What exactly is ESG?

Principles of ESG

As one of 2022's favourite phrases, the term 'ESG' essentially refers to Environmental, Social and Governance ('ESG').

For a better understanding, ESG is widely recognised to incorporate the following factors: environment, waste and pollution impacts [**ENVIRONMENT**]; wage conditions and diversity issues [**SOCIAL**]; and codes of conduct, anti-corruption, decision-making, and risk management [**GOVERNANCE**].

ESG vs CSR

This begs the question – is there not some similarities between ESG and Corporate Social Responsibility ('CSR')?

Whilst CSR discusses how companies can act ethically, ESG explores the specific metrics that quantify ethical outcomes and behaviour. CSR is the instrument used to hold corporations to account, whilst ESG is the mechanism through which specific efforts can be quantified and measured numerically.

Enforcement Schemes

Unlike CSR, it seems that corporations are taking ESG seriously and would appear to be held accountable.

An example is the European Unions' Corporate Sustainability Reporting Directive ('CSRD'), which will require certain corporations in the European Union ('EU') to expand the scope and extent of their reporting on non-financial matters. The CSRD will also apply to non-European Union companies that amass an annual revenue from the EU of over €150 million or that have securities listed on a market regulated by the EU. The CSRD requirements will likely begin to take effect from 2024 onwards. The European Financial Reporting Advisory Group ('EFRAG') will also produce standards for specific sectors.

Another reporting standard that would be prudent for companies to learn about is the standard produced by the Taskforce for Climate-Related Financial Disclosures ('TCFD'), which, as supported by G7 leaders, is predicted to become a reporting requirement for companies in the near future.

The TCFD produced four key recommendations that can be broadly applied across the board to companies and organisations, as well as guidance for specific finance-related disclosures, and broad and specific directions for sectors. The recommendations are formulated around the priority areas of risk management, metrics and targets, strategy, and governance. The four key recommendations are:

1. **Governance**: *Disclose the organization's governance around climate-related risks and opportunities*
2. **Strategy**: *Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.*
3. **Risk Management**: *Disclose how the organization identifies, assesses, and manages climate-related risks.*
4. **Metrics and Targets**: *Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.*

Shift in Corporate Practice

With the high-use and accessibility of social media, displeased consumers can easily gather and mobilise against organisations and companies which they deem to be unethical or unsustainable. This is something that investors are increasingly aware of when deciding to invest in a company.

A case study in the area of ESG that has been successful in influencing the practices of consumers and corporations is the Baptist World Aid Australia's annual 'Ethical Fashion Guide'. This guide follows the supply chain of large retail chains and exposes which brands are selling clothes made in unsustainable and/or modern slavery-type conditions.

They use six key indicators to develop their scores, which are (1) knowledge of source materials used along the supply chain; (2) payment a living wage to workers according to local standards along the supply chain; (3) the existence of avenues for workers to express complaints to the company; (4) the development of processes to deal with labour exploitation; (5) the sustainable use of fibres; and (6) a climate commitment and plan to cut greenhouse gas emissions in half by 2030.

Since first publishing their report in 2013, they have noted changes in the business practices of the companies assessed, including increases in raw material tracing, supply chain transparency, and an increase in awareness of the importance of ethical fashion – however, these improvements cannot be solely attributed to this one campaign, but a widespread effort to address exploitation within the textiles industry.

Legal Requirements

Company directors in Singapore (as well as Australia, the United States, and the United Kingdom) are at risk of "civil and criminal responsibility for actions and inaction" concerning climate issues.

Specifically, in Singapore, directors are subject to s 157(1) of the *Companies Act 1967,* which requires a director to always "act honestly and use reasonable diligence in the discharge of the duties of his office". Per s 157(4), this legislative requirement does not negate the directors' duties at the common law, meaning that the duty to act for proper purposes, amongst others, also applies.

Whilst a breach of the common law evokes a civil penalty, a breach of s 157(1) evokes a criminal penalty of a fine up to or equal $5000 or imprisonment up to or equal 12 months. This means that a director may be held liable if the court is of the opinion that said director, in order to act in a reasonable and honest manner, should have factored in climate risks in the making of their decisions. To avoid criminal liability, company directors must be careful in the discharge of their duties. An independent legal opinion released in April 2021 focusing on the responsibilities of directors in relation to climate change concluded that:

> *… any director who fails to factor in climate change considerations in their decisions qua director would be potentially exposing himself to not only criminal but also civil liabilities if either their company breaches provisions of legislation that prescribe measures for addressing climate change, or legal action is brought against the director for causing loss to the company by not considering climate change issues in their governance of the company.*

They also stated that:

> *… directors in Singapore are obliged, when carrying out their responsibilities as directors, to take into account climate change and its associated risks, particularly insofar as those risks are or may be material to the interests of the company.*

Despite this, there is yet to be a case in Singapore where a company director has been held liable on these grounds. Thus, it is crucial for individuals to be made aware of the legal requirements before becoming a company director.

Looking into the Future

All in all, it is clear that ESG is not a fad that will go away. The promise of financial return is no longer enough to satisfy investors of today. An increasing number of people are placing more value on companies which can demonstrate commitment and ability to create positive social, cultural and environmental change. It would thus be wise for corporations to look into incorporating new governance and directive policies, so as not to fall behind.

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