Directors' duties and sustainability: are you being true and fair?

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This article was previously published in the February 2004 edition of *Keeping Good Companies*, the Journal of Chartered Secretaries, Australia. The authors would like to point out that since then the importance of climate change to investors has been further emphasised in the US – the American Electric Power Company and Cinergy Corporation have both bowed to shareholder pressure to publicly report on their greenhouse gas emissions, and the business impact of potential federal and state regulation.

In the wake of recent major accounting scandals and corporate failures, spectacularly characterised by the collapse of Enron, Ansett, HIH and others, corporate governance is a hot topic for investors, regulators and companies alike. Regulatory bodies all over the world have leapt to address the apparent failure of current disclosure requirements with a wide range of legislative reforms and stringent new reporting requirements. Key examples include:

- The *US Sarbanes-Oxley Act*, and Financial Accounting Standards Board's proposed binding disclosure requirements about companies' intangible assets;
- the impending UK *Companies Bill*; and
- Australia's *CLERP (Audit Reform and Corporate Disclosure) Bill* (Cth).

At the same time, the need to deliver sustainable environmental, social and financial performance is emerging as a key concern for businesses and their shareholders, creating a host of new risks & opportunities.

The OECD estimates that the global market for environmental goods and services was worth US $550 billion in 2003, and projects that it will grow at 3-5% annually in developed countries, and at 8-12% in developing countries/economies in transition.[1] This bullish outlook is bolstered by the growing number of venture capitalists that identify the sustainability sector as one of three key growth opportunities (the other two being biotech and IT). In the view of one such investor, SAM Private Equity, the sustainability sector has the potential to generate a range of technologies that will produce disruptive changes in global industries, leading to outsized returns.[2]

This possibility of disruptive change is what presents the risk - if the venture capitalists are right, then existing businesses may suffer big losses as their industries are rapidly transformed. In light of the recent experience of the changes that the IT revolution brought with it, it does not take much imagination to see how sustainability technologies might well do the same.

So far these two developments - the renewed focus on corporate governance, and the growing interest in sustainability - have largely been proceeding along separate lines. However, it is increasingly apparent that they are in fact closely linked. This linkage becomes clear when considering the requirements that the *Corporations Act 2001* (**Act**) imposes on directors in relation to decision making and reporting - in particular, directors' obligations to diligently and carefully exercise their powers,[3] and to report annually on the company's financial and operational performance.[4]

The requirement that directors diligently and carefully exercise their powers is set out in s180 of the Act. This provision provides that directors and officers must exercise their powers and discharge their duties

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1 Dr Kenneth Ruffing (Deputy Director, Environment Directorate OECD), "Trade, Investment & Global Environmental Markets", presentation to Enviroseries 2003: Financing Sustainable Development Conference (Hong Kong Convention & Exhibition Centre, 10 September 2003)

2 Bruno Derungs (Principal, SAM Private Equity), "Creating Sustainable Value", presentation to Enviroseries 2003: Financing Sustainable Development Conference (Hong Kong Convention & Exhibition Centre, 10 September 2003)

3 Section 180 of the Act.

4 Part 2M.3 of the Act.

with the degree of care and diligence that a reasonable person would in the same circumstances. This duty is discharged in relation to business judgements that are made:

- in good faith for a proper purpose;
- in the absence of any conflict of interest;
- on an informed basis (to the extent reasonably believed to be appropriate); and
- in a rational belief that the judgment is in the best interests of the corporation.

Part 2M.3 of the Act deals with reporting requirements. There are two main reports that must be completed each year - a financial report and a directors' report (which deals with operational matters). The content of both of these reports are tightly controlled by detailed provisions in the Act. Of these provisions, particularly relevant are the requirements that the financial reports present a "true and fair view"[5], and that the directors' report addresses "any matter or circumstance…that has significantly affected or may significantly affect" the company's operations, results or state of affairs in future years.[6]

Directors that fail to comply with these requirements may be liable for a civil penalties of up to $200,000.[7] In the case of the reporting obligations, breaches that occur dishonestly constitute an offence that attracts a penalty of up to $220,000 and 5 years imprisonment.[8]

In order for directors to meet these obligations, it is necessary that they give careful consideration to their company's current sustainability performance, and what might be expected of it in the future. However, before examining this point in detail, it is perhaps useful to briefly review what sustainability is, and what it means for business today.

The concept of sustainability has been defined in many different ways, most of these definitions stem from the term "sustainable development", which was perhaps best defined by the World Commission on Environment and Development in *Our Common Future*:[9]

> *"Development that meets the needs of the present without compromising the ability of future generations to meet their own needs."*

In the corporate context, sustainability refers to initiatives that acknowledge this principle as a worthy goal, and seek to better align business practices with it. The growing acceptance of this as an objective, and the challenge of finding ways to incorporate such principles into business practice while achieving solid financial performance, is what creates the opportunities & risks discussed above.

Fund mangers are starting to pick up on this trend, and see value in measuring the sustainability performance of the businesses they invest in. This interest has led to the development of the Dow Jones Global Sustainability Index (**DJGSI**), which tracks the performance of sustainability leaders in all sectors. The DJGSI has consistently outperformed the Dow Jones Global Index since its inception in 1998,[10] suggesting that sustainability performance is a good metric for overall performance. In the Australian context, the Mays Report[11] reaches a similar conclusion - finding that sustainability performance can be a useful measure of managerial talent.

At a more general level, there is a growing acceptance that the intangible aspects of a company's business, such as sustainability performance make up the bulk of the value of a company. Examples of recent work in this area include:

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5 Section 295 of the Act.

6 Section 299 (1)(d) of the Act (This obligation is set to become more onerous in the case of listed public companies as a result of CLERP 9. The current draft of the *CLERP (Audit Reform and Corporate Disclosure) Bill* proposes a new s299A of the Act which would require (inter alia) that the directors' report for a listed public company include sufficient material to enable an assessment of the entity's business strategies and its prospects for future financial years.)

7 Section 1317G of the Act.

8 Section 344 of the Act.

9 World Commission on Environment and Development, *Our Common Future: Australian Edition*, Oxford University Press, Melbourne 1990, p8.

10 Performance statistics for the DJGSI are available at www.sustainability-indexes.com/htmle/news/monthlyupdates.html

11 Shaun Mays, *Corporate Sustainability - An Investor Perspective*, Canberra, Australian Government (Department of Environment & Heritage), 2003.

- A 2001 Brookings Institution study which concludes that roughly 85% of a company's true market value cannot be explained by traditional financial analysis;[12]
- Research by Deloitte, CSR Europe and Euronext which concluded that:
  - 80% of fund managers and analysts believe that the management of social and environmental risks has a positive impact on a company's market value in the long-term; and
  - 52% of fund managers and analysts believe that social and environmental performance will become a significant aspect of mainstream investment decisions within the next three years;[13] and
- Data presented by KMPG to a 2003 United Nations Environment Program Finance Initiatives meeting that showed that between 1996 and 2000 "10% of Fortune 1000 companies lost over 25% of their value within a one-month period", and that "in only 6% of [these] cases was the loss attributed to financial issues."[14]

With this in mind, institutional investors and fiduciaries are turning to a new breed of market analyst that offers assessment and comparison of environmental, social and governance performance of companies. As yet it is not clear which of the many competing approaches will ultimately be adopted as standard. However, this may not be a bad thing, as Robert Hahn and others have argued (in the wash up of the Enron scandal) that "policymakers should encourage experimentation in disclosure of a variety of non-financial indicators to better enable investors and analysts to ascertain the source and nature of intangible assets."[15]

One area where this trend is very well developed is that of climate change, an issue which is now widely acknowledged as being the world's major sustainability challenge. The major implication of climate change for investors is that they will increasingly need to be in a position to assess and differentiate between the carbon risk in different companies' operations. This is spelt out in some detail in the first report of the Carbon Disclosure Project (**CDP**),[16] which was established by 35 institutional investors (representing more than US $4 trillion in assets). The report summarises the results of responses to a survey sent by the CDP to the UK Financial Times 'FT500' regarding their understanding of and response to the risks presented to their business by climate change.[17]

The work of the CDP has sparked a number of similar projects, one of which is a recently released report on the impact of climate change on the automotive industry, *Changing Drivers*.[18] This report explores how carbon constraints in global automotive markets may affect value creation in 10 leading automotive companies between now and 2015. It translates an analysis of predicted costs of meeting new standards, and opportunities to capitalize on carbon constraints to enhance competitiveness, into changes in forecast Earnings Before Interest and Tax (**EBIT**) for each company. The report concludes that Toyota is best placed to capitalise on the coming carbon constraints, with a predicted 8% EBIT gain by 2015, and General Motors and Ford are worst positioned, with predicted EBIT decreases of 7% and 10% (respectively) over the same period.

Material like the CDP's first report and *Changing Drivers* provide a very tangible example of the implications that sustainability holds for investors and directors alike. In essence, they show that how a company responds to sustainability in the short term is likely to effect its financial performance in the long term.

12 Baruch Lev, *Intangibles: Management, Measurement and Reporting*, Washington DC, Brookings Institution, 2001.

13 CSR Europe, Deloitte and Euronext, *Investing in Responsible Business*, November 2003 (available from http://www.csreurope.org)

14 Commission for Environmental Cooperation & United Nations Environment Program Finance Initiatives, *Environmental Disclosures in Financial Statements: New Developments and Emerging Issues,* April 2003, p12 (available from http://unepfi.net/natf/materiality_cec_unepfi_nyc280203.pdf)

15 George Benston, Michael Bromwich, Robert Litan and Alfred Wafenhofer, *Following the Money: the Enron Failure and the State of Corporate Disclosure*, AEI-Brookings Joint Centre for Regulatory Studies, Washington DC, 2003.

16 Innovest Strategic Value Advisors, Carbon Finance and the Global Equity Markets, 2003 (available from http://www.cdproject.net)

17 The Carbon Disclosure Project (now representing 87 institutional investors with combined assets of US $9 trillion) sent a second survey to the FT500 on 1 November 2003, and intends to publish the results in May 2004.

18 Duncan Austin, Niki Rosinski, Amanda Sauer, Colin le Duc, *Changing Drivers: the Impact of Climate Change on Competitiveness and Value Creation in the Automotive Industry*, Washington DC, World Resources Institute and Sustainable Asset Management, 2003.

Compliance with the Act's decision making and reporting obligations in this context can be difficult, particularly given the current lack of knowledge about sustainability within companies. In respect of major decision making, it is likely that many boards would contain at least one member who would be unable to demonstrate that they had properly informed themselves in respect of the sustainability implications of some decisions that they have made in the past year.

Similar problems arise in relation to reporting. What material must be included to ensure that a financial report presents a "true and fair view", and that a directors' report identifies matters that "may significantly affect" operations is a difficult question. This difficulty is compounded by the fact these provisions have seldom been litigated.[19] However, as the body of evidence grows that sustainability performance and other intangible factors form the bulk of the value of a company, the more comprehensively these issues will need to be treated in the reports.

Directors of companies that are not in a position to determine the level of disclosure that is required, run the risk of breaching of the Act. Indeed, it is at least arguable that without a strong understanding of the intangible aspects of the company's operations, the directors cannot properly reach a conclusion about this question. It is likely that many boards contain at least one director who is currently in this position.

In the climate change context, the stakes are high. The CDP report concludes that, "[a]t the company level, an analysis of corporate 'carbon beta' – the metric for company risk exposure - implies that future threats to shareholder value differ significantly. Companies and industry sectors vary widely in their degree of risk exposure and the sophistication of risk management capabilities developed in response." [20]

The CEO of Innovest Strategic Value Advisors (authors of the CDP report), has noted elsewhere that: [21]

> *"Our own company's research has demonstrated that, in some high-impact sectors, even under highly conservative scenarios, as much as 45% of earning and 35% of total market capitalisation are at risk from the potential financial consequences of climate change."*

In the event that such risks crystallise for a particular company, it would be surprising if investors did not look closely at the level of disclosure made by the directors in previous reports, and ask some difficult questions about decision making processes. Whether litigation would follow is difficult to predict, particularly given the untested nature of the legislative provisions, however it is difficult to see how the careers of those involved would survive. With this in mind, current directors would do well to start educating themselves about sustainability issues, and ensuring that the companies they are involved with do the same.

19 The Act provides some guidance regarding "true and fair view" in s297 (which provides that this obligation must be met concurrently with the requirement in s296 to comply with accounting standards) and includes a note stating that where "compliance with the accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements".

20 The report goes on set out a number of examples in a table, reproduced below:

Autos	FT500 auto manufacturers vary by a factor of 35x in terms of reported CO2 emissions per vehicle sold/produced.
Electric Utilities	In the U.S. estimated total costs of reducing GHG emissions intensity by 10% range from over $1.7 to below $0.2 per MWh.
Oil & Gas	Total costs of reducing 2001 CO2e emissions by 10%, assuming a uniform 20_/t marginal abatement cost, range between 0.7% and 5.1% of"01 Net Income.
Banks	GHG-induced loan impairment of 10% could reduce share prices by up to 29%for banks without adequate carbon risk management.
Rail	In the U.S. a drought-induced reduction in agricultural commodity shipments of 5% would depress revenues by between 7.5% and 10.5% of net income.

21 Dr Matthew Kiernan, "The Perfect Storm: Climate Change and the new fiduciary" (in *0.618*..., UNEP FI, Issue 3, January 2003, p12) (available from http://www.unepfi.net)