

Reimagining the Code for an ESG world

Singapore should consider more fully embedding environmental and social issues into corporate governance principles. BY MAK YUEN TEEN

ONE of the key decisions the Corporate Governance Committee which developed the first Code of Corporate Governance in Singapore had to make was whether to base it on the shareholder or stakeholder model. It opted for the shareholder model, although it recognised that enhancing long-term shareholder value requires the interests of other stakeholders to be taken into account.

The first paragraph of its report defined corporate governance as follows: "Corporate governance refers to the processes and structure by which the business and affairs of the company are directed and managed, in order to enhance long-term shareholder value through enhancing corporate performance and accountability, whilst taking into account the interests of other stakeholders. Good corporate governance embodies both enterprise (performance) and accountability (conformance)."

I believe it was the right decision to adopt the shareholder model at that time, to provide a clear focus for companies and boards.

But times have changed. Starting from the 2012 version of the Code, we have seen an increasing focus on the interests of other stakeholders not only in the Code, but in other rules, such as mandatory sustainability reporting and climate-related disclosures, as part of a global trend. More companies have been caught in scandals involving environmental and social issues, and such issues will affect more companies throughout supply chains. Some companies now base their business models on sustainability, even going as far as obtaining B Corp certification or legally registering as benefit corporations in some jurisdictions to signal a clear shift towards stakeholder capitalism.

Revisiting the definition of corporate governance

Although taking into account the interests of other stakeholders was acknowledged in the definition in the 2001 report, the Code itself said little about how other stakeholders' interests can be considered. When the Code was revised again in 2018, the definition was changed to the following: "Corporate governance refers to having the appropriate people, processes and structures to direct and manage the business and affairs of the company to enhance long-term shareholder value, whilst taking into account the interests of other stakeholders."

The main change – an important one – is recognising that good corporate governance requires having the appropriate people to direct and manage the company. Most of the problems we see in companies start with having the wrong people at the top.

But is the change sufficient? Although the interests of other stakeholders now figure more prominently in the Code, I believe we should consider more fully embedding environmental and social issues into corporate governance principles, provisions and guidance.

As I propose this for consideration, I am also mindful that we should not dilute the focus on the basic tenets of corporate governance. But as one chairman said, the Code is not for devils or angels. I am paraphrasing him, but essentially he said the devils won't care and angels don't need it.

We should look for other more forceful ways to send the devilish ones on their way – the Code is not the answer as they ignore the spirit, if not the letter, anyway. For them, we should try a hard-coded Ten Commandments approach instead, with a credible threat of consequences for violation.

Let me start with a proposed revised definition of corporate governance as follows: "Corporate governance refers to having the appropriate people, processes and structures to direct and manage the business and affairs of the company to en-



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PHOTO: PIXABAY

hance long-term shareholder value and safeguard the interests of other key stakeholders."

It is a slight change, but I think this places greater emphasis on the interests of other key stakeholders rather than phrasing it as an afterthought.

Board matters

As for possible changes in the Code itself, we can start with the board's role and putting a more explicit emphasis on overseeing environmental, social and governance (ESG) factors, including ensuring that they are considered in strategic decisions. The mix of skills, knowledge and experience on the board can be expanded to include experience in material ESG issues relevant to the company and sector.

The board should also have an explicit responsibility for ensuring that there is an appropriate sustainability governance structure in place. Currently, there are a variety of sustainability governance structures that companies have adopted.

While there is no "one size fits all" solution, the board should ensure that board and management responsibilities are clearly defined and allocated, competencies such as that of the chief sustainability officer are appropriate for their role, reporting relationships allow the board to exercise appropriate oversight and be kept informed, there are appropriate channels for reporting non-compliance with ESG policies, procedures and controls, and so on.

The 2018 UK Corporate Governance Code recommends that for engagement with the workforce (the "S" in "ESG"), companies should either have a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. At Rolls-Royce, for example, 3 independent directors are identified in the annual report as employee champions – one overall employee champion, another for North America and the third for Asia-Pacific. Even if we do not recommend a formal mechanism to link the board and

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the workforce, boards need to have a good process for understanding workforce issues.

On board performance assessment, this should include an assessment of the board's effectiveness in overseeing ESG risks and opportunities, including involvement in the materiality assessment of ESG factors and setting realistic goals and targets.

Remuneration matters

In May, I released a report titled *Integrating ESG factors into executive remuneration*, published in collaboration with Sustainable Finance Institute Asia and CPA Australia. While institutional investors are increasingly expecting companies to link ESG factors to executive remuneration, they are also wary about companies using vague or soft ESG goals to over-compensate senior executives. The report proposed 10 questions that remuneration committees and boards should consider in deciding whether and how to do so. The Code could more explicitly recommend that the remuneration committee (RC) considers whether and how to link ESG factors to executive remuneration.

Currently, the RC's responsibilities under the Code focus on remuneration of directors and key management personnel (KMP). I believe the RC should also review the framework of remuneration throughout the company, to ensure pay equity and alignment with stakeholders' interests.

While share-based remuneration is encouraged as long-term incentives for directors and KMP, RCs can also be encouraged to consider broad-based employee stock ownership plans for rank-and-file employees, to improve engagement and inclusion.

RCs can also be encouraged to consider whether it is appropriate to set a cap on the ratio of chief executive officer (CEO) remuneration to median employee remuneration to promote better pay equity, and it can be recommended that companies disclose this ratio and gender pay gaps, which are already mandatory in a number of developed markets.

Risk management, internal controls and whistleblowing

Risk management, internal control and internal audit should cover policies and controls relating to material ESG factors. Currently, whistleblowing policies under the Code focus on reporting possible improprieties in financial reporting "or other matters", and that the policy be clearly communicated to employees.

Companies can be encouraged to either expand their whistleblowing policies to cover reporting by employees and other stakeholders on material ESG

breaches, or ensure they have alternative mechanisms for such reporting. We have seen a number of cases where whistleblowers' reports on material ESG issues were not acted upon, eventually causing companies to suffer significant reputational and financial damage.

Other issues

Other issues that can be included or further emphasised include ensuring the integrity of both financial and non-financial disclosures (especially ESG disclosures); and board oversight over the appointment of any external firm providing independent assurance on the sustainability report and ESG disclosures.

The risk of companies being accused of misreporting on ESG factors is increasing, and boards need to ensure that external firms that are engaged to add credence to their reports and disclosures are actually competent and free from conflicts. Just in the past few days, we have seen one company with a secondary listing here being accused of misreporting its emissions. This company has an external firm which provided independent assurance. While I believe that companies that are genuinely trying to produce accurate reports may still get it wrong due to the complexity of such reporting, boards do need to ensure that their companies mitigate the risk of being accused of greenwashing or deliberate misreporting.

If we are serious about embracing ESG factors for a better future, then we should be prepared to reconsider practices that are largely driven by the pursuit of shareholder value. In addition to what I have proposed above, other practices done in the name of "unlocking shareholder value", such as share buybacks, should also be carefully evaluated by boards. Should a company buy back shares, or reinvest in environmentally-friendly projects and improve the lives of their employees?

I will conclude with one practice that I have personally been very reluctant for companies to let go of, and that is quarterly reporting. There is a case for not requiring companies to report quarterly in an ESG world where the focus is on long-term value for stakeholders. However, for the miscreants who are bent on destroying value and enriching themselves, the 11th Commandment should be "Thou shalt do quarterly reporting".

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