SME Governance

How ESG leads to better outcomes and why SME’s should act now

Prepared by CPA Australia ESG Centre of Excellence

July 2022

CONTENTS

VALUE CREATION THROUGH ESG

Environmental Social and Governance (ESG) refers to the three key factors used by society to measure the sustainability and ethical impact of an organisation as well as the processes by which an organisation is directed and controlled. Thus, ESG are areas of rapid, significant change, shaping how business is conducted, regulated, measured and reported on.

Opportunities are emerging for small and medium sized enterprises (SMEs) to voluntarily make statements and take actions on a variety of these emerging issues that can potentially:

- improve organisational sustainability,
- reduce risks,
- meet rising stakeholder expectations and;
- drive a strong ethical culture.

This briefing, aimed at CPA Australia members who are directors or advisers to SME boards, seeks to identify those areas where there may not be specific obligations or disclosure requirements in place today, but where there are decisions to be made that could otherwise benefit organisations in a variety of ways.

Directors, executives, and their advisers should look for the green shoots of opportunity to take strategic, calculated risks in pursuit of profit and purpose during times of great uncertainty.

Many businesses have found niche opportunities to grow, increase market share and strategically pivot as major disruptions shake up industries and unlevel playing fields. Global pandemics, geopolitical instability, digital transformation and shifting community expectations are devastating for some and energizing for others.

It can be easy to focus on an immediate risk such as the global pandemic and lose sight of other significant simultaneous risks such as climate change. Part of the problem is that these risks play out differently across regions, markets, industries and individual businesses. Risks do not necessarily operate in silos without affecting each other. As identified in a World Economic Forum Report[1], world lockdowns in the first half of 2020 caused global carbon dioxide emissions to fall in the first half of 2020, but these are likely to bounce back as vaccination rollouts provide a level of certainty to business operations.

Directors and officers of Australian companies registered by the Australian Securities and Investments Commission (ASIC) are required by law[2] to exercise their powers and discharge their duties “in the best interests of the corporation.” This extends beyond focus on short term profit to include making decisions while considering a range of environment, social and governance considerations such as those contemplated in this briefing.

Determining the extent to which these matters are issues for an individual organisation is not only good governance, for some, it may also simply be the right thing to do when acting within the social licence afforded to organisations by the communities within which they have been granted their ability to operate and ultimately generate profits to shareholders. Whatever the reason, be it a social moral conscience, a chance to stand out from competitors or as part of a strategy to build a strong culture or reputation, there are many opportunities available.

---

[1] The Global Risks Report 2021, World Economic Forum, 2021, p7 accessed from http://www3.weforum.org/docs/WEF_The_Global_Risks_Report_2021.pdf

[2] Corporations Act (2001) s 181(1)(a)

KEY OPPORTUNITIES

SMEs may consider a variety of emerging ESG issues in the current business environment, including:

Corporate Governance	Putting in place an appropriate board of directors, to oversee management, is one step SMEs can take towards good corporate governance. An Advisory Board could be an interim measure before a Governance Board is set up. Making disclosures in annual reports and policies on websites can augment these structures.
Climate Change & Sustainability Reporting	Managing the organisations demands and impacts on the natural world is critical, and disclosing plans, targets and actions can build a strong corporate reputation. Reporting can also alert the organisation to potential supply chain issues so mitigating strategies can be implemented. A related matter is that financial performance is readily measured and reported for most organisations, but consideration should be given to reporting against sustainability metrics.
Culture & Ethics	Crafting policies and making disclosures about ethical issues can improve trust in an organisation by demonstrating a strong culture of doing what's right. A strong and ethical culture plays a central role in sustainable decision making and thus profitability.
Diversity, Equity & Inclusion	Creating a workplace comprised of a diverse mix of mindsets, given equal opportunities of success, while being respectful and inclusive of the richness of talent available, can strengthen culture and improve decision-making. Organisations that embrace a diverse and inclusive culture perform better financially and in attracting and retaining talent.
Modern Slavery	There is a role for all organisations to play in the journey towards elimination of modern slavery from the world today. Increasingly customers, employees and stakeholders seek out organisations that demonstrate their commitment to the elimination of Modern Slavery.

All the above are important opportunities for SMEs, not only because of the social licence to operate and good business practice, but also due to the requirements for tender or contract with large enterprises and governments if SMEs want to work with them.

Corporate governance may be described as a system of rules, practices, and processes by which an organisation is directed and controlled. Corporate governance essentially involves balancing the interests of an organisation's numerous stakeholders including providers of capital, shareholders, employees, customers, suppliers, Government, and the wider community. The board of directors is the apex of this system, and is responsible for formulating strategic aims, providing the leadership to facilitate strategy implementation, supervising management and being accountable to stakeholders.

Leveraging the opportunity

The 4th edition of the ASX Corporate Governance Council Corporate Governance Principles and Recommendations (ASX Governance Principles) advocates eight principles on which an organisation's corporate governance practices should be built representing best practice that may be adapted to most organisations. These are to:

- lay solid foundations for management and oversight;
- structure the board to be effective and add value;

- instil a culture of acting lawfully ethically and responsibly;
- safeguard the integrity of corporate reports;
- make timely and balanced disclosure;
- respect the rights of security holders and;
- recognise and manage risks and remunerate fairly and responsibly.

From a regulatory perspective, the ASX Governance Principles only apply to listed companies but SMEs, may use these principles as a benchmark for appropriate corporate governance practice. Given the role of the board of directors, particular attention should be paid to best practice around the role of the board and its structure.

The ASX Governance Principles recommends that companies should structure their boards to add value. In order to determine whether an existing structure is ideal, some of the criteria suggested for use in conducting an assessment include the board having a proper understanding of, and competence to deal with emerging issues the business faces and the effectiveness of the board in independently evaluating, and when required challenging, management. In practice, a skills matrix is often used to optimise the balance of the board's skills and experience.

The ASX Governance Principles also recommends that in order to have in place an optimum board structure, company boards require a number of attributes:

1. The board should be made up of a majority of independent directors and be led by an independent chairperson.
2. There needs to be CEO duality, that is, the chairperson and the CEO positions should be occupied by two distinct individuals.
3. There are also recommendations that nomination, audit and remuneration committees should be established along with guidance on their structure.

Potential Benefits

By using the ASX Governance Principle as a template especially on the board of directors SMEs may:

- Attract directors with an optimum mix of skills and experience to facilitate innovation and improve board decision-making
- Provide new networks that facilitate connections and access to resources
- Provide oversight of management creating checks and balances
- Build reputational capital amongst their stakeholders including providers of capital
- Find it easier to attract and retain employees

In sum, paying attention to the role and structure of the board of directors and wider corporate governance systems is important to facilitate longer term organisational sustainability and profitability. It should also be noted that a strong board and governance system underpins an organisation's ability to take actions on a variety of emerging issues outlined in this briefing that can potentially improve organisational sustainability, reduce risks, meet rising stakeholder expectations and drive a strong ethical culture.

Whilst being cognisant of the statutory requirements of a minimum number of directors and their duties, an Advisory Board could be an interim measure before a Governance Board is set up. This is often adopted by SMEs to help guide and improve their performance.

CLIMATE CHANGE & SUSTAINABILITY REPORTING

> The systems and processes required for capturing, measuring, and analysing the information required to prepare sustainability reports will likely place a focus on integrated organisational thinking.

Over the past few decades, regulatory and societal pressures have prompted businesses to adopt environmental initiatives. These initiatives include divesting from fossil fuels, preventing pollution, developing environmentally friendly products, and helping other organisations in their supply chains to become more sustainable. However, many now see the world at a tipping point as regards the ability to mitigate the impacts of climate change on the environment.

The most recent Deloitte Global climate survey of 750 global executives worldwide conducted between January and February 2021 indicates that nearly 30% of those surveyed reveal their organisations already feel the impacts of climate-related disasters on operations and more than a quarter are facing resources constraints due to climate change.[3]

As a result of these environmental concerns, many organisations voluntarily provide additional disclosures about environmental and social issues over and above financial reporting requirements.

Several different frameworks and standards for sustainability reporting are available for organisations to consider reporting against. These include:

- United Nations Sustainable Development Goals (UN SDGs)
- Global Reporting Initiative (GRI)
- Taskforce on Climate-related Financial Disclosures (TCFDs)
- Integrated Reporting Framework (<IR>)
- Sustainability Accounting Standards Board (SASB) Standards
- Carbon Disclosure Project (CDP)

In November 2021 the IFRS Foundation announced the creation of the International Sustainability Standards Board (ISSB) This is a welcome move towards the urgent need for a single set of globally accepted sustainability reporting standards that are integrated, consistent and of a comparable standing with financial reporting standards. The ISSB has recently released exposure drafts:

- IFRS S1: General Requirements for disclosure of sustainability-related financial information
- IFRS S2: Climate-related Disclosures

Leveraging the Opportunity

Governments, business and investors have made ambitious commitments, in forums such as COP26, to significantly reduce their environmental impacts. However, whilst the supply of the resources and infrastructure required to meet these commitments is likely to expand, it is

[3] Deloitte (2021), "Climate Check: Business' Views on Environmental Sustainability"

predicted the rapid growth in demand will likely outstrip supply, heightening competition and increasing costs.[4] This period of sustainability driven scarcities in areas such as recyclable plastics, raw materials required for batteries, green hydrogen and sustainable cotton, amongst others, brings new risks but also opportunities.

Similarly, market mechanisms play an essential role in the allocation of capital SMEs need to invest and grow. The finance industry is increasingly relying on timely and relevant information that includes disclosures about environmental and social issues. Hence there is an economic imperative, including the potential to reduce the cost of capital, about being “ahead of the curve” and preparing such reports even when not mandated. There are also likely to be increasing supply chain pressures that will generate a demand for such reporting. For example, BHP recently took a further step in the push to slash carbon emissions across its global supply chain, with a new goal for suppliers to be carbon-neutral by 2050.[5]

There are considerable benefits to be derived by creating the systems and processes required for capturing, measuring and analysing the information required to prepare sustainability reports. These processes and ensuing sustainability information provides the basis for optimizing sustainable business practices including the reduction of waste and energy costs and promoting health and safety. The processes will likely place a focus on integrated organisational thinking, breaking down silos between business units and departments which facilitates an enhanced understanding of the key opportunities and risks facing an organisation.[6]

These systems and processes can also be aided by commercial software, some specifically for sustainability reporting with SMEs in mind.

Potential Benefits

There are numerous potential benefits from taking actions to reduce negative environmental impacts and embrace sustainability reporting. These include:

- Having relevant and reliable sustainability information better informs strategic planning, risk management and decision making
- Integrated thinking accelerating competitive advantage by identifying opportunities for action
- The potential to reduce the cost of capital
- Securing supply and innovating to address and potentially exploit sustainability driven scarcities
- Becoming a preferred supplier, especially to Federal, State and Local Government
- Attracting and retaining employees, especially Millennials and Gen Z who increasingly prioritize purpose in their careers
- Providing better information and a basis for valuation hence optimizing the potential to sell the business
- Getting ahead of regulation

[4] Young, D., Hutchinson, R. and M. Reeves (2021), “The Green Economy Has a Resource-Scarcity Problem”, *Harvard Business Review*, July.
[5] Toscano, N. (2021) “BHP sets ‘net-zero’ goal for suppliers as climate scrutiny grows”, *Sydney Morning Herald,* 14 September.
[6] International Federation of Accountants (2021), ‘Sustainability Information for Small Businesses - The Opportunity for Practitioners’

CULTURE AND ETHICS

In the aftermath of the Banking Royal Commission, the latest edition (4th) of the ASX Governance Principles has made a significant shift in focus to instilling a culture of acting lawfully, ethically and responsibly, resulting in three new recommendations on:

1. **Values -** requiring a listed entity needs to articulate and disclose its values.
2. **Whistleblower policy -** requiring a listed entity to develop and disclose a whistle-blower policy that complements new laws in this area passed in February 2019.
3. A**nti-bribery and corruption policy** - requiring a listed entity to have and disclose an anti-bribery and corruption policy and ensure that any material breaches of that policy are reported to the board or a board committee.[7]

Whilst the ASX Governance Principles apply to listed companies, the broader shift in community sentiment is also an opportune time for SMEs to reflect on their corporate culture and purpose.

Leveraging the opportunity

The importance of leaders going back to core values and purpose at a time of crisis, as well as when leading out of it, is becoming very apparent.[8] To that end, reflecting on purpose and developing a mission statement is often a useful start. Purpose should be systemic and coherent but also emotional.[9] Staff should identify with the mission, and it should guide their decision making. A mission statement can send a powerful signal to stakeholders through the clarity and integrity of the articulated purpose.

It is important to establish operations processes and systems to try and ensure that behaviours throughout the organisation's hierarchy are consistent with its culture and mission. Similarly, it is important to establish performance metrics to measure what the organisations wish to achieve as well as progress towards those goals. More broadly, SMEs should establish and communicate policies and the required standards of ethical behaviour within the organization.

Potential benefits

There is growing evidence showing that overemphasising financial targets erodes employee morale and undermines long-term strategy. This suggests that financial results are an outcome, not a fundamental driver of employee performance.[10]

Organizations that are driven by purpose are likely to:

- Help focus strategy and its implementation including through capital and other resource allocation
- Build reputational capital amongst their stakeholders including their customers
- Find it easier to attract and retain employees, that could be critical at a time of skill shortages
- Increase employee engagement of employees resulting in productivity gains

Overall, organisations that are driven by purpose often strive more to attain their goals and, as a result, achieve more.

---

[7] ASX Corporate Governance Council Corporate Governance Principles and Recommendations 4th Edition February 2019 https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf
[8] CPA Australia, (2021), "Leading Out of a Crisis: Some Perspectives from COVID-19"
[9] McKinsey & Company, (2020) "More than a mission statement: How the 5Ps embed purpose to deliver value", November
[10] McLeod, L. and Lotardo, E. (2021), "Financial Targets Don't Motivate Employees", Harvard Business Review

DIVERSITY, EQUITY AND INCLUSION

Listed companies have obligations [11] to have a diversity policy together with reporting requirements including disclosing objectives and progress towards those objectives for diversity of the board, senior executives and the workforce generally. Large employers[12] are also required to report[13] information about gender diversity within their organisations. In a pluralist society such as Australia however, diversity extends beyond gender identity to other factors such as sexual orientation, age, disabilities, ethnicity, religious beliefs, cultural background, socio-economic background, perspectives and experiences.

All employees deserve to be treated fairly but don't always start from an equal position. Some individuals will have greater obstacles and challenges that may require organisations to consider ways to make such barriers to success irrelevant through support systems to create equal opportunity.

Encouraging and empowering individuals, regardless of their backgrounds, to contribute to organisational success is key for promoting an inclusive environment.

Creating a workforce that is diverse, equitable and inclusive is a challenge for any organisation, but can bring significant benefits worth pursing, irrespective of legal obligations. . McKinsey & Co in a report issued in May 2020[14] state "…greater diversity, in terms of gender and ethnicity, is correlated with significantly greater likelihood of outperformance, more than that, fostering a diverse and inclusive culture is a critical success factor…"

Leveraging the Opportunity

There are many ways organisations can demonstrate an intent to be more diverse, equitable and inclusive, such as:

- Documenting a policy on diversity, equity and inclusion to nurture a strong culture within teams and share with external stakeholders.
- Investing in unconscious bias training programs.
- Considering diversity, equity and inclusion factors in strategic plans (including Board and senior management appointments and succession plans), and setting KPIs and targets
- Making voluntary disclosures about performance against targets

Voluntary statements about an organisation's position on important social matters can be displayed on corporate websites and be used in proposals and responses to tenders. Important customers such as Governments and large businesses tend to look favourably and increasingly require trading partners to have policies and reporting in place that measures how diversity, equity and inclusion are embraced by an organisation when evaluating decisions for investing funds and outsourcing work.

Potential Benefits

By taking the opportunity to develop policies, create plans and disclose performance about diversity, equality and inclusion, organisations may:

- Strengthen their reputation amongst their peers and attract more customers to their business

[11] Corporate Governance Principles and Recommendations, 4th Edition, February 2019, ASX Corporate Governance Council, Recommendation 1.5
[12] Generally, where the entity or group employs more than 100 employees
[13] Workplace Gender Equality Act 2012
[14] McKinsey & Company (2020), "Diversity Wins: How Inclusion Matters"

- Improve their ability to attract and retain talent
- Increase the engagement of employees leading to productivity improvements
- Foster an innovative culture to get the very best ideas and improve their decision-making
- Diverse organisations are more likely to outperform non diverse companies on profitability

In addition, there is an ethical perspective to diversity, equity and inclusion. It is simply the right thing to do and therefore important to longer term organisational sustainability and profitability.

MODERN SLAVERY

Slavery exists today in every region around the world[15]. It can include practices such as forced labour and human trafficking. In 2016, over 89 million people experienced some form of modern slavery[16]. Organisations have a responsibility to respect human rights both within their own operations and in the supply chains that provide goods to services to those organisations[17].

There is currently no legislation requiring businesses to undertake mandatory due diligence to assess modern slavery risks when procuring good and services from new suppliers, however increasingly stakeholders are seeking out organisations who embrace policies and procedures which work towards stamping out Modern Slavery.

Leveraging the Opportunity

Large[18] organisations are required to report on modern slavery in their operations and supply chains, including assessing and addressing modern slavery risks. However, SMEs may also choose to voluntarily act too.

Modern slavery statements can be voluntarily made by Australian or foreign entities carrying on a business in Australia if they don't meet mandatory reporting thresholds. However, if a voluntary statement is formally submitted to the Australian Border Force (ABF), entities will be bound as if they were mandatory reporting entities. For this reason, some organisations choose to note in their statement, that it has not been formally submitted to ABF.

Organisations may elect to develop policies and procedures regarding the on-boarding of new suppliers and require a due diligence exercise be conducted to identify any potential modern slavery risks. This can include enquiring into the modern slavery statements and practices employed by those suppliers, as risks can run into the entire supply chain, not just vest with the contracted parties.

Providing training to executives, managers and leaders about modern slavery and other human rights violations can build a strong corporate culture to further combat these risks.

Potential Benefits

First and foremost, adopting a position on modern slavery will play an important role in the eradication of such practices. It also signals to important stakeholders such as customers, investors and employees an organisations position. Importantly adopting a Modern Slavery Policy

---

[15] Modern Slavery Risks, Rights & Responsibilities: A Guide for Companies and Investors, ACSI, 2019
[16] Global Estimates of Modern Slavery, Geneva, 2017
[17] Guiding Principles on Business and Human Rights, United Nations, 2011
[18] With a turnover of more than $100 million under the Modern Slavery Act 2018 Cth (or $50 million under the Modern Slavery Act 2018 NSW)

can help protect your organisation from reputational damage associated with the exploitation of people.[19].

Reputational damage can affect share prices and sales volumes, and result in a loss of market share. Avoiding lawsuits and class actions, as well as reducing the risk to directors of civil and criminal proceedings for illegal forced labour may also be considered as benefits to taking an active position on modern slavery risks.

CONCLUSION

SME boards are operating in a period of exponential change that requires agile decision making. This goes beyond a focus on short term profitability and extends to a range of governance, environmental and social issues discussed in this briefing.

Whilst the regulatory and societal pressures to address these issues are largely directed at larger ASX listed companies, SMEs have an opportunity to enhance their reputational capital and to add economic value by being early movers while acting in accordance with their social licence to operate.

CPA Members who are directors, or who advise SME boards, have an opportunity to fashion these conversations and the transformations that will ensue. Therefore, we will be preparing a checklist of ESG matters for SMEs to consider and action over the coming months.

SMEs commencing this process need to avoid being overwhelmed by what is possible and prioritise their ESG efforts in accordance with their strategic context.

The risks of inaction could be significant.

---

[19] Modern Slavery Act 2018: A practical guidebook, Deloitte, 2020, p11

REFERENCES

Australian Council of Superannuation Investors (2019): Modern Slavery Risks, Rights & Responsibilities - A Guide for Companies and Investors
https://assets.kpmg/content/dam/kpmg/au/pdf/2019/modern-slavery-guide-for-companies-investors-feb-2019.pdf

ASX Corporate Governance Council (2019): Corporate Governance Principles and Recommendations 4th Edn
https://www.asx.com.au/documents/regulation/cgc-principles-and-recommendations-fourth-edn.pdf

Deloitte (2020): Modern Slavery Act 2018: A practical guidebook
deloitte-au-risk-modern-slavery-act-2018-guidebook-110820.pdf

Deloitte (2021), "Climate Check: Business' Views on Environmental Sustainability"
https://www2.deloitte.com/global/en/pages/risk/articles/2021-climate-check-business-views-on-environmental-sustainability.html

International Federation of Accountants (2021), 'Sustainability Information for Small Businesses - The Opportunity for Practitioners'
https://www.ifac.org/system/files/publications/files/SMP_Sustainability-Information-for-SMEs-SMPs_0.pdf

International Labour Organization and Walk Free Foundation (2017): Global Estimates of Modern Slavery: Forced Labour and Forced Marriage
https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/publication/wcms_575479.pdf

McKinsey & Company (2020), "Diversity Wins: How Inclusion Matters"
https://www.mckinsey.com/~/media/mckinsey/featured%20insights/diversity%20and%20inclusion/diversity%20wins%20how%20inclusion%20matters/diversity-wins-how-inclusion-matters-vf.pdf

Toscano, N. (2021), 'BHP sets 'net-zero' goal for suppliers as climate scrutiny grows', *Sydney Morning Herald,* 14 September
https://www.smh.com.au/business/companies/bhp-sets-net-zero-goal-for-suppliers-as-climate-scrutiny-grows-20210914-p58rey.html

United Nations (2011): Guiding Principles on Business and Human Rights
https://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf

World Economic Forum (2021): The Global Risks Report 2021
http://www3.weforum.org/docs/WEF_The_Global_Risks_Report_2021.pdf

Young, D., Hutchinson, R. and M. Reeves (2021), 'The Green Economy Has a Resource-Scarcity Problem', *Harvard Business Review*, July.