Engaging boards of directors at the interface of corporate sustainability and corporate governance

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- Despite the growing significance of the corporate sustainability agenda, the level of engagement of the boards of directors is not clearly understood.
- A recent report encourages a practical approach for effective board engagement on relevant environmental or social issues that significantly impact business performance.
- Of critical importance is the integration of sustainability issues across the strategic agenda of the board.

Globalisation, privatisation and deregulation have meant that corporations have moved far beyond their traditional sphere of influence, thus presenting significant governance challenges.

As a consequence, corporate governance practices and the role of boards of directors are becoming critically important considerations with social, economic, environmental and political implications. As the body with ultimate responsibility for the governance of the corporation, the board of directors must navigate an increasingly complex and interconnected environment, whether through direct operations or globally connected supply chains. Yet remarkably little attention has been focused on the role of corporate boards in this area. As noted by Professor Robert Eccles (Harvard Business School 2014):

> Until recently there have been two separate worlds. There are experts in the fields of corporate governance, those who focus on compensation and other boardroom issues — and there has been the sustainability universe, which includes investors. Now we are beginning to see a convergence.[1]

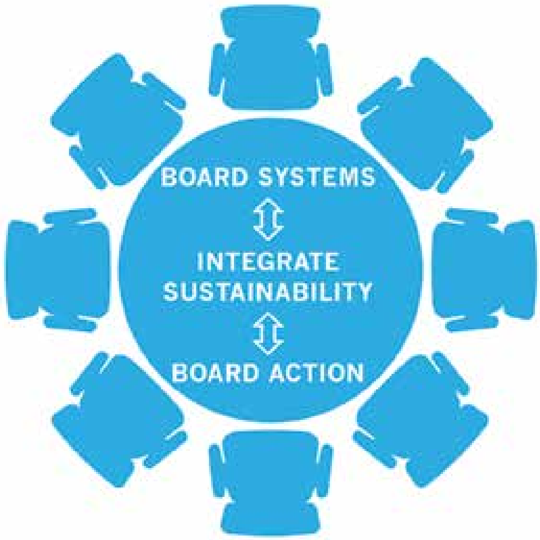
Setting the scene

Today, the field of corporate governance is converging with that of corporate sustainability, towards a re-assessment of the purpose of the corporation, or put more broadly, the role of business in society. Collectively, a new global dialogue is growing around businesses' activities in recognition of the fact that corporations have grown to become one of the most dominant institutional forms. Approximately half of the world's one hundred largest economies are global corporations. This figure is likely to grow with the continuing globalisation of trade and commerce.

As noted in the World Economic Forum's recently released *2016 Global Risk Report*, the internationalisation of business increases both economic opportunities, and exposure to global risks — environmental, economic and political. Over the past decade, a global regulatory vacuum has given rise to key corporate sustainability initiatives such as the UN Global Compact, the Global Reporting Initiative (GRI) and Integrated Reporting, in Australia and internationally. These initiatives aim to integrate broader multi-stakeholder issues into business models, and to assist companies in meeting environmental, social and economic challenges, in order to sustain a social license to operate. Seen as a form of global governance, they provide a voluntary, self-regulation framework for business, where civil society groups, international institutions, and business firms contribute and participate.

As a result, over 90 per cent of the world's largest 250 companies by revenue (G250) produce an annual corporate responsibility or sustainability report (KPMG 2013).[2] However, challenges persist. The corporate social responsibilities of business are being increasingly scrutinised through social and mainstream media, revealing ongoing issues such as human rights abuses in supply chains, tax avoidance, corrupt business practice, and a global lack of consistency in carbon reporting and performance (KPMG 2015).[3] For instance, around half of the world's largest companies do not publish targets for carbon reduction. At the same time, the 2016 Global Risk Report finds that a failure of climate change mitigation and adaptation tops the list of most significant long-term risks worldwide. Corporate governance inaction on climate change is increasingly likely to breach the directors' duty of due care and diligence as seen in international developments such as the Oslo Principles on Climate Change Obligations (Barker & Youngdahl, 2015).[4]

Figure 1: Sustainability integrated into board systems and action



Source: Ceres, 2015, *View from the Top: How Corporate Boards Can Engage on Sustainability Performance*.

Engaging boards of directors

Despite the growing significance of the corporate sustainability agenda at the interface with corporate governance, the level of engagement of the *boards of directors is not clearly understood*. A 2014 global survey of sustainability practices of nearly 3,800 senior managers and executives conducted by the MIT Sloan Management Review with the Boston Consulting Group and UN Global Compact,[5] found that 65 per cent of companies had corporate sustainability as a top management agenda item but only 22 per cent of managers believed that their boards provide substantial oversight on corporate sustainability (or CSR) issues. Barriers to engagement were perceived to be due to unclear financial impact, lack of sustainability expertise on the board, not seen as a priority for stakeholders, short-termism, shareholder value and a common misunderstanding about the fiduciary duty of the board. A joint report from Ceres[6] and Sustainalytics[7] (2014) evaluated the progress of over 600 of the largest, publicly traded US companies in integrating sustainability into their business to find incremental progress is underway but not at a scale that is required to tackle global climate change and other sustainability threats. A growing number of companies are incorporating sustainability performance into executive compensation packages and engaging investors on sustainability issues, particularly from those sectors with a high exposure to social and environmental risks. Some boards are beginning to see the connection between long-term competitiveness, sustainability challenges and corporate sustainability policy. A number of leading companies have begun to include sustainability expertise as a core criterion for board member selection. Yet more than 60 per cent of the companies surveyed have no board oversight of sustainability.

Earlier research may shed light on these results. In an experiment conducted with a sample of experienced corporate directors from US Fortune 200 corporations, directors were able to perceive the ethical and social implications of their role. However, they believed that corporate law 'requires them to pursue legal courses of action that maximise shareholder value', emphasising 'legal defensibility at the expense of personal ethics and social responsibility.'[8] Therefore it is likely that tensions and tradeoffs exist at the board level. Entrenched beliefs and practices of maximising shareholder value have lead to a focus on short-term over long-term performance, and a range of negative social and environmental consequences. In response, recent international collaborative efforts are challenging the norm of shareholder primacy, building a multi-stakeholder dialogue to assess how corporate governance and the fiduciary duties of boards of directors should be positioned in the 21st century. For example, Governance Institute of Australia's recently released discussion paper *Shareholder primacy: Is there a need for change*,[9] the Purpose of the Corporation Project,[10] and the UN Environment Programme's (UNEP) *Fiduciary Duty in the 21st Century*[11] report. The investment community, mobilising through bodies such as the UN Principles for Responsible Investment (PRI) is increasingly focusing on the role that corporate boards play in overseeing material sustainability issues as a part of their fiduciary responsibility, requiring a greater disclosure of a company's environmental, social and governance (ESG) practices and performance.

Practical guidance

Leaders of global corporate sustainability initiatives are also recognising the importance and challenges of actively engaging boards of directors (and the business institutions representing them) in order to achieve their objectives of an inclusive sustainable economy. For example, in a follow up to their earlier report, Ceres have recently launched *View from the Top: How Corporate Boards Can Engage on Sustainability Performance*[12] (October 2015). Based on extensive interviews with corporate directors, senior corporate leaders, and governance experts both in the US and internationally, the report takes a practical approach to identify key strategies for effective board engagement aimed at producing tangible environmental and social impacts. Two inter-related approaches are recommended. The first includes recommendations on how sustainability[13] can be integrated into *board systems and processes*, thereby ensuring that key issues are considered systematically and as a part of standard governance processes. The second approach outlines specific tactics for boards and individual directors, in order to take advantage of *opportunities for action* that build on the structures being put in place. Ceres believes that this combination of robust systems and responsible action will lead to meaningful sustainability performance improvements (see Figure 1). Specifically, in terms of effective board sustainability oversight systems, the report recommends:

- rather than considering 'sustainability' too broadly, focus on company-specific *material* issues that significantly impact operations and revenues
- embed sustainability in committee charters, and in discussions on strategy, risks and incentives
- recruit diverse candidates with expertise and backgrounds on key sustainability issues and offer sustainability training
- Involve key staff responsible for enterprise profit and loss in board deliberations on sustainability.

Recommendations for board action towards stronger sustainability performance improvements include:

Table 1: Integrating sustainability into existing board committee responsibilities

Governance committee: Oversee sustainability trends and their impacts on the business; Introduce director training for sustainability; Review corporate policies on sustainability.
Audit committee: Understand risks and opportunities relating to reporting the sustainability performance of the firm; Ensure quality and timeframe of sustainability and other corporate disclosures; Monitor research and development on sustainability; Ensure compliance with new regulations on sustainability.
Compensation committee: Link material sustainability issues to ESG targets; Integrate sustainability executive performance evaluations and compensation; Engage with investors on sustainability and compensation.
Nominations committee: Integrate sustainability into the director nominations process; Integrate sustainability into board performance evaluations.

- avoid over-emphasis on short-term returns by embedding sustainability and longer-term thinking in strategic planning
- integrate sustainability in risk oversight
- engage with external stakeholders
- establish stronger linkages between executive compensation and sustainability goals
- disclose the role of the board and its oversight in prioritising sustainability.

The report is designed for directors and executives looking to engage corporate boards on these issues. It could also be useful to investors and other stakeholders who want to assess how a company is being governed for sustainability.

Report author Veena Ramani, Senior Director, Corporate Program, Ceres acknowledges the challenges in implementing the report's recommendations. In particular, the board's agenda has become increasingly crowded. Therefore it is essential that sustainability issues are:

- made as relevant as possible to the business of the board. Rather than talk about 'sustainability' — a broad term that can be interpreted in many ways, the report encourages dialogue relevant to specific, material environmental or social issues that significantly impact operational and business function
- tailored towards the corporation's culture and strategic and operational priorities
- linked to risk and revenue deliberations.

These can be identified through formal processes run by management in order to determine sustainability opportunities and risks. For example, in extractive industries, where the impact of environmental and social issues are often better understood and are the focus of regulatory and compliance rules. In other industries such as heavily branded products, reputational risk may be the most material.

The report emphasises the importance of formalising sustainability at the board level by including specific mention in relevant board charters. As an example, the 2014 National Association of Corporate Directors report *Oversight of Corporate Sustainability Activities* includes a model charter for corporate sustainability committees that addresses purpose; membership; duties and responsibilities; performance evaluation; and structure and operations. Opinion is divided as to whether sustainability issues should be considered in a dedicated board committee where in depth considerations could take place, or integrated into an existing committee to incorporate these issues into core business functions, or finally as the shared responsibility of the entire board. Nevertheless, of critical importance is the integration of sustainability issues across the strategic agenda of the board. In their 2014 report *Integrated Governance: A new model for governance for sustainability*,[14] the UN Environment Programme Finance Initiative (UNEP FI) sets out how different board committees can incorporate sustainability into their functions. See Table 1.

To build sustainability capacity boards must aim to recruit diverse candidates with relevant expertise, provide training opportunities on sustainability priorities, and allow sustainability issues to be discussed as part of the board agenda. This includes making time for questions as a part of the strategic planning process which may lead to a greater understanding of the sustainability related responsibilities of the board, and better oversight of sustainability risks and opportunities (Table 2).

Table 2: Questions that boards should ask on sustainability

Materiality: What are our sustainability priorities and how were they identified? Are these priorities financially relevant to investors in the short- and long-term? Were stakeholders engaged in identifying these priorities?
Strategy and risk management: How have the sustainability priorities been factored into the strategic plan and risk management process? How are emerging issues being identified?
Disclosure: Have sustainability priorities and their impacts on the strategic plan been disclosed to stakeholders in a complete, comprehensive and credible manner?
Performance: What goals have we set to improve our performance on our sustainability priorities? How do these compare with the goals set by our peers? Do these goals set us up for leadership in our industry?
Scope: Do the sustainability goals cover our significant impact areas, including operations, supply chains and products?
Employees: What is our strategy to build our employee base to meet our sustainability priorities?
Compensation: Do we have the right incentives in place for management to meet sustainability priorities and goals?
Governance: Have we established a governance structure that allows the board to oversee the management of sustainability issues and their integration throughout the enterprise?

Source: Ceres, 2015, *View from the Top: How Corporate Boards Can Engage on Sustainability Performance*.

Collaborative efforts

In complement to the Ceres report's recommendations, other initiatives at the interface of corporate sustainability and corporate governance are underway. The world's largest corporate sustainability initiative, the UN Global Compact has also come to recognise the importance of board engagement in order to meet its sustainability leadership objectives. Piloted successfully across the boards of leading multi-national signatories, the Global Compact Board Programme[15] has been developed to provide boards with an opportunity to go beyond compliance issues, and consider emergent sustainability issues such as resource scarcity, climate change impacts, human and labour rights in the supply chain. The program, developed in consultation with each corporation, focuses on the integration of material sustainability issues in the corporation's strategy and business model innovation, and follows up with an action plan for embedding sustainability into board responsibilities and structures.

In association with the Global Compact Board Programme, an ambitious campaign is currently being led by Professor Robert Eccles and Tim Youmans of Harvard Business School in collaboration with the American Bar Association's Task Force on Sustainable Development.[16] As noted earlier, a key challenge in engaging boards of directors in sustainability issues relates to what is understood to constitute the fiduciary duty of corporate boards, that is, how a board defines and balances the often-competing interests among various stakeholders and the corporation itself. Careful legal analyses of the fiduciary duty of corporate boards across the jurisdictions of G20 countries (including Australia) challenge the myth of shareholder primacy and allow for a more considered deliberation of key stakeholders, material issues and long term performance of the corporation, by directors of boards. Preliminary findings reveal that, internationally, the board's duty is first to the corporation as a separate legal entity, as distinct from shareholders. Globally, the laws on fiduciary duty to the broader stakeholder interests are variable, from *specifically required to passively allowed*. For Eccles and Youmans (2015), the purpose of this campaign is to engage boards in identifying their most significant stakeholders (including shareholders) and the time frames in which the company evaluates the impact of its decisions on them. In short, a disclosure on how the board, looking after the interests of the corporation as a separate legal person, articulates the company's role in society as presented in an annual 'Statement of Significant Audiences and Materiality'.[17]

Conclusion

The role of the corporation in society is one of the most pressing issues facing the sustainable development movement, amplified by the recently ratified United Nations Sustainable Development Goals (SDGs). Access to and engagement of boards is of critical significance in driving the corporate sustainability agenda. Therefore the convergence of initiatives and resources at the interface of corporate sustainability and corporate governance is of particular importance. As the Ceres report concludes, there is no single solution to the question of how boards should oversee sustainability. Environmental and social issues pose significant risks and opportunities for long-term value creation across all industry sectors. The combination of capacity building and practical guidance together with collaborative efforts that challenge the norm of shareholder primacy signal a shift in the governance of corporations globally, making it incumbent upon today's boards of directors to engage in and contribute to these deliberations.

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Notes

1. Medland D, 2014, 'Protecting Long-Term Interests Of Stakeholders Is Fiduciary Duty.' weblog, *Forbes*, viewed 1 February 2016, <http://www.forbes.com/sites/dinamedland/2014/11/20/protecting-long-term-interests-of-stakeholders-is-fiduciary-duty/>.
2. KPMG 2013, Corporate Responsibility Reporting Survey 2013, viewed 1 February 2016. <http://www.kpmg.com/au/en/issuesandinsights/articlespublications/pages/corporate-responsibility-reporting-survey-2013.aspx>.
3. KPMG 2015, Survey of Corporate Responsibility Reporting 2015, viewed 1 February 2016. <http://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Pages/Corporate-Responsibility-Reporting-2015.aspx>.
4. Barker S & Youngdahl J, 2015, 'From ethical fringe to investment mainstream: Governance law and climate change risk management.' *Governance Directions*, 67(9), p.525.
5. Kiron D, Kruschwitz N, Haanaes K, Reeves M, Fuisz-Kehrbach SK and Kell G, 2015, 'Joining forces: collaboration and leadership for sustainability', *MIT Sloan Management Review*, Vol 56, no. 3.
6. Ceres is a non-profit organisation advocating for sustainability leadership based in the US, mobilising a network of investors, companies and public interest groups to accelerate and expand the adoption of sustainable business practices and solutions.
7. Sustainalytics is a provider of environmental, social, and governance (ESG) research and analysis to support investors around the world with the development and implementation of responsible investment strategies.
8. Rose J. 2007, 'Corporate Directors and Social Responsibility: Ethics versus Shareholder Value', *Journal of Business Ethics*, vol 73, no 3, pp 319-31.
9. Governance Institute of Australia, 2014, Shareholder primacy: Is there a need for change? viewed 1 February 2016. <http://www.governanceinstitute.com.au/media/695936/govinst_shareholder_primacy_disc_paper_october2014_web.pdf >.
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11. UNEP FI, 2015, Fiduciary Duty in the 21st Century, viewed 1 February 2016. <http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf> .
12. Ceres, 2015, View from the Top. How Corporate Boards Can Engage on Sustainability Performance, viewed 1 February 2016. <http://www.ceres.org/resources/reports/view-from-the-top-how-corporate-boards-engage-on-sustainability-performance/view>.
13. In this report, Ceres defines sustainability as economic, social, and environmental issues that affect corporate strategy and performance over the long term.
14. UNEPFI 2014, Integrated Governance. A New Model of Governance for Sustainability, viewed 1 February 2016. <http://www.unepfi.org/fileadmin/publications/investment/UNEPFI_IntegratedGovernance.pdf >.
15. UN Global Compact Board Programme, viewed 1 February 2016. <https://www.unglobalcompact.org/take-action/action/gc-board-programme>.
16. American Bar Association (ABA), Task Force on Sustainable Development, viewed 1 February 2016. <http://www.americanbar.org/groups/leadership/office_of_the_president/sustainable_development_task_force.html>.
17. Eccles R and Youmans T, 2015, 'Why Boards must look beyond shareholders.' weblog, *MIT Sloan Management Review*, viewed 1 February 2016, <http://sloanreview.mit.edu/article/why-boards-must-look-beyond-shareholders/>.

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