21ST-CENTURY GOVERNANCE

THE CASE FOR SUSTAINABILITY

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Social and environmental accountability is becoming the new benchmark for directors.

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A PIONEER OF BUSINESS sustainability, John Elkington, reminds us that corporate governance is about how, and in whose interests, companies should be run. In ground-breaking work that introduced the term 'Triple Bottom Line', Elkington described how social expectations have gradually transformed the governance of leading global companies.

THIS CHANGE HAS been driven not only by environmental crises, demands from consumers, and stakeholder activism, but also by the potential for harnessing entrepreneurial creativity for the good of society.

As Silicon Valley entrepreneur Peter Thiel said: "the most successful companies were never established to make money – they wanted to change the world."

In New Zealand, the traditional boardroom focus on shareholder value is slowly expanding to take in new thinking on sustainability. Broader understandings of corporate responsibility are being integrated into governance for New Zealand companies, as signalled by Air New Zealand's establishment of a high-powered advisory group to drive its focus on sustainability.

However, all too often the existing model still prevails. Increased diversity is only slowly filtering into most boards, and has yet to spark more profound, long-term thinking about the role of the board and the corporation in a complex and interdependent world. Most boards of New Zealand's listed companies are still oriented towards holding management accountable to shareholders, rather than themselves being accountable for corporate impacts on the environment and society. A culture change is needed in our boardrooms, institutional change is needed in the business sector, and our regulatory framework must be updated.

STEPPING UP TO THE CHALLENGES

The case for action on sustainability by business reflects the mounting challenges posed by issues such as climate change. The Paris Agreement of December, 2015 underscored the urgency of reducing emissions, and the importance of an integrated approach. Climate change cannot be left to governments to solve – all sectors within society must step up to their responsibilities to reduce emissions, and business has a crucial role to play.

For most enterprises, the term 'sustainability' provides a framework for business interactions with society. It has been used in business circles since the Earth Summit in 1992, to describe an integrated approach that includes the social, economic, and cultural well-being of people and communities, providing for future generations' needs, and safeguarding the life-supporting capacity of air, water, soil, and ecosystems.

The World Business Council for Sustainable Development (WBCSD) advises that sustainability should not be viewed through a compliance lens, but should be a framework for boards to think positively and creatively.

WBCSD noted that: "Power has already shifted from the corporate boardroom to company-stakeholder interactions as businesses have become networked organisations subject to multiple forces, rather than monolithic entities largely in command of their own destinies."

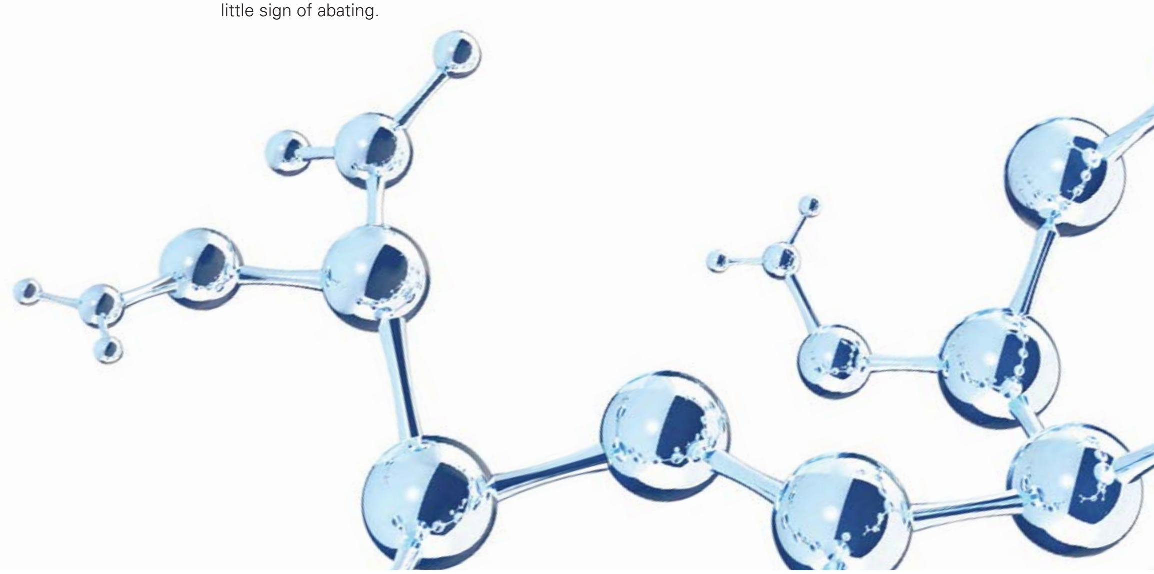
ALIGNING GOVERNANCE WITH ACCOUNTABILITY

Governance structures have been designed to ensure that managers pursue shareholders' interests, reflecting a concern that the interests of managers are not always aligned with those of owners. Therefore, the corporate governance agenda has been dominated by formal mechanisms for annual meetings and appointments of directors, pay and incentives, audit and oversight, and financial reporting.

In recent decades, the agenda shifted to a focus on transparency in the wake of corporate fraud, scandals involving Enron, Arthur Anderson, and WorldCom in the US, Parmalat in Italy, HIH and OneTel in Australia, and systemic governance failings exposed by the Global Financial Crisis. New Zealand has had more than its share of high-profile failures in corporate governance over the period, most notably including the failure of 67 finance companies in 2006-12 that cost $3 billion and affected 150-200,000 savers.

Ethical failings have been at the heart of most of these corporate failures, along with a narrow focus on maximising short-term profit and associated short-term key performance indicators for employees and managers. The governance response has concentrated on strengthening mechanisms for audit, control, risk management, and transparency, but it remains firmly rooted in the principal/agent model through legislative reforms such as Sarbanes-Oxley in the US, the Corporate Law Economic Reform Programme in Australia, and the Higgs Report in the UK. Reform in New Zealand has focused narrowly on the financial industry, through the Financial Market Authority (FMA) Guidelines of 2015.

However, recent scandals such as the deception practiced by Volkswagen and others on vehicle emissions show the limitations of these reforms, as does the lack of progress in restraining executive pay increases. The ratio of pay between chief executives and median salaries has increased from 30:1 to 300:1 over the past four decades, and shows little sign of abating.



CONNECTING SUSTAINABILITY TO GOVERNANCE

Despite growing pressures for action on sustainability, these issues are not always high on the agenda for boards. One reason is that the drivers for action on sustainability are not felt uniformly. Shareholder activism is not relevant for privately-owned companies, and some businesses' suppliers are neither visible to consumers nor part of consumer-facing supply chains. Others operate in highly price-sensitive, low-margin markets. Even where there are reasons for companies to act, some boards do not see sustainability as strategic. For example, a recent international study found that the majority of firms with climate change policies have never discussed climate change at board level.

Action on sustainability requires long-term thinking and a broad perspective. For most boards, there remains a tension between sustainability and investors' demands for short-term profits and increased share prices. Mark Wilson, the New Zealand CEO of insurance giant Aviva, recently spoke at the University of Auckland Business School about his decision to stop reporting quarterly results to investors on the grounds that this was driving a short-term perspective, rather than a longer-term commitment to investment and sustainability. He described the challenge of convincing Aviva's board that this change was necessary. Other business leaders, notably Paul Polman of Unilever, have also gained support from their boards for discontinuing quarterly reporting and setting ambitious goals for creating social benefit.

As well as having a long-term perspective, it is also important for boards to adopt a deeper understanding of shareholder value. In this context, investments in intangible assets need to be taken into account, as well as financial returns. For example, investments to promote sustainability can often be justified through less waste, higher efficiencies, or improved productivity, but for other companies the costs of action outweigh the direct benefits. These financial costs need to be balanced against a broader analysis of the value of the company's intangible assets.

Research by the US National Academy of Sciences shows that the value of intangible assets as a proportion of corporate net worth of the S&P 500 increased from 23 per cent in 1975 to 85 per cent in 2015. A significant proportion of intangible value is represented by corporate reputation, brand value, and stakeholder relationships. This is striking. For many businesses, corporate reputation represents a huge investment. It is enhanced by meeting or exceeding societal expectations for social and environmental performance and reduced when companies pollute the environment or exploit workers.

DRIVERS OF BUSINESS SUSTAINABILITY

A number of developments are encouraging companies to embrace sustainability. The pull comes from new opportunities. Consumers committed to Lifestyles of Health and Sustainability (LOHAS), comprise about 20 per cent of European consumers, an even higher proportion in New Zealand and Australia, and a rapidly growing segment in Asia. LOHAS, typically, are willing to pay more for products that are eco- and socially-friendly, provided the claims are supported by credible certification. The growth of such consumers is fueled by a generational change. Within a decade, millennials will amount to 75 per cent of the global workforce, and surveys suggest they will buy from and invest in enterprises that they feel an affinity with.

The push comes primarily from the threat to reputation and brand. A large global survey in 2013 revealed that nine out of ten consumers want companies to go beyond minimum legal standards, and to operate responsibly on social and environmental issues. In New Zealand, the 2013 Business and Consumer Behaviour survey found that 68 per cent of adults would switch brands if they felt a product or service was having a negative effect on people, the environment or society, or if a company behaved unethically.

NGOs and consumer movements play a crucial role in informing consumers and influencing companies, and in the absence of government regulation, retailers have responded by driving standards through their supply chains – not always in response to specific consumer concerns, but as a reflection of perceived responsibility. For example, UK retailer Marks & Spencer explains that its adoption of the Forest Stewardship Council (FSC) standard for timber products is not in response to consumer demands, but was part of its responsibility as a retailer to deliver products that do not destroy forests and harm local communities and wildlife. It is as much a part of the company's bond of trust with consumers as selling safe food.

Most New Zealand export-oriented agricultural producers are embedded in international supply chains. Farmers and processors increasingly are obliged to meet retailer-mandated standards, and to use tracing, verification, and labelling systems to contribute to credible supply chain assurance. As always, the challenge of complying with onerous standards can also provide an opportunity. Innovative New Zealand companies are able to gain access to highly competitive supply chains and attract a higher value through products differentiated on the basis of their social or environmental benefits, supported by credible social and environmental labels, including organic, fair trade, grass-fed and GMO-free.

Expectations of institutional investors have also motivated companies to take action on sustainability, especially in the US and EU. Verity Chegar, Vice-President of BlackRock, the world's largest asset manager, explains: "We are committed to measuring company performance against the key governance, environmental and social factors that we find support long-term, sustainable, financial performance". Its expectations of corporate governance include a long-term perspective, responsibility for sustainability at a senior executive level, strategies for managing risks, and transparent reporting. Partly as a result, reporting on sustainability increased from 35 per cent of Global Fortune 250 firms in 1985 to 93 per cent last year, according to Ethical Corporation. There is growing evidence to support the rationale for responsible investing. A recent review of more than 200 research studies by Oxford University's Smith School shows a positive correlation between sustainability performance and a lower cost of capital, improved operational performance, and higher share price.

NEW ZEALAND CORPORATE GOVERNANCE FOR SUSTAINABILITY

Change in corporate governance is accelerating in leading international companies, and New Zealand risks being left behind. There are few reliable surveys of corporate performance on sustainability performance, but New Zealand companies score low on key indicators. KPMG surveys show that our top 100 companies are amongst the bottom quartile in the international ranking of corporate responsibility reporting. In 2006, New Zealand topped the Yale Environmental Performance Index. By 2016 we were ranked 11th.

The expectations that society has of business are often encapsulated in the term 'social licence to operate' – the permission that society confers on business to operate, basing their legitimacy on social, environmental and accountability performance. A review of the concept for New Zealand business by the Sustainable Business Council found that "most New Zealanders want economic growth, but at the same time they want to protect the environment (even at the cost of slower economic growth and jobs) as this underpins their quality of life."

Public concern is regularly expressed over issues such as palm oil in chocolate, animal welfare of chickens and pigs, pollution of freshwater rivers and lakes, mining in wild areas, unsafe workplaces – most notably Pike River Coal, and food labelling for GMOs and sugar content. Brand reputations that have taken years and costly investment to build have been destroyed overnight through poor performance in these areas, where as companies that get it right are rewarded through a halo effect and strong brand loyalty.

There are now signs of change. When Air New Zealand announced its sustainability strategy to 450 business leaders in Shed 10 on Auckland's waterfront in November, 2015, it felt like a turning point. Not only was the strategy ambitious and comprehensive, but it stemmed from an innovation in the airline's governance system, through the creation of a highly visible Advisory Panel with independent members and specialist expertise. The Panel is chaired by sustainability leader, Sir Jonathan Porritt, and includes New Zealanders with strong sustainability credentials including Dame Anne Salmond, Rob Fenwick, and Derek Handley.

Other companies, including Vector and Villa Maria, are positioning themselves for a future of technology and market disruption. The message of opportunity amidst change is being highlighted by Pure Advantage, a group of business leaders who have identified seven areas of advantage for New Zealand business through action on climate change. In addition, worthwhile initiatives are being undertaken by support networks, notably the Sustainable Business Council and Sustainable Business Network.

The importance of sustainability to investors is also shown in the policies of New Zealand's largest investor, NZ Super Fund. It has a mandate to invest in ways that uphold New Zealand's international reputation, and is a signatory to the UN Principles of Responsible Investment. The Fund engages with fund managers and companies to improve sustainability performance, recognising that responsible investors must apply ESG principles to their portfolios because they are material to long-term returns.

New Zealand has few large New Zealand-owned companies, and a large number of small and medium-sized Enterprises (SMEs) and non-corporate entities – including co-operatives, state-owned enterprises, and social enterprises registered as charities. Some of the most exciting change on sustainability is coming from nimble and innovative SMEs. The annual Sustainable Business Network awards provide a snapshot of the dynamism and energy of rapidly growing businesses meeting customer needs and the demands of international supply chains.

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However, the adoption of good practice is uneven, and while there are examples of leading practice in New Zealand, evidence suggests that the majority of companies are falling behind. Outdated notions of good governance, which fail to reflect changes in societal expectations of business, contribute to a narrow view of directors' responsibilities.

STRENGTHENING GOVERNANCE GUIDELINES AND SUPPORT

Directors' organisations generally focus on shareholder interests, and do not give priority to the broader role of business. For example, the Institute of Directors' Code of Practice advises: "Accountability means, through independent oversight, making management answerable, and as directors being answerable to shareholders for the performance of the company" and "Fairness means the protection of shareholder rights".

The Code of Practice briefly acknowledges the need to "recognise and respect the legitimate interests of stakeholders", but this falls well short of leading governance practice that recognises multiple accountabilities and the obligation of business towards society and sustainability.

The Financial Markets Authority's handbook for directors, executives, and advisers, *Corporate Governance in New Zealand*, (2014), is virtually silent on the role of corporate governance in relation to the environment and society. In the 42-page document the only reference to social and environmental issues is "relevant social, ethical, and environmental factors need to be taken into account when considering the interests of stakeholders".

Without a stronger direction on governance for sustainability from support bodies, there is a risk that New Zealand companies will fall further behind international good governance for responsible business and that our international standing and business prospects will suffer as a result.

UPDATING THE LEGAL AND INSTITUTIONAL FRAMEWORK

REPORTING STANDARDS

The lack of action by New Zealand companies also reflects uncertainty about future regulatory standards. The legal framework in New Zealand has lagged behind developments in other countries. For example, the October 2014 EU Directive on reporting requires 6000 large EU companies to report on non-financial information, including human rights, by 2017. Companies including Unilever, Nestle, and Ericsson have programmes underway to extend their reporting to include complex issues such as human rights.

Several reviews are currently underway in New Zealand. The Financial Markets Authority is considering whether it needs to update its corporate governance principles in light of the OECD's new principles. Proposals have been submitted to the NZX reporting review calling for mandatory reporting of non-financial performance, or for a 'report or explain' requirement, supported by best practice guidance on materiality of issues covered, balance, and disclosure. This would bring the NZX into line with the Australian ASX's Corporate Governance Principles, which recommend that "a listed entity should disclose whether it has regard to economic, environment and social sustainability risks". The NZX should also consider joining the 55 members of the UN Sustainable Stock Exchanges initiative.

DUTY OF CARE

Currently, directors do not have a duty of care toward the environment or stakeholders in society, with the notable exception of the recently enacted Health and Safety at Work Act 2015. This Act creates an obligation on directors to provide a safe workplace, with penalties if they fail to do so. The legislation and its sanctions have sharply focused the attention of directors on health and safety issues, with early indications of a significant improvement in safety at work. The Health and Safety Act offers a model for extending a duty of care to the environment and other stakeholder interests.

DUTIES TOWARD STAKEHOLDERS AND SOCIETY

Legal clarification of directors' responsibilities may also be needed where there is a divergence between shareholders' interests and the public interest. Section 131 (1) of the Companies Act provides that directors must "act in good faith and in what the director believes to be the best interests of the company". This is generally interpreted to mean in the financial interests of the company. An ethical company might choose to 'do the right thing' and act in the public interest even when it is not in the company's financial interest, particularly where the company is tangibly adversely affecting others and not bearing the full cost of its actions. But there is a problem. A narrow legal interpretation suggests that directors have a duty under New Zealand law to pursue sustainability only where it can be shown to be in the interests of the business.

A divergence between private and social costs occurs where business activity creates costs that are borne elsewhere – by the environment, individuals, communities, other companies, or the public sector. Climate change has been called "the world's greatest externality" by leading economist Lord Nicholas Stern, in recognition that the costs of greenhouse gas emissions are not paid for by those who pollute. Such externalities become more common under 'light-handed' regulatory systems or voluntary codes of conduct which reduce the compliance burden and transfer decision-making to individual businesses. Under the OECD's Polluter Pays Principle, government regulation is guided to ensuring that polluters bear the costs of their externalities. At the very least, company law should recognise such obligations, and encourage the internalisation of costs, as part of the fiduciary duty of directors.

Unlike legal systems in many other countries, there is no explicit right in New Zealand for directors to pursue sustainability where it is not in the direct interests of the company. Germany's Corporate Governance Code recognises "the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value." Under South Africa's King Code of Corporate Governance it is unethical for a company to rely on society and future generations to bear the environmental costs of its operations because companies should ensure their impact on the economy, society and the natural environment is sustainable.

A change to company law in New Zealand could encourage companies to address externalities or risks through actions that do not create financial benefits for themselves. This would enable a more responsible approach, and would reflect the public desire for companies to act responsibly, beyond mere compliance with regulations. It would also make clear that companies could undertake activities for the benefit of society, even where there is no direct benefit to the company. ■

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KEY TAKE-OUTS

- New Zealand risks being left behind in the drive toward sustainability and the adoption of responsible governance practices.
- A multi-stakeholder approach is needed to restore the country's reputation for sustainability.
- Improving the sustainability focus of New Zealand companies would improve the country's international competitiveness in demanding supply chains and markets, as well as creating social and environmental benefits.