NUS National University of Singapore

Source: *The Business Times*, p15
Date: 13 December 2023

The board's key priorities for sustainability

Boards need to ensure that corporate governance, and the firm's policies and practices, support its sustainability journey. BY MAK YUEN TEEN

FOLLOWING the global financial crisis 15 years ago, many countries around the world began paying greater attention to sustainability and the interests of a broader group of stakeholders. By around the mid 2010s, sustainability reporting requirements for listed companies had been introduced in many countries. Nevertheless, these developments have occurred largely separately from reforms of corporate governance rules, although some principles and guidelines on sustainability started appearing in corporate governance codes.

Today, boards have a key role to play in guiding companies on their sustainability journey and should ensure that existing policies and practices at the board level and throughout the company are aligned with the focus on sustainability and the wider interests of stakeholders.

The sustainability reporting standard IFRS S1 issued by the International Sustainability Standards Board states that companies shall disclose "the governance body(s) (which can include a board, committee or equivalent body charged with governance) or individual(s) responsible for oversight of sustainability-related risks and opportunities" and specifically "how responsibilities for sustainability-related risks and opportunities are reflected in the terms of reference, mandates, role descriptions and other related policies applicable to that body(s) or individual(s)".

One of the most critical activities that companies need to get right is the assessment of what sustainability-related factors are most material for the company. PHOTO: ONG WEE JIN, ST

Ensuring appropriate competencies for the board and senior management

IFRS S1 also states that companies should disclose "how the body(s) or individual(s) determines whether appropriate skills and competencies are available or will be developed to oversee strategies designed to respond to sustainability-related risks and opportunities".

Boards should review the board skills matrix (BSM) used for their search and nomination process for directors. It is not just a matter of adding "sustainability" into the matrix but ensuring that the sustainability competencies are aligned to the most material sustainability-related risks and opportunities relevant to the company. A 2019 report by the NYU Stern Centre for Sustainable Business, based on a study of 1188 Fortune 100 board directors, found that while 29 per cent had relevant ESG credentials, most were under the "social" or "S" category and few had climate-related expertise.

Many companies disclose a BSM in their annual report and "sustainability" is now one of the most common skills/experience listed. Often, companies tick the box that most of their directors possess this skill/experience.

For example, one ASX100 company disclosed that at least seven of their nine directors have each of the nine skills/experience listed, with the box for sustainability ticked for eight of the nine directors. It could possibly have an extremely multi-talented board, but more likely the company is greenwashing the credentials of its directors.

Boards also need to ensure that management and employees are adequately equipped with relevant sustainability-related experience and knowledge.

To provide a dedicated focus on sustainability, more companies are appointing a chief sustainability officer (CSO). There is no "one size fits all" when it comes to the best candidate for a CSO. A director of a large European oil and gas company shared that it went through two CSOs who had strong sustainability credentials before landing on a third CSO who was a member of the senior management who knew the business. This third CSO needed to be a fast learner on technical climate change issues given its business.

One Singapore company has its head of corporate services double-hatting as its CSO. When I asked about the choice, it explained that most of the company's sustainability issues related to its supply chain, and procurement was the responsibility of its corporate services head. Another large Singapore company made its chief people officer concurrently the CSO, possibly because human capital issues under the "S" of ESG are considered most important. Employee-related factors made up three of the top 10 factors in this company's materiality matrix. A Malaysian insurance company made its chief of staff concurrently its CSO as her extensive experience in the business was seen to be critical.

One cautionary note relates to the tendency for some companies to make their head of investor relations or corporate communications the CSO. The perception this may create is that sustainability is more about public relations than integration into the business. I would also be somewhat sceptical if a company makes its chief legal counsel its CSO. This is not to say that such persons can never become effective CSOs.

Some companies are also supplementing the competencies of the board and management by co-opting external advisers, including forming external advisory panels.

One would expect more scrutiny of the "sustainability" credentials of directors and management by investors, as more disclosures are made pursuant to mandatory sustainability reporting standards.

Putting in place an appropriate sustainability governance structure

IFRS S1 requires companies to disclose "the governance body(s) (which can include a board, committee or equivalent body charged with governance) or individual(s) responsible for oversight of sustainability-related risks and opportunities".

Boards should review their corporate governance structure to ensure that they are equipped to oversee sustainability in an integrated manner.

A report by this author, published by Sustainable Finance Institute Asia and Governance for Stakeholders in February 2023, found a variety of sustainability governance structures that large listed companies in Australia, Singapore and Malaysia have put in place. Again, there is no "one size fits all" as to what sustainability governance structure works best for a company.

However, it is important that the board does not take a "silo" approach in addressing sustainability issues. For example, simply tasking a board sustainability committee or an existing committee like the risk committee or audit committee to address sustainability issues may not support the integration of sustainability into the business.

Materiality assessment of sustainability-related factors

One of the most critical activities that companies need to get right is the assessment of what sustainability-related factors are most material for the company.

The board should ensure that management is undertaking in-depth analysis, and review and challenge the materiality assessment.

There could be good reasons why the materiality assessment for a company is different from its peers in the same business as companies may have different business models and strategies. Nevertheless, it is useful for boards to ask for comparisons with peers and ensure that the company is not missing out blind spots.

Take the case of the four largest glove manufacturers in Malaysia. In 2022, many companies in this sector faced "forced labour" accusations from international NGOs and government authorities, with some facing export bans. The latest materiality assessments of these four companies were substantially different. While human rights, labour management, and health and safety were rated among the most material sustainability-related factors by two companies, environmental issues were almost totally absent from the most material factors. In contrast, another company had four climate-related factors listed among the most material, together with labour practices, workplace safety, and product quality and safety. The fourth company included a mix of business performance, data security and social issues among the more material, with only one factor which is directly climate-related rated very low in the materiality assessment.

Some key questions that boards can ask about the materiality assessment process include:

- What is the process used in identifying material ESG factors?
- Which internal and external stakeholders are involved, how are they identified and prioritised, and how did the company engage with them?
- Have we benchmarked our materiality assessment against our peers, standards and other external sources? What are the reasons for the differences?

Preliminary findings from my current study of published materiality assessments by listed companies in Singapore, Malaysia and Australia across 10 different sectors found that overall, climate-related factors are generally ranked last, with governance, economic and social factors ranked first, second and third respectively. The exceptions are two sectors where climate-related factors are ranked first.

Integrating sustainability into the business

In the Novartis Lecture in November 2021, Dr Lutz Hegemann, group head corporate affairs and global health of Swiss-based global healthcare company Novartis, explained how Novartis's materiality assessment underpins the integration of ESG into the company's strategy. In its case, the social element is inherent to why it exists and is reflected in its purpose and mission statement.

For Novartis, the most important ESG factors are innovation and access to its medicines. Other elements such as safe and effective medicines, and running the business ethically are also very important. The environmental factor is important, and Novartis recognises that it needs to consider how it can reduce any potential harm that its operations can do to the environment, but the company believes that this does not define the contribution it makes to society.

The most material ESG factors – innovation and access to its medicines – are then integrated into Novartis' business. Dr Hegemann shared how Novartis changed its business approach in Sub-Saharan Africa, home to the largest number of underserved patients. The company looked at how to make the biggest impact and measured that through patient reach, and included this metric into its decision framework, above all the traditional financial metrics.

This approach also helped the company perform better financially, demonstrating that purpose and profit need not be a paradox.

Effective integration of ESG into the business also requires the board to ensure that material ESG factors are considered in the business plans; risk management framework and policies; setting of goals, metrics and targets; and other company policies and practices. Boards also need to ensure that there are adequate resources to support this integration.

Other issues

Other important issues and developments in this area that boards need to pay attention to include whether and how to link sustainability-related factors to executive remuneration, the use of third-party assurance for sustainability reports, and greenwashing risks.

In summary, boards need to ensure that corporate governance, and company policies and practices are fit for purpose in supporting their company's sustainability journey. This has to start from an honest assessment of whether the board itself is fit for purpose. Investors need to scrutinise the true sustainability credentials of boards and senior management, and not just accept company disclosures at face value.

The writer is professor (practice) of accounting at the NUS Business School, National University of Singapore, where he specialises in corporate governance. He teaches a corporate governance and sustainability masters course at NUS and a programme on remaking corporate governance for an ESG world for Malaysian directors. This article is based on his forthcoming article in the journal of the Hawkamah Institute for Corporate Governance in Dubai, where he serves as a member of its international advisory board.