Responsibility

- *The newly adopted Supplier Social Responsibility Code places expectations on suppliers to provide a safe workplace for employees, respect basic human rights, and apply proper ethics standards in all business dealings.*
- *Sony Ericsson inspects all first level suppliers to ensure the requirements are realized on a practical level*
- *The substances as listed and defined in the Restriction of the Use of Certain Hazardous Substances Directive (ROHS) such as lead, cadmium, mercury, chromium (VI), PBB and PBDE as well as halogenated flame retardants in printed wiring board/plastic housing have been eliminated. Current phase out efforts focus on removing PVC and PVC blends.*

Source: <http://www.sonyericsson.com>

A prominent example of market access failing to gain due recognition is illustrated by lack of disclosure on meeting the requirements of recently introduced EU Directives – Waste Electrical and Electronic Equipment (WEEE) and Restriction of Certain Hazardous Substances (ROHS). Taking the case of ROHS, the Directive requires the substitution of various heavy metals such as lead, mercury, cadmium, and hexavalent chromium and brominated flame retardants, polybrominated biphenyls (PBB) or polybrominated diphenyl ethers (PBDE)), in new electrical and electronic equipment (EEE). Manufacturers of EEE outside of Europe must also abide by this legislation if the equipment is imported into an EU member state. It is intended that this will provide incentives to design electrical and electronic equipment in a more environmentally efficient way, which takes waste management aspects fully into account.^{vi} Consequently as of 1st July 2006, access to European markets is effectively barred for non-compliant products.

Of the electronics companies in our sample which are affected by ROHS, only three actually reported their status regarding compliance with the directive, despite the fact that over half acknowledged the European market as part of their customer base and ROHS compliant company products were cited on product and company websites. Of the three, only one company – AAC Acoustics, provided clear disclosure as to the applicability of ROHS to the company and its current status of compliance, although the prospectus was ambiguous on future compliance. The other two, Alltronics and Fitec International, referred to ROHS, but only in the context of lead free soldering, leaving the reader wondering as to whether or not lead is the only company-relevant substance covered by the Directive.

Global Flex Holdings and Foxconn’s lack of disclosure on this issue and customer ESG requirements in general is particularly notable, as Motorola (see Figure 5) is cited as one of Foxconn’s three key customers, and is Global Flex’s largest customer - accounting for nearly two thirds of company sales in 2004.

The issue is set to expand beyond Europe as China and Korea develop and implement similar national legislation. China, is reportedly introducing its own ROHS requirements as of March 1 2007, thus providing similar restrictions albeit with a different scope, to the domestic market^{vii}.

The apparel sector leads on social disclosure

Social issues such as child labour, forced labour, discrimination, excessive overtime, are widely associated with supply chains in developing countries. Inadequately managed, such labour issues can represent significant business risks, yet, only three companies, all from the apparel sector, specifically recognized the regulatory risk linked to bad labour practices or the issue of social responsibility and related customer requirements in their prospectuses. This is doubtless driven by the numerous labour scandals which have plagued the industry in recent years. These scandals have resulted in the enforcement of strict requirements by apparel customers concerned over brand and reputational risk associated with poor supply chain performance. For example global brands now support costly industry-based efforts such as the Fair Labour Association (FLA) to police the supply chain. Indeed China recently introduced its own answer to the SA 8000 accountability standard in the form of its own national standard CSC9000T, specifically for the apparel sector.

Scandals have influenced the enforcement of strict requirements by apparel customers

Figure 6 A Company with No ESG Risks?

Bauhaus, an emerging Asian brand is an interesting case. Its prospectus is the only one to almost entirely omit environmental and social disclosures, yet as an apparel manufacturer with production facilities in the PRC, it is exposed to a number of material ESG risks which are commonly addressed by its peers.

Other sectors are known to be closely watching this issue and are beginning to scrutinize the ESG performance of suppliers while introducing standards and codes. The absence of these issues in the disclosures, however, would suggest that such risks have not yet been fully recognized by the supply chain companies themselves.

Public scandals and legal breaches driving disclosure

One of the key drivers of more substantive disclosure, particularly for those companies with global customers, is the need to respond to a significant legal issue or public scandal. This would seem to be supported by the relatively better transparency of apparel companies on social issues. Although there are no highly visible examples of companies that have been the subject of such scandals within the current sample^{viii}, juice manufacture China Haisheng is notable because it outlines its environmental protection measures. This would appear to be in response to what are reported to be unsubstantiated claims by shrimp farmers to the regulatory authorities and the media that the company caused water pollution resulting in shrimp kills. Although not admitting any liability, the company voluntarily compensated the farmers with RMB 400,000, plus RMB 30,000 towards court costs.

A more prominent example supporting the hypothesis that legal exposure drives disclosure is provided by Luen Thai, an apparel company which listed in 2004. Its unusually informative disclosure on social issues would appear to be driven by a public class action suit against the company concerning labour rights in Saipan.

Reports concerning Foxconn and HBV discrimination in mid-2005 and the current debate on allegedly poor workplace conditions at Foxconn factories supplying Apple ipods provide an interesting case, where the limited disclosure in the company's prospectus on social issues is only likely to heighten the somewhat negative 'surprise' factor of the allegations.

Labour issues on the move, while disclosure remains static

On the strategic side, it is now a widely held view that the landscape of Southern China as a supplier of endless cheap labour is changing, with labour supplies reportedly become less stable, increasingly mobile and generally less predictable. However, only half of the companies acknowledged the importance of low cost labour and far fewer acknowledged the potential for labour shortages as a risk, despite the fact that the business models of these companies are frequently based on cost advantages provided by access to a local low cost labour market. AAC Acoustics as an example did not identify labour shortages as a potential risk despite stating that:

...low labor costs in the PRC relative to the United States, Japan and other developed countries in Europe make us cost-competitive and position us well to compete with competitors in countries with high labor costs or shortages of skilled labor.

It goes on to declare that: *The location of our production facilities (Shenzhen and Changzou) have been determined to access relatively low labour costs and greater proximity to our customers and major transportation hubs.*

ONE DIMENSIONAL DISCLOSURES LEAVE INVESTORS GUESSING

Disclosures consistently fail to map ESG issues from existing to future operations

There is a noticeable gap between increasingly well documented ESG business issues and the minimalist disclosure typical of the listing documents reviewed. Indeed the prospectuses consistently fail to map the ESG issues from existing facilities and levels of production to the proposed expanded facilities and increased production for which the listing proceeds are most frequently required. In a changing regulatory environment such as China, it is the new facilities and increased production capacities that are likely to capture the attention of regulatory authorities charged with administering higher standards.

This bare bones approach to disclosure simply serves to raise further questions, rather than be informative. Where action has been taken to address environmental issues, details are rarely provided. Similarly, disclosure relating to breaches in legislative requirements is often vague or incomplete, with little information provided as to how the company intends to prevent future breaches.

Disclosures often stop short of providing data necessary to determine materiality

Perhaps one of the most prominent examples is the recognition of energy and water shortages as a potential business risk. Yet the disclosure often stops short of providing the data necessary to determine the materiality of these issues, such as quantity and cost of electricity / water used and forecasts of future consumption relative to proposed expansion programs. This gap suggests a growing inconsistency in the markets understanding of the issues as more investors are asked to look at investment opportunities in companies positioned to benefit from rising water and power demands and tariffs.

Furthermore, there is insufficient assurance and discussion beyond the deployment of contingencies as to how the company will address potential future risk. In the case of electricity supply for example, the deployment of emergency generators is cited in preference to disclosing longer term energy management initiatives. Indeed, we found no instances where the typically higher cost of on-site diesel/electricity generation was compared to grid provided power. In the case of water, there is scant mention of water resource management such as recycling, despite China's regulatory authorities increasingly focusing on water efficiency requirements as a means of addressing water shortage problems.

On water, garment manufacturers provided the most informative disclosure

In addition, few companies frame these issues in the context of potentially rising energy costs and increased water-use regulation. On energy, China Glass provides one of the notable exceptions in its disclosure, indicating that the price of heavy oil has fluctuated between about RMB1,082 per ton and RMB1,789 per ton. On water, the garment manufacturers provide the most informative disclosure. Shenzhou Holdings provides perhaps the most useful information on its water consumption, presenting figures to indicate how it intends to increase the capacity of its waste water treatment facilities in line with increased dyeing capacity as production expands. It also mentions water recycling. Addchance recognizes significant water consumption as part of its dyeing operations and raises the interesting issue of preferentially low water tariffs, with its company mills paying significantly lower than the standard charge. The company suggests that such tariffs are a result of government incentives to attract foreign investment. Although the company recognizes the financial risk if such preferentially low tariffs are ended, it fails to further develop the discussion towards future water consumption, water risk management and its approach to water conservation initiatives such as recycling. Persistently low water tariffs in China perhaps provide a false sense of water security.

Similarly, Kasen provides an interesting example of a company that uses and discharges quite substantial quantities of water in its operations processing raw cow hides and wet blues^{ix}. It does not address water use, but does disclose its investment in waste water treatment during the track record period - which shows a threefold increase during that period, however the disclosure fails to address whether this investment is attributed to capital expenditure or operational costs. Moreover there is no discussion concerning implications of the proposed increase in production, such as increased quantities of water consumption and waste water discharges.

Figure 7 Necessary, but not Sufficient

<p>AAC Acoustic Technologies</p>	<p>State that its <i>production maybe interrupted limited or delayed if it cannot obtain sufficient energy supplies.</i></p> <p>Additional information as to how these potential impacts maybe mitigated are not provided.</p>
<p>China Glass</p>	<p>Indicate that its <i>production processes require large amounts of fuel oil electricity and water...We source our water from the Beijing – Hangzhou grand canal adjacent to our facilities, for which we are required to pay a water usage fee to the local government</i></p> <p>Disclosure as to the financial implications is not evident.</p>
<p>China Ting</p>	<p>Indicates that <i>for Jiangsu Fuze, the relevant local environmental protection department has issued a confirmation letter on 14 November 2005 that as at the date of issue of such confirmation letter, Jiangsu Fuze was not required to obtain the permit for the treatment and discharge of waste water.</i></p> <p>The circumstances of such a waiver are unclear, as is the actual authority of the environmental protection department.</p>
<p>Fittec</p>	<p><i>Fittec Shenzhen and Kuan Da Electronics have obtained the relevant environmental certificates in the PRC.</i></p> <p>No information is provided on the nature of the environmental certificates.</p>
<p>Global Flex</p>	<p>The company goes a step beyond typical disclosures and provides the capacity of its waste water treatment plant, but fails to provide the information needed for this to be assessed in a meaningful way.</p>
<p>Huali</p>	<p>Disclosure of Huali’s waste water discharges was notably vague. The company disclosed fines for the discharge of excess waste water, however it did not provide information on the amount of waste water, costs of treatment and how this will likely change with the proposed 16% increase in production capacity.</p> <p>The company also indicates that it has installed special facilities and engaged external companies for monitoring compliances with environmental regulations relating to air, water, noise and solid waste pollution.</p> <p>No other information is provided as to what these special facilities might be.</p>

Figure 7 Necessary, but not Sufficient (continued)

<p>Kasen</p>	<p>Mentions the discharge of ‘<i>substantial quantities</i>’ of solid waste and waste water – it goes on to provide some details on the treatment of waste water , but fails to mention how the solid waste is dealt with . Also subsidiaries of Zhejiang Kasen are reported to have obtained waivers relating to waste water discharge.</p> <p><i>Subsidiaries of Kasen have obtained waivers from the obligation to obtain a pollutant discharge permit for their current operations within the business scope indicated in their respective licenses</i></p> <p>The reasons for the waivers are not disclosed</p>
<p>Mint</p>	<p>The Group faced certain power shortages at its Chinese operating subsidiaries in the summers of 2004 and 2005. It indicates that that such shortage will likely continue in future summers. However, the Group is able to compensate for lost production time during the day by shifting production to the night when the power restrictions are lifted. The Directors confirm that such power shortages did not have any material adverse effect on the Group’s operations in the past.</p> <p>The disclosure does not however map this issue to the planned production expansion.</p>
<p>Shenzhou</p>	<p>Indicate that <i>the Group is required to pay an annual environmental protection fee for the amount of pollutants discharged in excess of the limit allowed by the Ningbo City Environmental Protection Bureau, and an annual environmental protection fee for the polluted air discharged from its boilers.</i></p> <p>It is not clear why the company would appear to be consistently discharging in excess of its limits imposed by the regulatory authority.</p>
<p>Xinyi Glass</p>	<p>Indicates that they <i>have implemented certain environmental control measures to ensure compliance with laws and regulations.</i> However the environmental measures are not disclosed.</p>

DISCLOSURES DEFINED IN LEGALISTIC TERMS PROVIDE LITTLE ON ESG THEMES

For investment-oriented users, one of the perplexing aspects of reading prospectuses is the legalistic orientation meant to protect issuers and sponsors, rather than to provide investors with informative disclosure to facilitate analysis. It would appear that the main aim of the bulk of disclosures reviewed is to point to the fact that no assurance can be provided against future environmental risk, usually associated with legal compliance. For the non-legally oriented user, the language is often unclear, at times appearing ambiguous if not contradictory.

For investors, a perplexing aspect of prospectuses is the legalistic orientation meant to protect issuers and sponsors

Figure 8 Ambiguous to the Non-legal Reader

AAC Acoustics— on ROHS in the Risk Factors Section state that: *There is no assurance that our products will continue to comply with this (ROHS) Directive andin the future.*

In the Business Section - *We do not expect any difficulties in complying with the ROHS Directive in the future*

Across the sample of prospectuses reviewed, the companies tend to adopt one of two approaches to disclosure. The first approach is to provide definitive statements, for example concerning legal compliance; the second is more guarded providing only the directors' 'belief' in compliance. Figure 9 provides typical examples of such disclosure which provide little insight as to companies' ESG risk management.

Figure 9 Terminology Commonly Used for Statements on Legal Compliance

Xiwang Sugar - *Our Directors believe that our production facilities conform to the applicable environmental protection regulations in the PRC in all material aspects. Nevertheless, there can be no assurance that the existing laws and regulations in the PRC will not change in the future. If there is any such change, we may incur additional costs to comply with the new laws and regulations, which could have an adverse impact on our financial position.*

Sandmartin - *directors believe that the Group's environmental system and facilities are adequate to comply with applicable national and local environmental protection regulations*

Foxconn - *Further additional environmental matters may arise in the future at sites where no problem is currently known or at sites that we may acquire in the future*

The use of terms 'believe' and 'aware' appears to be common where lawyers and sponsors are not confident of their ability to prove compliance. This may be due to common and understandable issues such as opaque regulations, although some companies are more definitive in their assertions on compliance where the same regulations apply. Alternatively it may reflect inadequate company records, controls and procedures – all of which flag potential ESG risks.

DISCLOSURES SUGGEST POOR INTERMEDIARY UNDERSTANDING OF ESG ISSUES

The language in the documents frequently indicates poor understanding of ESG issues, presumably by the lawyers, bankers and accountants responsible for drafting the documents. Moreover, obvious repetition and similarity in the language used between prospectuses raises questions as to whether language is simply being adapted from inappropriate sources.

Referring to environmental risks in particular, a clear example of poor understanding of disclosure relates to the international environmental management standard ISO 14001:2004^x. Nearly half of the companies emphasize certification to the international environmental management standard ISO14001 in their prospectus. Indeed a company’s certification to ISO 14001 is frequently highlighted as a prominent accomplishment rather than a baseline achievement. Readers should bear in mind that ISO 14001 is not an absolute standard and cannot therefore be taken as assurance of achieving a high level of environmental performance^{xi}.

Mischaracterisation of the ISO 14001 standard within the prospectuses is obvious to the informed reader. The language used consistently indicates minimal understanding of the aim and nature of the standard, as demonstrated by numerous instances where it’s clearly confused with quality management standards. Some prominent examples are listed in Figure 10.

Figure 10 Disclosures on ISO 14001 - Confusion with Quality Standards

China Glass state that: *We have been awarded ISO9001:2000, ISO14001 and OHSMS18001 certification for our quality control procedures.*

Fittec state: *We were accredited with ISO 9002:1994 certification in 1999 for maintaining a quality system for electronics and computer products, ISO 14001:1996 certification in 2001 for establishing a quality system and maintaining an environmental management system for PCB assembly for audio, telecommunication and computer related products*

EVA indicate that: *In recognition of the business achievements and stringent standards of quality control achieved by the Group, Yihe Precision Hardware was obtained the ISO 9001:2000 and ISO 14001:1996 certifications in 2003.*

Global Flex indicate that: *As a result of its stringent quality control, the Group has obtained several accreditations for its quality systems including ISO14001:1996*

In numerous other cases reference to ISO 14001 can also be found under ‘Quality Control’.

Mischaracterisation of the ISO 14001 standard is obvious to the informed reader

It is important to stress that ISO 14001:2004 is not a quality standard but broadly prescribes the requisite components for the development and implementation of an environmental management system that will effectively identify and control environmental aspects, that is, the elements of an organisation's activities, products and services that can interact with the environment, such as emissions to air, water etc. The standard also requires continual improvement in environmental performance. Confusion with the quality standards may arise as a result of the fact that both are ISO management standards and have been designed to be compatible.

It is significant that the scope of ISO 14001 certification may vary such that a holding company may certify only part of its operations. The implication is that while ISO 14001 provides some indication that environmental risks are being managed, a selective scope can exclude material risks. None of the listing documents provide adequate information for the reader to determine which activities and indeed which of the group's companies implement such an environmental management system and hence are theoretically managing their environmental risks. Of the 11 organisations claiming ISO14001 certification, six indicate which of its companies have been certified, but without defining the scope of activities. The remaining five companies leave the reader to guess how much of the organization and its subsidiaries are operating to the standard's environmental protection requirements.

Figure 11 Disclosures on 14001 - Scope Remains Unclear

EVA – the Group has obtained ISO 14001 certification for environmental management control

China Glass – Our commitment to high standards of environmental protection has resulted in **our company** receiving ISO 14001:1996 certification for our environmental management systems

This gap in disclosure related to ISO certification is particularly surprising as meeting the standard's requirements involves development and implementation of systems and procedures which should yield substantive information on company environmental performance, which can support clear and coherent disclosure. Indeed, to a practitioner, the gap created by vaguely drawn statements about ISO14001 and the lack of associated disclosure on impacts and systems is analogous to promises of profitability while failing to provide financial statements.

The gap in disclosure related to ISO certification is particularly surprising

Another example of inappropriate language, again concerning ISO 14001, is the statement in the Shenzhou prospectus: - *Leveraging on its strong waste water treatment ability, the Group has maintained its ISO14001:1996 certification for its environmental management system.* Those with full appreciation of ISO 14001 will know that waste water discharges will only be one of many environmental aspects associated with the company's operations covered by the standard. Hence certification cannot be achieved by leveraging off one aspect.

Finally, eight of the companies are certified to the original 1996 version of the standard, whilst one company does not reference the version it is certified to. However, ISO 14001:1996 was updated to ISO14001:2004 with the revised version published in mid November 2004. Although the majority of companies reference the older version, none disclose their intention to upgrade their management systems to conform to the revised version, despite producing the prospectuses after the publication of the revised standard. The International Organization for Standardization and the International Accreditation Forum agreed a transition period of 18 months from the revision publication date for companies to update their systems in accordance with the new standard. Beyond this period, the IAF will recognize only certificates to ISO 14001:2004. Hence it is unclear from the disclosures whether the companies intend to conform to the transition plan and maintain their certified systems into 2006.

Whilst the above examples indicate a worrying lack of awareness concerning a specific environmental issue, there are also numerous other examples in the documents where the language is simply uninformative. As an example, Alltronics and Ju Teng are in the electronic component manufacturing sector and the respective assertions that the companies do not ‘emit industrial waste water’ and ‘do not discharge water’ thus require clarification. These sectors will almost inevitably use water in their operations and therefore produce waste water. Whilst this water may be recycled thus minimizing industrial discharges, such uninformative use of language denies investors the opportunity to pursue potentially material and common sense issues such as effluent discharges.

Figure 12 Form but not Substance

Alltronics	<i>in accordance with the production factories’ environmental impact report, the production factories <u>do not emit industrial waste water</u> and shall report any changes to the Shenzhen Environmental Bureau</i>
Ju Teng’s	<i>claim that – save for the production of a small amount of solid waste production materials, our Group’s production plants <u>do not discharge waste water</u> nor do they emit smoke from their production processes.</i>

Readers are disadvantaged if they do not possess prior and substantive knowledge of an ESG issue

Readers of the prospectus are in many cases further disadvantaged if they do not possess prior and often substantive knowledge of an ESG issue, as little explanatory information is offered for the benefit of the reader. This immediately poses a problem with the disclosure of ESG issues which are multi-disciplinary and often technical by nature covering such issues as management of hazardous substances, land and groundwater contamination, air emissions, waste water management, solid waste and chemical waste management as well as a suite of health & safety and labour issues. Over the past two years, China’s regulatory environment has become more stringent and ‘polluter pays’ policies are increasingly common. As a result, intermediaries have material concerns to address covering the costs and capital expenditure needed for compliance.

Another somewhat confusing aspect of some environmental disclosures is the focus on specific issues without explanation as to relevance. For example, Kenford's environmental disclosure consists of outlining the requirements of the Ordinance of Management on the Environmental Protection of Building Project. In addition to being limited in scope, the disclosure neglects to put this legislation in context.

Taken together, the gaps in presentation and disclosure raise further questions about the overall quality and intent of issuers and sponsors.

SIMPLE METRICS PROVIDE INSIGHTS INTO ESG RISKS

Although for the most part, disclosure on ESG issues was not found to be substantive or presented in a meaningful way in the prospectuses reviewed, the disclosure of standard metrics for the track record period, whilst not highly visible, does provide the opportunity for investors to track and gain some insights into potential ESG risks and opportunities. Examples of such metrics include:

- cost of labour (salaries and / or benefits);
- breakdown of staff numbers by year/turnover;
- cost of energy and utilities (electricity, price of oil/ton, steam, water);
- capital expenditure on pollution control equipment;
- payment of pollution control fees; and
- gross profit margins.

Table 3 Labour and Environmental Cost Indicators Disclosed

Metrics	% of companies disclosing	No. of companies
Labour Costs:-	83.3	
Staff costs		18
Staff numbers breakdown		4
Environmental costs:-	50.0	
Energy ^a		3
Electricity		5
Steam		2
Water		3
Capital expenditure		3
Environmental fees		2
Operational costs		1

^a Electricity and or oil

As Table 3 indicates, these quite useful metrics are for the most part inconsistently reported across the prospectuses, yet they do provide useful indicators as to the potential ESG risks. For example, reporting on energy and water costs by companies that are intending to use the listing proceeds to expand production, as indeed most are, can differentiate leaders from the laggards in an environment where water and energy shortages are increasingly being factored into operational constraints. Yearly capital expenditure on pollution control equipment on the one hand provides some assurance that environmental risks have been identified and mitigation addressed, and on the other hand can flag potential problem areas to watch. A similar case can be made for disclosing environmental protection fees and the operational costs of pollution abatement equipment.

Gross margins routinely reported as part of the financials can also be telling. In addition to being the clearest indicator of core profitability of the supply chain manufacturer, thin and falling margins – as was the case for just under 40% of the prospectuses reviewed, indicate that these companies are likely being squeezed and are therefore less likely to invest in improving ESG performance.

*Qualitative indicators
can provide interesting
insights relevant to
ESG risks*

Other more qualitative indicators such as legal non-compliances, approach to staff training, connected transactions and board structures can also provide interesting insights relevant to ESG risks and are commonly disclosed. In particular, indicators such as numerous and complicated connected transactions which are not fully explained, significant family representation on the board, directors being major shareholders, nomination of board chair and CEO as the same person, questionable qualifications of independent non-executive directors, newly appointed CFOs pre-listing and directors pay trends are all relatively common in the disclosures and provide an indicator as to potential governance risks.

Useful information on potential ESG risks can further be gained from examining the ‘use of proceeds’. Despite the fact that many of the companies cite expanding production and construction of new facilities as part of the use of proceeds, relatively few indicate the implications in terms of the necessary environmental and social risks and requirements related to such expansion.

RED FLAGS TO WATCH AND QUESTIONS TO ASK

Two broad issues that may serve as red flags in relation to ESG issues are insurance and landuse. Both are common reference points in the documents reviewed and raise some interesting questions regarding attitudes to social responsibility and the recurrent problem of inadequate insurance coverage, defective property title and indeterminate landuse rights.

Insurance coverage and landuse are commonly accepted risks - The issue of insurance cover is commonly disclosed and reveals that many companies have insufficient coverage with respect to accidents at work, third party liability and also product liability. Similarly there are many instances where disclosures indicate that landuse rights have not been clearly established and property title on leased land maybe defective. The approach to both issues is fairly inconsistent with some organisations citing one or other of these issues as a risk, whilst others do not recognise them as specific risk factors.

Disclosures indicate landuse rights and property title as potential risks

While some of the disclosures doubtless serve to acknowledge standard operating risks in China, it is important to note that these issues are areas seeing significant development in terms of government policies and commercial practice. For investors to accurately assess a company's standing and overall risk profile, it is crucial that compliance risks and asset ownership be addressed in a more appropriate fashion.

Two of the companies - Kasen and Addchance, also candidly disclose failure to pay social insurance fees, representing a clear breach of legal requirements in an area where the PRC government is reportedly increasing its focus on enforcement with respect to both joint ventures and foreign invested companies.

The different approaches to the issue are interesting, with Kasen disclosing that it will pay the missed social insurance fees, only if requested to do so by the regulatory authorities or the employees. Addchance on the other hand states that the insurance premiums are gradually being paid. The companies' intentions are clearly to disclose the potential financial risks which have accrued as a result of the lapsed payments. The question remains however, as to why such companies which are in a sufficiently strong position to be listed, have neglected such fundamental obligations.

Despite these breaches, Addchance joins the 80% of companies in the sample which provide assurance through the use of somewhat standard terminology that the company *believes it maintains a good relationship with its employees*. Kasen on the other hand makes no such claim, in fact omitting staff issues completely from the section headed 'Directors, Senior Management and Staff'. Instead the following disclosure is offered in its Business Section: *We have historically experienced a low turnover rate for our management and key staff. As is typical in China, however, we have experienced a higher turnover of temporary factory production workers*. This statement provides little information without the benefits of further contextual data. Indeed, as it stands, it intimates that by virtue of working in China high turnover rates are the accepted norm.

On red flags in general, a number of the issues and indicators frequently disclosed in the documents can also serve as a red flag to investors. These issues can be further assessed by posing a number of simple questions as indicated in Table 4.

Table 4 Red Flag Statements

Common Red Flag Statements	Initial Follow-up Questions for Investors
Environmental Management	
<p><i>The Group has obtained ISO 14001 certification for environmental management control</i></p>	<ul style="list-style-type: none"> • Clarify the scope of the ISO 14001 certification, does it cover all subsidiaries and are any operations excluded? If so, what activities and why? • Can the list of the Group's significant environmental aspects which is potentially very informative) be viewed, if not, why? • What version of the certification is maintained? • Is the certification body internationally accredited?
<p>[The Company has] <i>installed special facilities and engaged external companies for monitoring compliances with environmental regulations relating to air, water, noise and solid waste pollution.</i></p> <p>[The Company has] <i>implemented certain environmental control measures to ensure compliance with laws and regulations</i></p>	<ul style="list-style-type: none"> • What are these facilities/measures and why are they needed? • Are any performance indicators monitored? • If yes, against what standard/requirement are they audited? • Have there been any breaches in meeting legal and any other requirements and if so, what corrective action(s) has been taken? • How are such breaches to be prevented in the future?

Table 4 Red Flag Statements (continued)

Common Red Flag Statements	Initial Follow-up Questions for Investors
Water	
<i>Our Group's production plants do not discharge waste water/industrial waste water</i>	<ul style="list-style-type: none"> • Clarify what is meant by waste water. • Does the company have a water resource management strategy – as an example, does the company have any water recycling facilities?
<i>The Group is required to pay an annual environmental protection fee for the amount of pollutants discharged in excess of the limit allowed by the xxxx Environmental Protection Bureau</i>	<ul style="list-style-type: none"> • Clarify why discharges are necessary in excess of the legal requirements
<i>Our production processes require large amounts of water</i>	<ul style="list-style-type: none"> • What is the source of water? • How does the company intend to address the issue of water supply in the long-term and what are the implications on water use considering planned increases in production?
Energy	
<i>Production may be interrupted limited or delayed if it cannot obtain sufficient energy supplies</i>	<ul style="list-style-type: none"> • How does the company intend to address the issue of energy supply in the long-term? • Does it implement or plan to implement any energy efficiency initiatives if so, clarify details?
Legal Compliance	
<i>In a document dated xxx, the xxx Environmental Protection Bureau is satisfied that xxx and its subsidiaries in xxx, are in compliance with PRC environmental laws and regulations applicable to pollutant discharge</i>	<ul style="list-style-type: none"> • What is the nature of 'the document' and what is its legal standing? • What is the basis for Bureau's judgment?
Environmental Management	
<i>Our Directors believe that our production facilities conform to the applicable environmental protection regulations in the PRC in all material aspects</i>	<ul style="list-style-type: none"> • How does the company keep up-to-date with legal requirements? • On what basis is the directors' belief that the company is compliant?
<i>[The Company has] obtained waivers from the obligation to obtain a pollutant discharge permit for their current operations within the business scope indicated in their respective licenses</i>	<ul style="list-style-type: none"> • Clarify the reason(s) for such waivers?

ENDNOTES

- ⁱ Taking Stock – Adding Sustainability Variables to Asian Sectoral Analysis – Supply Chain, ASRIA, February 2006
- ⁱⁱ In some cases compliance is also addressed in the Risk Factors section
- ⁱⁱⁱ See <http://www.china-embassy.org/eng/xw/t237218.htm>
- ^{iv} Global brands include Puma, adidas, Nike, GM, Honda, Nissan, Ford Chrysler, Toshiba, Sanyo, Epson, Panasonic, Konika, Minolta, Liz Claibourne, Philips, Sony Ericsson, Kyocera, Motorola, HP
- ^v Taking Stock – Adding Sustainability Variables to Asian Sectoral Analysis - Supply Chain, ASRIA, February 2006
- ^{vi} Source: europa.eu.int/comm/environment/waste/weee_index.htm
- ^{vii} Included are automotive electronics, radar equipment, medical devices, semiconductor and other manufacturing equipment, components, some raw materials, etc. as well as packaging materials.
- ^{viii} It is noted that Foxconn was publicly criticized for alleged discrimination on HBV and at the time of writing was in the headlines due to claims over poor workplace conditions and excessive overtime
- ^{ix} ‘Wet Blues’ are cow hides or skins that have undergone chrome tanning and are wet and blue in colour
- ^x ISO 14001:2004 Environmental management systems. Requirements with guidance for use
- ^{xi} ISO 14001 What Investors Need To Know, ASRIA 2005

ABOUT ASrIA

The Association for Sustainable & Responsible Investment in Asia

www.asria.org

ASrIA is a not for profit, membership association dedicated to promoting corporate responsibility and sustainable investment practice in the Asia Pacific region. ASrIA's members include investment institutions managing over US\$4 trillion in assets, however membership is open to any organisation which has an interest in sustainable investment.

ASrIA has taken a leadership role in promoting sustainable investment in Asia since our founding in 2001. ASrIA has run conferences, seminars and workshops, and published wide-ranging research on SRI issues. ASrIA has also created a very wide network of organizations and individuals interested in the broad range of policy issues and investment strategies which are essential to the implementation of SRI in Asia. ASrIA's website, www.asria.org, is the primary resource for SRI in Asia, attracting over 4,000 page views per day and over 5,000 subscribers to our regular e-bulletin.

ESG Disclosure

