Stakeholder Governance

ESG as a Company Focus: Compliance Issue or Strategic Imperative?

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Margaret's portfolio includes advising young entrepreneurs, and supporting and advising organisations on governance and advising those, in particular women and BAME or LGTBQ+ people, who wish to embark upon board careers. She is passionate about establishing diversity on boards and is an ambassador of Board Apprentice.

Should ESG be relegated to a set of metrics that allows the Audit and Risk Committee of the Board to monitor a company's levels of compliance, or should a dedicated ESG committee promote relevant issues as part of the company's strategic ambition, for itself and also for society?

Introduction

The saving grace for the future of humanity and indeed the world must be whether through proper organisation we can mobilise both our combined power and our shared responsibility.

Some of the largest and thereby, most powerful organisations today are corporations, rather than governments. in 2021 Walmart, with 2.3m employees, would rank with the People's Liberation Army of China as the joint second largest employer in the world; and second only to the US Defence Department which according to 2015 records employed 3.2m. Amazon employs around 1.3m people. In terms of revenue, the World Economic Forum records that compared with the GDP of nations, Walmart would be the tenth largest entity in the world!

So, arguably, we might sensibly impose upon corporations a wider purpose than purely to be commercially successful to the benefit of shareholders; in other words, that they should also help us deal with many of the major issues we currently face, in so far as these issues might be considered relatable to the company's operation. In its programme 'Future of the Corporation', the final report of which has recently been published[1], the British Academy states that this 'lies at the heart of the future of capitalism, the future of humanity and the future of our planet'.

Increasingly, investors take the view that an acknowledgement of such wider purpose demonstrates a quantifiable additional asset value when it comes to assessing the value of the company. Indeed, the International Corporate Governance Network (an organisation principally made up of asset owners and managers responsible for invested assets of around $60 trillion) states that:

"The purpose of the company... calls for deep reflection and a long-term perspective with regard to balancing the needs and interests of investors and other key stakeholders. **Consideration of stakeholder relations and a company's broader social role also gives rise to how environmental, social and governance factors are built into company strategy and operations** – and integrated in investment analysis and engagement."[2]

It's important to examine what might now be considered a proper interpretation of the terms 'Environmental', 'Social' and 'Governance' for the purposes of ascertaining how a company might appropriately prepare itself to accommodate an understanding of those terms, and thereby promote, preserve and/or enhance the value of the company in line with its directors' statutory duties and so that this becomes clear to customers, investors and other stakeholders.

[1] 'Policy & Practice for Purposeful Business'; British Academy; 2021
[2] 'Policy Priorities 2020-21': International Corporate Governance Network; 2020

Company directors' duties

Company directors of course have several overlapping and separate responsibilities arising out of different regulation. The starting point of which in England and Wales would be those in Section 172 of the Companies Act 2006, which place a duty on directors to act in the way that they in good faith consider would be most likely to promote the success of the company. In so doing, they are required to have regard to a number of matters including:

- the likely consequences of any decision in the long term,
- the interests of the company's employees,
- the need to foster the company's business relationships with suppliers, customers and others,
- the impact of the company's operations on the community and the environment, and
- the desirability of the company maintaining a reputation for high standards of business conduct.

The enormous scale of the potential issues covered under the banner of ESG clearly demands a materiality test.

This extended focus on more than the commercial aspects that would promote the economic success of the company, requires directors to identify other key stakeholders, whose interests, in addition to those of shareholders, they should have regard, in arriving at their decisions.

This is important not only for the purposes of clear direction and recording, when decision-making, but also to enable directors consistently to explain or illustrate how key stakeholder interests have been considered or impacted. This helps the company focus on what is relevant to their operation even if wider impacts are also considered.

There will be those who still insist that the company has no business fixing climate change, considering public welfare, social well-being or social engineering or any wider purpose than to ensure that the company's value is preserved or enhanced to the benefit of its shareholders.

ESG can easily be relegated to a series of checks by those who see the company in this way – checks which serve only to establish compliance with necessary requirements and that regulatory or policy risks are not being taken that might undermine the company's reputation or jeopardise its commercial value. This view of 'useful metrics' will therefore be influenced only by what's needed to satisfy legislation, regulation or codified guidance.

The Audit and Risk Committee's traditional areas of oversight could legitimately be expanded in this regard sufficiently to ensure that periodic checks are carried out to a necessary standard. This is helpful only in a defensive way and doesn't encourage proactive strategic thinking about the company's role in the context of community, social issues, or the environment.

Corporate purpose and sustainability

However consumers increasingly show that they want to be reassured about a company's values when they interact; and investors increasingly make it clear that they not only look for indications that the company's inherent commercial value is being preserved or enhanced, but that the company also demonstrates its societal value. It can do so through having an enhanced stated 'purpose' or set of objectives that go beyond the defensive and beyond the preservation of commercial worth, by which the company gives a value to its 'values-set' and through which it can demonstrate the principles that it promotes, maintains or seeks to enhance. Tata, in India is a prime example.

Some analysts align ESG objectives with purpose objectives. Consultancy and accountancy firm Deloitte notes that "Purpose-driven companies witness higher market share gains and grow three times faster on average than their competitors, all while achieving higher workforce and customer satisfaction."[3]

Consultants Accenture's recent analysis showing the link between profitability and a mindful purpose found that: "Companies with stronger Sustainability DNA are more likely to deliver financial value and a lasting positive impact on society and the environment... The EBITDA margin of top quartile companies on [their] Sustainable Organisation Index is 21% higher (+3.4 percentage points) compared with the bottom quartile. Their sustainability performance is also 21% higher (+9.2 index points)".[4]

The Environmental Social and Governance purpose is considered by some as being necessary to support the company's framework for establishing its commitment to environmental, health and safety, corporate social responsibility, corporate governance, sustainability, and other public policy matters that are thus relevant to the company.

Some aspects of this responsibility are covered by legislation (such as relate to health and safety, equality and data privacy); other aspects are recognised in codes (such as those promoting good standards of corporate governance) and other aspects, like air quality, carbon reduction, water and noise pollution are covered by national and international government policy, regulation and codes, and importantly the Sustainable Development Goals of the United Nations, which are the fundamental policy context for all of these subjects.

The Sustainable Development Goals are the blueprint to achieve a better and more sustainable future for all. They address the global challenges we face, including those related to poverty, inequality, climate change, environmental degradation, peace and justice, Also known as the Global Goals, they were adopted by the United Nations in 2015 as a universal call to action to end poverty, eradicate inequality, protect the planet, and ensure that by 2030 all people enjoy peace and prosperity.

The enormous scale of the potential issues and subjects that might therefore sensibly be covered under the banner of ESG oversight and horizon-scanning for risks, clearly demands a materiality test to be carried out by companies and an examination of whether directors understand the materiality to their business in order that the executive isn't buried under an avalanche of studies, reports and accountability requirements and so that company resources are not unduly dissipated.

However, recent data from research by consultancy EY shows that many companies either had not performed a sustainability materiality assessment to identify and prioritise ESG topics (40 percent) or the directors were unsure whether such an assessment had taken place (12 percent)! EY noted that:

"Directors' views on what would improve their oversight of ESG matters reflects the potential value of a materiality assessment. When asked what would most enhance their board's current oversight of ESG matters, the top two answers were greater integration of ESG issues into discussions about strategy and risk (33 percent) and developing a better understanding of which ESG issues are material to the company (23 percent)—both of those actions are enabled by a robust materiality assessment."[5]

[3] 'Purpose is Everything'; Deloitte; 2021
[4] 'Shaping the Sustainable Organisation'; Accenture in collaboration with the World Economic Forum; 2021
[5] 'Four opportunities for enhancing ESG oversight'; EY; 2021

The need for strategic clarity

The lack of awareness on the part of so many directors suggests a lack of strategic clarity, a failure to communicate through management to the rest of the organisation what has been prioritised and who owns the delegated responsibility for delivery on the ESG or purpose imperative. It also suggests that there is no ostensible link between the company's reward incentivisation linked to delivery on any of these really important elements that involve ESG factors.

It seems clear that any positive strategy should sensibly start with a view to limiting their ambit to something ostensibly manageable whilst ensuring clear lines of ownership and responsibility for the issues of primary concern. This indicates a need for a forward strategy that would sit with a dedicated ESG committee or with the entire Board focussing on:

- **Environmental:** Impact upon and conservation of the natural world, having regard to climate change and carbon emissions reduction; and limiting any potential air and water pollution

- **Social:** Consideration of people and relationships, including employee interests, development, and well-being as well as customer satisfaction; data protection and privacy; and health and safety (specifically heightened in light of the pandemic)

- **Governance:** Standards and indicators used for giving investors comfort about the prudent and where appropriate progressive running of the company, including the impact on outlook and strategic direction from the Board and management operation and composition having regard to the impact of equity, equality, diversity and inclusion.

In order to understand these better perhaps the Board or Committee should consider a further level of detail, through questions such as:

Environmental

- How lightly are we treading on the world? How is the company using resources?

- Is this a question purely of aiming for a carbon neutrality in its operation or is there an expectation that the company will do more to promote more sustainable lifestyles in its employees, suppliers and customers?

- Does the company see its role as preservational of resources to ensure that its own asset value remains undiminished or does it have a wider view of its role?

The fragility of the world, the massively adverse impact of climate change strongly suggests that any company that does not see that it needs to have a strategy that is more forward thinking and strategically active than being purely preservational could experience a diminution of its reputation which these days would have an adverse impact on investment value.

Social

- Does we recognise a role for the company in creating social change/'social engineering' alongside its business objectives?

- Does our interpretation of ESG contribute to upholding the preservation or enhancement of the company's value to the benefit of our shareholders?

(In this regard it's useful to note that the actual output of the commercial aims of some corporations like Facebook, Amazon and Netflix clearly drives some cultural shifts.)

The range of the E part of ESG has been taken by most to mean that there should be a focus on climate change as that is mankind's most pressing agenda. But 'environment' does of course have a much narrower interpretation, requiring us to look at how we impact those in the 'vicinity' of our operation, i.e. the local community.

So an easy clarification of these two perspectives would suggest that we might do better to place the local community into the S category: Social. So that it isn't forgotten in our ambition to save the world from climate change damage. Consider, for example, the impact of Shell's oil extraction on Nigerian fishing communities and the massive compensation and reparation costs now faced; and the impact of disasters such as Chernobyl and Bhopal.

Governance

- How are the Board and Management running the company? Are they delegating competently, and appropriately allocating and overseeing responsibility?

- How is the Board monitoring, receiving reports and reporting to key stakeholders? Do those with responsibility understand the width and range of their responsibility and are they scanning the horizon appropriately to understand the risks that might undermine or compromise the areas of their responsibility, whether in terms of policy, regulation, or reputation? Does the company have the right structures in place?

As findings by consultancies like Accenture lead to the clear conclusion that there is significant capital value in companies actively nurturing a cultural shift to embrace sustainability and equity, this places a greater emphasis on the sense in companies having a strategic ambition for their approach to ESG rather than its being seen as appropriate for relegation to a mere regulatory or code compliance exercise.

Following data driven analysis, Accenture concluded, that 'operating sustainably and equitably is not an option – it's a business imperative' on the basis of which they maintain that the right diagnostic tools can sustainably drive profitability, that can 'realise the promise of stakeholder capitalism'

A matter of risk management or strategic planning?

On the basis that 'Governance' encapsulates a litany of rules, policies, behaviours and interests – from executive pay, board composition, regulatory oversight, ESG policies and fiduciary duties - it would seem that ESG is far too important to be reduced to risk management which can so easily become a mere compliance or box ticking if not seen as part of the organisation's strategic plan.

Such a plan should set out the most effective yet efficient route to achieve all elements of the strategic ambition toward active cultural shift. Furthermore, ESG might always be seen as secondary to the commercial and economic health of the company if seen only as part of a risk management focus for the enterprise, which would allow it to be accommodated within the limits of an Audit and Risk committee's oversight function.

Whether ESG is considered as critical to helping the company contribute to curing the mismanagement of global resources (and other issues of macro importance), or whether ESG is seen as a method of gaining and retaining talent, value and competitive advantage and of preserving if not enhancing reputation, it should clearly be part of a formal strategic planning focus.

This being the case, it would sit better with the whole Board or a dedicated ESG committee to identify and drive the issues, to oversee the delegations, and to monitor delivery and accountabilities, rather than its oversight being shoe-horned into the work of an already busy committee.

Some companies see the Social element of ESG as appropriately handled through the Remuneration or Compensation Committee. There is a danger that this limits its focus to employment and staffing issues (such as pay, well-being and EDI) rather than there being consideration of external social impact such as might avoid racist or misogynist advertising or promotions or that could create an environment in which disabled customers are not 'seen'. These latter issues matter very much to young people and companies that score badly on these risk an inability to recruit from the widest possible pool of talent.

According to the consultancy firm PWC[6] , pertinent questions are:

- **Strategy:** Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?
- **Messaging:** Do ESG messaging and activities align with the company's purpose and stakeholder interests?
- **Risk assessment:** Have material ESG risks been identified and incorporated into the ERM? Has the board allocated the oversight of these risks to the full board or individual committees?
- **Reporting:** What is the best communication platform to use for the company's ESG disclosures?

EY surveyed 400 directors[7] and found that many are approaching ESG as a compliance matter rather than as a strategic opportunity, and a number of them lack confidence in their understanding of shareholders' expectations related to environmental and social factors.

Understanding which ESG issues are material to the business is somewhat challenging for many directors, particularly for those who say their companies have not yet performed a sustainability materiality assessment. While most directors confirmed that their companies are reporting ESG information externally, only about a third of them say their company has controls in place around the collection and disclosure of material ESG information. Thought needs to be given to how the company can amass data in a helpful way, and whether the metrics used enable all relevant KPIs to be set to allow key stakeholders to understand the likely impact of the company's operation?

What is required now is a structured approach to delegation of all these issues, with top down interest and bottom up assurance, and for the reporting not to be enshrined in side-issue reports such as a sustainability report.

[6] A ESG Oversight: The corporate director's guide'; 2021
[7] 'Four opportunities for enhancing ESG oversight'; EY; 2021

It is now important for corporates to put these issues at the centre of their governance – so the board takes responsibility and delegates that successfully to directors who understand the width of their personal responsibility and who in turn, seek assurance from those to whom they delegate the operational aspects of the policy and its action plans.

This necessitates a reward strategy that underscores the importance of delivery on the ESG objectives. If the delegation is clear, the policy is transparent and there are periodic statements of assurance the reporting should be easy and reliable – and analysts and investors should understand the strength of the organisation. Its strength comes from its ability to analyse, understand and manage its risk.

It isn't that things go wrong that causes investors to lose faith in a company - it is the way the company demonstrates that it was ready and able to deal with the incident, evidence of sound structures being in place to anticipate, manage the risk, or to deal with the outfall of the incident arising. Lack of evidence of a structure severely undermines faith, and faith goes to value.

Investors' engagement can help to improve governance, diversity and ESG. So information and reporting should give them information to ensure appropriate understanding of the way in which value is being added through the company's acknowledgement of its wider purpose. The materiality of that purpose to the operation should, through carefully chosen metrics explain how KPIs are being met.

Boards are increasingly mindful today of their responsibilities to listen to shareholder concerns and investors are increasingly aware of the power of their activism.

The social imperative of improving diversity on boards and in management complements the economic benefit to shareholders. Governance diversity aids sophisticated horizon scanning as it enables a broader range of issues to be anticipated and accommodated. More varied

perspectives allow a wider view to be taken of the horizon of risks that may be scanned at any time; and because this can be achieved there is a broader range of expertise and skills that may be relied upon to manage risks.

Thus, there is a clear link between the S and the G if one defines 'social' as incorporating a view of equity, diversity and inclusion. It becomes clear that the way in which the company views its own diversity can be part of both its checks and assurance and the way in which it gives confidence to investors about the way in which it is protecting its own future.

However, one of the often-quoted concerns with regard to ESG is that there is a lack of standardisation in data recording and metrics, making it difficult for Investors to assess how best to make judgment about investment or divestment.

Executive search and governance consultancy experts, Fidelio recently published a report on a small survey that they carried out from which they found that the consensus was that "divestment did not encourage positive movement in strategy and that to 'invest and engage' is a productive approach". And that "measuring and reporting on portfolio exposures, such as on carbon intensity as against stock market indices, could provide valuable points of reference".

It isn't that things go wrong that causes investors to lose faith in a company but the way the company deals with the outfall.

A further analysis from an experienced practitioner states that:

- the asset management industry is putting significant resources into analysing, understanding, and measuring quoted companies current and future ESG plans and their anticipated potential success and failures;

- this is not on the basis of asset managers' altruism, rather than their recognition that long term share price performance will be closely linked to quoted companies' success or failure on ESG and particularly the 'E';

- many large asset managers are devoting substantial and increasing resources to climate change analysis and research (100+ MBAs each in addition to their normal research and fund manager teams). This therefore allows lengthy and comprehensive research and discussion with all large companies and detailed assessment of not only a company's climate change policy and plans but the likelihood of these plans actually delivering the desired results. For example, two oil companies having been found to have very similar carbon zero plans, one company was assessed as very likely to achieve its plan, while the other was seen as likely to fail.

On this basis, it is fair to believe that this analysis and pressure by the key owners of companies will ensure increasing focus and action toward achievement of carbon zero targets etc in the corporate world, to which ESG board committees contribute supported by shareholder pressure, which may well prove to be the key determinant of success in this crucial area.

We should also not underestimate the extent to which blockchain technology will in due course enable better strategic forward-planning to take place. For example, innovative enterprises like Vechain would allow sight and better understanding of the ripples that might be caused by the impact of something going awry in a specific part of a supply-chain (from employee discontent, or lack of capacity, to crop failure or climactic difficulties).

This would allow those making governance strategy decisions to map the implications, and isolate or even eliminate the elements that would be most adversely affected by the occurrence, so that the risk area can be properly managed or avoided, even before it arises to be dealt with. Again, this militates towards a forward-planning agenda and capability and suggests that an ESG committee's digital understanding needs to be appropriate to the task.

Summary and conclusion

'Governance' encapsulates a litany of rules, policies, behaviours, and interest – from executive pay, board composition, regulatory oversight, ESG policies and fiduciary duties. The governance aspects that are most important in terms of benefitting shareholders and other stakeholders changes over time – it tracks the mores of society, so deserves strategic review.

On a basic level it is very apparent that years ago when pure unbridled capitalism was king, and the primary stakeholders were the shareholders it was important only to ensure the financial health of the organisation. Therefore, the Audit and Remuneration committees were critical, and the report and accounts looked in just one direction: to the bottom line.

Similarly, the regulatory focus was financial, to ensure that the executive was extracting maximum value from all resources – including human and environmental resources - in order to ensure value for the shareholders, without extracting too much for themselves. So executive remuneration and reward was set to incentivise without taking out too much from the company.

As the individual was a resource, their career development was not of great significance, although successful career advancement might be a fortunate by-product for the few.

The environmental resource was seen as permanently exploitable so there was no need for any significant accountability about long-term strategy for curbing potential depletion of environmental resources, and societal issues were the responsibility of government or for the individual in their community and not for corporate institutions.

21st century employees or workers will no longer countenance being viewed purely as a resource and the COVID19 pandemic has made us aware that even the lowest paid undoubtedly have a critical value to the effective operation of industry that was previously, almost recklessly underestimated. This now necessitates a structural recalibration. It is not merely that individuals on minimum wage are now demanding and can command more, but as evidenced by the HGV driver shortage across Europe they also have leverage to demand better working conditions.

Similarly, the young want their well-being to have a relevance to future planning or they will just not stay around. So, the moral imperative to do better is allied to a commercial value to improve the strategic review not only of businesses but of whole industries – in the way that they look at appointment, support and development of members of their workforce, their impact on other resources and the society in which we now recognise business to be a critical part of a sustainable ecosystem.

Investors looked at the ESG track record of companies and would consider that if important KPIs were not met they could divest.

However, now that there seems to be a real need for national and transnational review of pay and employment structures - for example, where logistics and distribution have seriously lagged behind the demand and value that's extracted from 'just in time' retailing - it seems clear that retention of investment by investors, to allow them to be more proactive in the way they choose to engage, might promote behavioural shift leading to action rather than just words.

In 2006 the Companies Act brought in a reworked section 172 that asked us to have regard to treading lightly on the environment, knowing what was on the end of our supply chains, fostering better employee well-being and employee relations. The Board's interest in ensuring that there was accountability throughout the organisation, for all these areas, therefore had to become an integral part of the company's governance.

21st century workers will no longer countenance being used purely as a resource.

The assurance framework and whether real or tick box is increasingly deployed to helping our understanding of the health of a structure. The 2006 Act failed though, to impose an actual duty on directors to take account of the interests of stakeholders and the environment, which is why the IoD is backing the campaign for a Better Business Act which would introduce one. The Centre's Regenerative Business Working Group issued a paper earlier this year that explores this in more detail[8].

In the absence of such a duty, it behoves a company that wants to realise any capital value that may be derived from sustainability, to embed ESG strategy and an accountability structure that's driven by the Board or a dedicated committee as part of the overall strategy of the company formally within the enterprise.

This is most efficiently done through having a separate ESG committee; and enlightened companies are already looking to do so, or have created one. So taking retail as an example some elements of what the Co-op Group's founding fathers incorporated as its differentiating ethic are now found also to have a recognised value by a company like Tesco, that hitherto had always put the highest priority on realisation of financial success, and now has a dedicated ESG committee.

[8] 'Amending UK Company Law for a Regenerative Economy'; IoD Centre for Corporate Governance; 2021

About the IoD Centre for Corporate Governance

The IoD Centre for Corporate Governance exists to explore current issues in corporate governance, company stewardship and ESG - for the benefit of the business community, IoD members and wider society. The Centre arises from the IoD's Royal Charter obligation to "promote the study, research and development of the law and practice of corporate governance". The Centre functions as an independent, not-for-profit centre of excellence under the umbrella of the IoD. Please note that views expressed in Centre publications do not necessarily reflect the position of the IoD or the Centre Advisory Board, and are solely the responsibility of the authors.

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