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CERTAINTY EMPOWERS YOU

ESG matters – just don't forget the G

January 11, 2022

December 2021 was the 20th anniversary of Enron's bankruptcy. The collapse of the Houston energy giant and Tech wannabe due to fraud caused the loss of thousands of jobs. Ordinary workers' retirement funds went up in smoke. Investors saw a company that once had a market capitalisation of around USD $300bn in today's money, go to zero.

Its demise was rapid: from the CEO's surprise resignation to game-over in less than four months. The shocking story captured America's imagination. Directors were jailed, the founder died from a heart attack before being sentenced, and one senior executive committed suicide.
To prevent similar collapses, the Sarbanes-Oxley Act was passed into US law in 2002 and with it came recognition of the importance of Governance, the discipline that encompasses everything to do with the management, supervision, and regulation of a corporate entity.
In today's Australia, Environmental, Social and Governance (ESG) has been frequently stated as a top priority in the year ahead for business leaders and investors. But we must not forget the G.

Despite its inclusion in ESG, Governance tends to lag behind when set against Environmental and Social issues. It offers no existential threat to the world and its population, no climate catastrophe or icecap endangering ticking time bomb. Nor does it jeopardise the mental health of the vulnerable, subvert the democratic process or impinge on people's privacy. Matters Environmental and Social quite rightly grab the headlines.

However, Governance does play a vital role in the success of Environmental and Social initiatives and importantly, ensures investors, staff and government stakeholders are not misled. Governance is the original gangster - not just the G but the OG: the discipline without which the first two constituents of ESG would be less effective.

Australians pay a price for domestic and offshore governance failures. Beyond Enron, we only have to look at WorldCom, Tyco, multiple financial institutions in the GFC, and Wirecard, to see the extent of damage beyond the confines of their corporate borders. Australia has not been without its own smaller but notable debacles such as ABC Learning Centres and Babcock & Brown.
The critical importance of Governance can be appreciated by focusing on two areas: disclosure and earnings quality. If Australia is truly committed to ESG in 2022, we must place greater focus on them.

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Disclosure may be a concept so dry that it has you reaching for the pillow, but it supplies the answer to the first of all ESG questions: does this company publish sufficient, accurate information for an outsider to understand how the company is run?
Most large public companies now regularly disclose their senior management's remuneration policy. As remuneration tends to drive behaviour, the way it's structured can offer powerful evidence on where a company's Environmental and Social priorities lie. Take French oil major TotalEnergies, which will be excluded from some portfolios as a fossil fuel company, but which is arguably a poster child for its ambition to transition to renewables.

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It is encouraging that TotalEnergies has disclosed that nearly half of its CEO's variable remuneration depends on ESG criteria such as safety targets, the evolution of greenhouse gas emissions and Corporate and Social Responsibility (CSR) performance.

There is clearly a difference between ambition and execution, but this sort of policy shows the Board is ensuring goal congruence by aligning ESG and senior management targets.
Earnings quality will also be vital for Australians to watch this year. Earnings quality not only shows whether a company's accounts provide a truthful picture of its economic reality, but importantly, gives a near objective insight into the type of management with which stakeholders are dealing.

Earnings quality answers important questions by focusing on, for example, cash flow rather than profit, and the differences between the two. Profit is an accounting phenomenon open to distortions and manipulation. Cash flow, on the other hand, is a more robust measure. To paraphrase an old golf saying: profit for show, cash flow for dough.

Now there are investors who claim to have greater insight than usual by being close to management, but it doesn't take much examination to see that this is hard to prove. After all, what constitutes closeness, especially in an age when regulation is rightly focused on a level playing field?

I would argue that with a few hours digging into the accounts, Australian investors should be able to understand a great deal about the people running a given company. In Enron's case, outsiders would have benefited by focusing on the company's financial statements rather than believing the lies of its management.

As our nation heads into 2022 with increasing focus on Environmental and Social commitments and action, it's clear that without Governance, without the OG, Australian stakeholders will be far less able to judge if a corporate entity is delivering on its commitments. And that will be to the detriment of us all.