

Could organisations more proactively address environmental, social and governance issues before being required to do so by regulation? How might this be achieved and what do you see as the role of the governance professional?

Introduction

‘Companies do not operate in a vacuum, and they cannot flourish in a parallel universe.’

A corporate citizen or a profit-making entity? For the benefit of society as a whole or an entrepreneurial mechanism for enhancing individual wealth? The role of the company in society has been debated and disputed globally, with differing theories and approaches emerging through the economic epochs that have permeated global markets in the last century. Moreover, there has been a gradual and yet remarkably impactful shift in organisational strategy, from a capitalist outlook – that is, wealth generation in the short term, to preservation and sustainability; the overall result being value creation in the long-term. Companies have been influenced and, in some instances, forced to adopt strategies of this nature due to enhanced legislation and regulation in connection with corporate social responsibility (CSR). This has had a huge effect on organisations, especially large international corporations and the responsibilities they have in their respective countries of operation. In particular, and with respect to CSR, a requirement that has gained significant momentum is the growing pressure on companies to address the environmental, social, and governance effects of their business (together known as ESG). Whilst the meaning of ESG is somewhat subjective, ultimately its purpose is to encourage corporations and investors to acknowledge their societal duties beyond their legal obligations, in turn creating sustainable capital markets and better outcomes for society both now and in the future. This essay will analyse whether companies should wait to be made to comply with ESG requirements or whether they should voluntarily seek to pursue objectives that address ESG issues and, if so, how they could do this and what the role of the governance professional might be in such a pursuit.

Evolution of ESG

It is practically impossible to discuss ESG without reference to its founding father, corporate social responsibility (CSR). CSR is the umbrella term for companies taking into account their responsibilities as an organisation for the impact they have on society. Its actual definition varies depending on location, approach to governance, and the type of company being discussed. In the UK (and western society more generally) the concept has gained significant traction since the 1980s, where a company’s focus on achieving financial wealth and the prioritisation of the quantitative above the qualitative began to worry the public. In response to a number of corporate scandals, the UK’s government felt societal pressure to introduce stricter legislation and regulation that legally obliged companies to take into consideration different stakeholder interests. These obligations were more complex and exhaustive for the larger, listed organisations and, in particular, there was a rise in regulation relating to the protection of employee interests, environmental

¹ Dr. Josef Ackermann, ‘The Role of Business in Society’, (*Annual Report 2010, The Conference Board*, 2010), <https://www.conference-board.org/pdf_free/AckermannEssay.pdf> accessed 26 December 2019

interests, supply chain and human rights interests, and the interests of the wider community as a whole.² With the development of CSR came an internationally recognised need for businesses to act in furtherance of society. Coalitions and committees formed across the world and this global drive for CSR stimulated a number of different movements, including ESG.

ESG is a vital mechanism for companies, critical to their value creation and, if not taken seriously, value destruction. It is an evolving phenomenon, concerned with environmental issues such as climate change, social issues such as modern slavery, and governance issues such as executive pay. A survey conducted by KPMG LLP found that,

...Business leaders acknowledge the value of addressing ESG concerns that are material to their companies, in line with growing evidence that ESG factors contribute to long-term sustainable financial performance.

In PwC's report on ESG, it is referenced that Larry Fink, CEO of BlackRock, emphasises that companies must serve a social purpose. He stated,

To prosper over time every company must not only deliver financial performance, but also show how it makes a positive contribution to society.

Companies that adopt this methodology usually engage directly in ESG practices. However, the question is whether companies should undertake this approach before the guiding hand of regulation intervenes.

ESG – proactive or passive?

A company is deemed to communicate with its stakeholders regularly on its mission, vision, values, performance and goals through its mission statement, code of conduct and annual report. Therefore, it is unsurprising that the primary way in which companies demonstrate their approach to ESG is through disclosure and reporting. However, unlike a mission statement, such reporting is usually mandated by law and regulation or recommended in best practice voluntary codes (non-compliance with which is often subject to scrutiny). Previously, reporting focused on a company's financial performance and shed light on little else. Now, listed corporations especially, are required to report on non-financial matters such as environmental practices, corporate governance, remuneration, supply chains, payment practices, and diversity. This enhanced reporting led to the evolution of integrated reporting, which focuses on value creation by delivering comprehensive and meaningful information to internal and external stakeholder groups.⁵ Going hand in hand with ESG, it collates key information about an organisation's strategy, governance, performance and prospects and in doing so, reflects the commercial, social and environmental

² Alison Dillon Kilbridge and Andrew Hamer, *Corporate Governance* (1st Edn, ICSA Publishing 2019) 258

³ KPMG LLP, 'ESG: A view from the top', (*The KPMG, CLP and HKICS Survey on Environmental, Social and Governance (ESG)*, 2018), <<https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2018/09/esg-a-view-from-the-top.pdf>> accessed 26 December 2019

⁴ PwC's ESG Pulse 2019, 'ESG in the boardroom: What directors need to know' <<https://www.pwc.com/us/en/services/assets/pwc-esg-directors-boardroom.pdf>> accessed 17 December 2019

⁵ Deloitte, 'Integrated Reporting', <<https://www2.deloitte.com/uk/en/pages/audit/articles/integrated-reporting.html>> accessed 24 December 2019

context within which it operates.⁶ This can be a costly exercise, and often it is argued that the burden on companies to disclose so much information is unfair. More than this, it is argued that increased levels of disclosure compromise competitive advantage on a global scale. James Dyson, the inventor and business tycoon opines,

It's not so much the cost of it — although there is a huge cost — it's the fact that our competitors in foreign countries can see exactly what we're doing and we have no sight of what they're doing.⁷

This, coupled with the cost and time associated with putting these reports together, can act as an overall deterrent to going above and beyond ESG regulations, much less proactively seeking out opportunities to promote it. It is understandable, therefore, to see why some companies, especially private ones (not subject to listing rules and continuing obligations) choose to take a passive approach to ESG: they can save on costs by adhering only to minimum expectations.

A downside to taking this approach, however, is that it fails to acknowledge the noticeable shift that there has been in investor behaviour. Investors are challenging companies to act in accordance with ESG principles and standards in order to be regarded as trustworthy.⁸ Companies who listen to their investors in this regard are more likely to secure capital, enhance their reputation and attract new business. Additionally, some investors have felt the need to take this responsibility to the next level, engaging directly in shareholder activism which, in its more extreme occurrences, compels companies to change their ESG policies for the betterment of wider stakeholder groups. By voting against resolutions at annual general meetings or making known to the public their discontent with a company's actions, activist investors can heavily influence the direction of an organisation, propelling ESG to the forefront of business decisions. An instance where this is commonly exercised is the controversial governance issue of executive pay. However, shareholder activism has faced criticism as to whether their positive effects are ever truly realised.⁹

...Critics of the movement raise concerns about the skewed interest of activist initiatives. This is because activists may not wait to see through the promised changes, instead capturing the momentum of media exposure...¹⁰

Despite this, activism in this sense is generally deemed to be an effective method for pushing through change and driving the agenda on ESG strategies in the boardroom.

In addition to having investors onside as a major benefit, companies that actively pursue ESG-centric strategies can boost their reputation with other external stakeholders such as consumers, potentially attracting

⁶ Ibid 5

⁷ Madison Marriage and Michael Pooler, 'James Dyson attacks private company disclosure rules' (*Financial Times*, 1 March 2018) <<https://www.ft.com/content/3785d034-1ca6-11e8-956a-43db76e69936>> accessed 24 December 2019

⁸ James Comtois, 'Companies must address ESG issues to be deemed trustworthy by investors — Edelman survey', (*Pensions and Investments*, 30 November 2018), <<https://www.pionline.com/article/20181130/ONLINE/181139989/companies-must-address-esg-issues-to-be-deemed-trustworthy-by-investors-edelman-survey>> accessed 24 December 2019

⁹ Yuliya Ponomareva, 'Shareholder activism is on the rise: caution required', (*Forbes*, 10 December 2018), <<https://www.forbes.com/sites/esade/2018/12/10/shareholder-activism-is-on-the-rise-caution-required/#7c5b76464844>> accessed 26 December 2019

¹⁰ Ibid 9

a wider customer base, thereby increasing revenue, demand, and securing brand loyalty.¹¹ ESG can also be seen as a means by which an organisation can develop competitive advantage within its industry.¹² By establishing forward-thinking policies that promote ESG and align with the interests of society as a whole, companies can ensure that they stand out, driving growth and marketability.

Finally, by staying ahead of the curve, companies – especially those which are listed or heavily regulated – may be able to act as a benchmark within their industry; a pillar amongst their peers, demonstrating new ways to tackle ESG in a climate where it is a hot topic of discussion. Garnering this type of positive attention and recognition may also curry favour with governmental and regulatory bodies, building trust and eventually allowing more scope for companies to self-regulate, rather than having legislation force-fed in reactive economic circumstances.

Given the aforementioned, it is difficult to see why a company would not proactively employ ESG friendly policies since doing so seems to present more benefits than passivism. It is worth considering, however, that there are still a number of reasons why companies may choose the passive option. One is that their approach to ESG matters may not produce results as expected. For example, companies who have complex and unachievable ESG targets will be reluctant to report on their unsuccessful ESG initiatives. They may therefore be more inclined to rely on regulation to set these minimum standards instead of using resources and time doing it themselves, only to fail. Another reason is that in order to have truly successful ESG outcomes, there needs to be a culture within the organisation that supports the underlying ethical behaviour that precludes it. Without this, companies may be accused of ‘greenwashing’ (a term that implies a company’s actions are misleading or unsubstantiated),¹³ making the approbation of stakeholders less likely; compromising the integrity of the company overall. It is important to note however, that embedding organisational culture can be a difficult and lengthy process that requires constant monitoring and adjustment. A culture that infiltrates a business at every level will also require commitment and an active focus at board level and again, companies may not view this as a worthwhile use of resource or time.

Whilst the passive approach may require less from a company in the present, it could compromise their ability to compete in the future. This is because organisations that proactively pursue ESG practices have become increasingly important to the current generation. Millennial employees, investors, and consumers are changing the discourse on the role of the corporation in society with CSR, ESG and sustainability at the very heart of the conversation. According to research by Forbes,

Millennials care deeply that the companies they work for (and the businesses they support) embrace values that are aligned with their own.¹⁴

¹¹ Avista Group, ‘Avista Insight – what are the benefits of ESG reporting to companies?’

<<https://www.avaval.com/en/publication/research-and-insight/2450-avista-insight-esg>> accessed 24 December 2019

¹² Ibid 11

¹³ Ibid 1, 263

¹⁴ Betsy Atkins, ‘How Your Company Should Embrace Environmental, Social And Governance Issues’, (*Forbes*, 21 November 2018) <<https://www.forbes.com/sites/betsyatkins/2018/11/21/how-your-company-should-embrace-environmental-social-and-governance-issues/#add2a46af8a8>> accessed 26 December 2019

Fortunately, there are a number of ways in which companies can address ESG issues of their own volition. One way would be to develop genuine partnerships with other organisations that tackle social matters, such as Unilever's Dove Self Esteem Project which partnered with Girl Guide Associations to improve body confidence and self-esteem of young girls on a global scale.¹⁵ Companies should be willing to dedicate effort and attention to projects such as this and to ESG as a whole by incorporating it into their strategy in an innovative yet genuine way, where the ethical values underpinning ESG are woven into the fabric of the organisation. Doing this increases the company's legitimacy amongst stakeholders and makes it more likely for initiatives to be tackled with greater enthusiasm by the workforce, improving the company's ability to realise ESG targets. Moreover, employees are key stakeholders too, so another way for companies to tackle ESG issues could be to include the workforce directly, asking for their suggestions on how best to fulfil ESG objectives. They could seek this involvement by forming working groups, advisory panels or encouraging participation in surveys. Not only could this provide a sense of morale, but it potentially avoids the need to use expensive consultants and strategists.

On balance, it seems more rewarding for companies to act proactively rather than passively when tackling ESG issues. However, in choosing the proactive approach, organisations ought to proceed with caution, assessing the risks as well as the opportunities that an ESG project or policy may present. In doing so, companies armour themselves against criticism, high costs, and limit their exposure to any potential risks.

Role of the governance professional

The Corporate Secretary is the guardian of the company's reputation, playing a pivotal role in maintaining the company's legal and social license to operate.¹⁶

Given that an element of ESG is in fact governance, it is crucial that the board has a governance professional who is able to ensure that ESG is consistently on the agenda and discussed intensely at board level. The company secretary is often the longest-serving member of the board, able to provide vital commentary on the history of the company and valuable insight on previous approaches to ESG. They are in an opportune position to advise on the risks and opportunities presented by different ESG strategies as well as ensuring compliance with the legal duties of the company in this regard. Additionally, the governance professional will be key in assisting the board to determine culture it wishes to set, providing a tone at the top that will support any future endeavours to proactively address ESG issues.

The company secretary should ensure that the interests of the wider stakeholder groups are considered, listen to the company's investors, and encourage the chairman to maintain an active dialogue with them so that the shareholder's vision of how the company should incorporate ESG into its operations are understood by the board and considered when developing related strategy and objectives.

¹⁵ Ibid 1, 266

¹⁶ United Nations Global Compact, 'The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide' (September 2016), < <https://corostrandberg.com/wp-content/uploads/2016/11/corporate-secretaries-guide-board-sustainability-governance.pdf> > accessed 26 December 2019

Overall, if a company is to proactively pursue tackling ESG issues, then it needs to ensure that they have an effective governance professional to act as a key driver, who thoroughly understands the importance of ESG both to the sustainability of the company and to the society in which it operates.

Conclusion

How society views the role of the company will continue to determine what is on the social agenda. ESG is currently the focal point and the manner in which organisations approach it is likely to be key to their success and longevity. It is clear that there are benefits to a company adopting ESG policies such as enhanced reputation and improving the societies and communities around them. However, it can also be argued that regulation will eventually mandate rules and standards that, at a minimum, protect the interests of society and the environment anyway, making the proactive pursuit of ESG slightly redundant or 'more trouble than it is worth'. Ultimately, companies could address ESG issues before regulation necessitates it and reap multiple rewards from doing so, but it largely depends on the board, the company secretary, their attitude to governance, and their willingness to mould corporate culture accordingly. Corporations should recognise that by embracing ESG, their sustainability and favourability amongst stakeholders is only likely to improve, as now more than ever, companies are truly being held to account and scrutinised heavily in the court of public opinion, where their saving grace may just be how much they have effectively sought to contribute to the society in which they operate.

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