

## GOVERNANCE, BUSINESS AND THE ENVIRONMENT

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### Abstract

Traditionally, discussions on corporate governance (CG) have largely focused on economic sustainability. This is not surprising as CG issues have largely arisen out of accounting irregularities uncovered at prominent organizations, such as Enron, Tyco and WorldCom, and various other well-known companies. The focus of CG now, however, is broader...besides profits, companies are also focusing on the “people” and the “planet” too. Thus, the emphasis of CG today is on both the economic and environmental sustainability. Given this, boards cannot be lackadaisical about social and environmental issues. How can companies achieve this? According to the Coalition for Environmentally Responsible Economies (CERES) in its CERES Roadmap for Sustainability”, a sustainable company is one that has the necessary governance structures in place, extensive stakeholder engagement undertaken and the standards and scope of public disclosure and transparency instituted. Essentially, the Roadmap contains 20 specific expectations for corporate performance that are categorised into 4 main perspectives: governance, stakeholder engagement, disclosure and performance. Thus, companies should embed sustainability issues in management and board structures, goal-setting and strategic decision-making and engage in robust dialogue with stakeholders across the whole value chain. Additionally, companies should regularly report on sustainability strategies and performance. Disclosure will include credible, standardized, independently verified metrics encompassing all material stakeholder concerns, and detailed goals and plans for future action. Further, a sustainable company is one that embarks on achieving reductions in carbon emission and water use, procurement of renewable energy, improved energy efficiency and having a supply chain that meets high environmental and social standards. More importantly, companies are increasingly aware that a large part of their output consists of material waste (or non-product output). In particular, material flow cost accounting (MFCA), an environmental management accounting (EMA) tool that has now become an international standard, ISO 14051, can help companies address environmental issues as well as improve their bottom lines. Finally, to be proactive on environmental issues companies must understand and manage its environmental costs; introduce waste minimization schemes; understand and manage lifecycle costs; measure its environmental performance and embark on a strategic approach to environment related management. Most importantly, the tone should be set at the top. Top management commitment is essential, preferably at the board level. Accordingly, companies should ensure that directors’ skill sets include risk management of social and environmental issues. Most importantly, companies should realize that enhanced environmental performance can and will lead to improvement in the economic performance of the enterprise.

*Keywords* : Corporate Governance, Coalition for Environmentally Responsible Economies (CERES)

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### 1. INTRODUCTION

Traditionally, discussions on corporate governance (CG) have largely focused on economic sustainability. This is not surprising as CG issues have largely arisen out of accounting irregularities uncovered at prominent organizations, such as Enron, Tyco and WorldCom, and various other well-known companies. The focus of CG now, however, is broader...besides profits, companies are also focusing on the “people” and the “planet” too. Thus, CG is not solely focusing on economic sustainability but CG is also about environmental sustainability. In fact, the 2013 KPMG report on CG and sustainability revealed that between 30 and 40% of the world’s largest institutional investors and asset managers systematically take into account management activities relating to social responsibility,

environmental protection and corporate governance. Additionally, the PricewaterhouseCoopers survey on Gen Y employees in 2009, found that 86% of respondents “seek employers with social responsibility values that reflect their own” and that 77% would consider “leaving an employer whose social responsibility values were no longer in alignment with their own.” Given such evidences, can companies afford to ignore social and environmental issues?.

## **2. WHAT IS CORPORATE GOVERNANCE?**

The often quoted definition of CG is that of the OECD (2004). In its preamble, CG is defined as follows:

CG involves a set of relationships between the company’s management, its board, its shareholders and other stakeholders.

CG also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

The definition then moves on further to:

good CG should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring (OECD, 2004: 11).

Whilst the earlier paragraph made reference to stakeholders, the last sentence only refers to shareholders. Accordingly, it is not surprising that traditionally, CG is all about focusing on the shareholders and the bottom line and the share value of the firm. Thus, as indicated earlier, traditional CG puts emphasis on achieving economic sustainability. However, this view is slowly but surely changing. Companies realise that balancing long term economic sustainability with social and environmental issues are indeed important. In other words, while traditionally a company’s focus is on profits...now it is on profits, people and the planet.

## **3. WHAT CAN BOARDS DO?**

What does all this signal to the boards? They cannot be lackadaisical about social and environmental issues. Companies must realize that people and the planet are considered as assets and like all assets these should be managed in a proper manner. Ernst and Young (2012) in its report entitled “Leading corporate sustainability issues in the 2012 proxy season: Is your board prepared?” suggested that proactive boards should ensure that there exists substantive stakeholder engagement and disclosure. Two years earlier, in 2010, the Coalition for Environmentally Responsible Economies (CERES) came up with a broader framework, “The 21st Century Corporation: The CERES Roadmap for Sustainability”. The Roadmap actually provides the guideline on what a sustainable company should do to ensure sustainable development. According to the Roadmap, a sustainable company is one that has the necessary governance structures in place, extensive stakeholder engagement undertaken and the standards and scope of public disclosure and transparency instituted. Essentially, the Roadmap contains 20 specific expectations for corporate performance that are categorised into 4 main perspectives:

- governance
- stakeholder engagement
- disclosure and
- performance.

### **A. Governance:**

Companies should embed sustainability issues in management and board structures, goal-setting and strategic decision-making.

In the US, companies are increasingly having board level sustainability committees. While formerly, such committees were formed in response to scandals or lawsuits, currently, such committees have been formed to reflect a conscious decision by organizations to devote board-level resources to sustainability issues. This proactive stance is the result of companies realising that sustainability practices may lead to decreased costs (hence increased profits) and also because sustainability issues provide companies with positive corporate branding.

Essentially, a board level committee is needed for the following reasons (Barnard, 2011; p212):

- i. it stimulates high-level attention to the goal(s) of sustainability;

- ii. it encourages competent oversight of in house sustainability functions;
- iii. it provides a focal point for resource allocation decisions;
- iv. it emphasizes the notion that environmental compliance is not a sufficient corporate goal
- v. it fosters education of committee members, and
- vi. it helps in branding a corporation as a moral leader

In 2012, two years after the Roadmap was issued, CERES conducted a survey to evaluate the progress of 600 U.S. companies along the road to sustainability. Of the 600 companies that they assessed, 28 percent have instituted board oversight of sustainability issues, 39 percent have instituted management oversight and 23 percent have both.

#### **B. Stakeholder engagement:**

Companies will proactively engage in robust dialogue with stakeholders across the whole value chain, and will integrate stakeholder feedback into strategic planning and operational decision-making.

Why stakeholder engagement? Engagement provides board with a better perspective on stakeholders concerns. In fact it is through stakeholder engagement that some companies such as Microsoft, Apple Inc, and many others have addressed their social and environmental concerns successfully. For example, Microsoft was the first US company to require their suppliers to prepare sustainability reports annually. Apple Inc and HP, again through stakeholder engagement, instituted programs to improve tracking of suppliers' compliance with internationally recognized human and worker rights. Additionally, KB Home and Pullman, two construction companies in the US, have successfully adopted efficient energy practices in new home construction. All the preceding examples were the result of substantive stakeholder dialogue.

#### **C. Disclosure:**

Companies will regularly report on sustainability strategies and performance. Disclosure will include credible, standardized, independently verified metrics encompassing all material stakeholder concerns, and detailed goals and plans for future action.

Why is disclosure important? Issuing sustainability reports demonstrate the seriousness with which companies are addressing these issues. Reports that address stakeholders concerns and indicate progress on social and environmental metrics further demonstrate accountability and also indicate how these practices are contributing to long term shareholder value. Disclosure is so pertinent that the UK's Department of Environment, Food and Rural Affairs has announced that from April 2013 all companies registered in Britain and listed on the London Stock Exchange's main market will have to publish details of their greenhouse gas emissions.

In Malaysia, from 2007 onwards, Bursa Malaysia requires all listed companies to disclose four dimensions of accountability: responsibility towards the market place, the environment, the community and the workplace. Indonesia is very much at the forefront in this. In 2007, a law was passed requiring companies involved in operations that affect natural resources to create, implement, and disclose CSR programs. Later, in 2010, this is extended to all listed companies. All listed companies must report on the effects of their activities on society and the environment. Failure to do so necessitates an explanation for not disclosing this information.

While attempts by developing countries such as Malaysia and Indonesia are indeed commendable, there is no specific guideline put forth. In Malaysia for example, the framework is too general. Nevertheless this is a good initial step. Specific to disclosure, CERES, in partnership with the United Nations Environment Program (UNEP), helped develop the Global Reporting Initiative (GRI), the Sustainability Reporting Guidelines for evaluating the economic, environmental, and social performance of corporations, governments, and non-government organizations. The latest GRI (GRI version 4) was issued in May 2013. An earlier version,

version 3.1 was issued in 2011. While the GRI actually focuses on disclosing economic, social and environmental matters, other guidelines such as the ISO 26000 and SA 8000 provides a framework on the disclosure of social issues. The GRI is a very comprehensive framework for disclosure purposes and most companies throughout the world are actually preparing their sustainability reports to accord with the GRI guidelines.

The very process of reporting puts pressure on companies to continuously improve its performance. More importantly, when businesses are forced to report on their environmental performance they would have no choice but to be environmentally responsible. As information on the environmental impacts of their activities is made publicly available, firms would be inclined to want to portray the image of an environmentally responsible organization

#### **D. Performance:**

According to CERES, performance is all about achieving reductions in carbon emission and water use, procurement of renewable energy, improved energy efficiency and having a supply chain that meets high environmental and social standards. In order to improve the environmental and social metrics across a company's operations, companies are now developing systematic, proactive responses to environmental matters. More importantly, companies are increasingly aware that a large part of their output consists of material waste (or non-product output). For example, Nitto Denko, a manufacturer of adhesives for the electronics industry, had almost 33% of its material input as non-product output. Similarly, another Japanese company, Canon Inc. also had a non-product output of about 32%. Closer to home, a Malaysian SME Alpha Enterprise (not its real name), an automotive parts supplier, had 55% of its material input as non-product output. Accordingly companies realize that in order to improve productivity and profits, managing waste is pertinent. Essentially, proactive companies are now concentrating on reducing their material input in order to manage its waste. Such companies are now focusing less on the recycle and reuse concepts when addressing environmental issues.

In particular, material flow cost accounting (MFCA), an environmental management accounting (EMA) tool that has now become an international standard, ISO 14051, can help companies address environmental issues as well as improve their bottom lines. MFCA is said to address the impact of a firm's activities on the environment by using less natural resources and simultaneously increase productivity and profits. What is MFCA and how can environmentally responsible companies adopt this tool?

#### **4. MATERIAL FLOW COST ACCOUNTING**

MFCA, an EMA tool that is now widely used in Japan, has its origins in Germany in the late 1990s. In 1994, to address the challenges of sustainable development, the Asia Productivity Organization (APO) launched its Green Productivity (GP) project. Essentially, the GP project recommends that companies put both economic development and environmental protection initiatives as their key strategies to ensure sustainable development. Subsequently, in 2000, MFCA was first introduced in Japan (Kokubu et al., 2009). In Malaysia, the MPC has played an active role in the dissemination of MFCA information. More importantly, collaborating with the JPC and APO, MPC has assisted with the implementation of MFCA in 5 medium sized enterprises (SMEs) in Malaysia. The MFCA project in Malaysia is a collaboration between Malaysia Productivity Corporation (MPC), Asia Productivity Organization (APO) and the Japan Productivity Centre (JPC). The project aims to develop local expertise in the area of Green Productivity with an emphasis on Material Flow Cost Accounting (MPC, 2011).

MFCA traces the physical and monetary flows of materials in the production process. Thus, fundamental in MFCA is the twin concept of "material balance" and "material flow". This stems from the fact that mass and energy can neither be created nor destroyed. The physical inputs that flow into a system should be equal to the physical outputs exiting from the system. Accordingly, materials input will exit as product or material loss (see Figure I). Its concept is simple. Because wasted materials carry with it various other costs, if the company is able to reduce material input, then logically, there would be less non-product output and less costs. MFCA actually enable companies to focus on efficiency and

productivity by identifying opportunities to reduce their relative consumption of materials. Essentially, what MFCA does is to focus on material inputs and outputs. However, the tool is not a magic wand. MFCA can be likened to an X-ray. Once the results from the X-ray are obtained and there appears to be a problem (in this case, the wasted materials) it is up to the company to decide what it is going to do about it. Thus, MFCA only points to where the wastes are generated. Subsequent steps involve kaizen activities.

As indicated in Figure I, conventional cost accounting generally does not attach any costs to material loss. However, in MFCA, part of the conversion cost is also allocated to the non-product output. Thus, including the purchased cost of wasted materials of \$2,800, the cost attached to material loss is actually \$8,600. More importantly, this implies that, not including waste disposal costs, \$8600 per product (25% of the total manufacturing cost) is wasted. MFCA provides such information to management and motivates them to reduce waste substantially. It is interesting to note here that in MFCA, the conversion cost is also allocated to material and this is done on the basis of its mass. Additionally, it must be remembered that this cost of \$8,600 does not include the cost of additional storage, processing costs of wasted materials, administrative costs of processing waste, cost of machinery abrasion caused by wasted materials and labour costs of processing waste. Thus, companies should realize that cost of material waste does not merely refer to waste disposal cost. Figure II clarifies the various costs that are attached to waste. Ideally, a company should be able to determine all the “hidden costs” of material waste. However, in practice this may be difficult. Accordingly, at the initial stage of MFCA implementation, it would suffice if cost of material loss consists of purchased cost of wasted materials and the allocated conversion costs.

According to Kokubu and Kitada (2010), while ISO 14001 may be effective in reducing a company’s environmental impact, it need not necessarily improve a company’s bottom line (at least in the short term). However, MFCA, as evidenced by various cases studies (e.g. Kokubu and Nakajima, 2004; Jasch, 2009) has enabled companies to achieve better economic and environmental performance. In other words, MFCA enables companies to simultaneously address its environmental issues and increase its profits. Elaborating further on the usefulness of MFCA, Kokubu and Kitada (2010) gave the example of a lens manufacturer in Japan. The company proudly announced that out of 100 pieces of material input, 99 come out as finished products. Given this, they erroneously concluded that the production yield ratio was 99%. This almost perfect ratio stems from the fact that defective products were regarded as losses generated from the production line and that such losses resulted from the design of the product and the given standard production processes. However, when MFCA was implemented and the company focused on the material input that comes out as product and non-product (waste) outputs, the yield ratio was only 68%. Thus, 32% of material input ended up as waste!

Kokubu and Kitada (2010) added that companies generally do not focus on wasted materials for two main reasons. The first is due to the material input and output falling within the permitted range of standards or estimates, and secondly because the estimated revenue would be able to cover such wastes. This is precisely what happened to the lens manufacturer in Japan. The authors further argued that in conventional production and cost management, the difference between input and output which is permissible in terms of standard design is normally regarded as an “inevitable loss”. MFCA on the other hand, quantifies this “inevitable loss” that conventional production and cost management have overlooked. Such is the beauty of MFCA.

## 5. CONCLUSION

Given stakeholders increased attention on social and environmental matters, forward thinking boards should undertake substantive stakeholder engagement and provide robust sustainability reporting. Additionally, to be proactive on environmental issues companies must understand and manage its environmental costs; introduce waste minimization schemes; understand and manage lifecycle costs; measure its environmental performance and embark on a strategic approach to environment related management. Most importantly, the tone should be set at the top. Top management commitment is essential, preferably at the board level. Accordingly, companies should ensure that directors’ skill sets include risk management of social and environmental issues. Most importantly, companies should realize that enhanced environmental performance can and will lead to improvement in the economic performance of the enterprise.

As Malaysia’s former Director General at the Department of Environment, Datuk Hajah Rosnani Ibrahim, once said,

“Doing well and doing good are not separate ideas. Corporations can deliver superior returns to shareholders by getting actively involved in the social and environmental spheres of business”

The same sentiment is echoed by EL Artz, the Chairman and CEO of Proctor and Gamble, when he said.

“We simply can’t protect the interest of the shareholders unless we do our part to protect the environment”.

Finally, Frank Popoff, the CEO of Dow Chemical, warns,

“No matter how competitive you are and how globally you trade, if you are environmentally irresponsible someone can and will - and should – padlock your door.”

**APPENDIX**

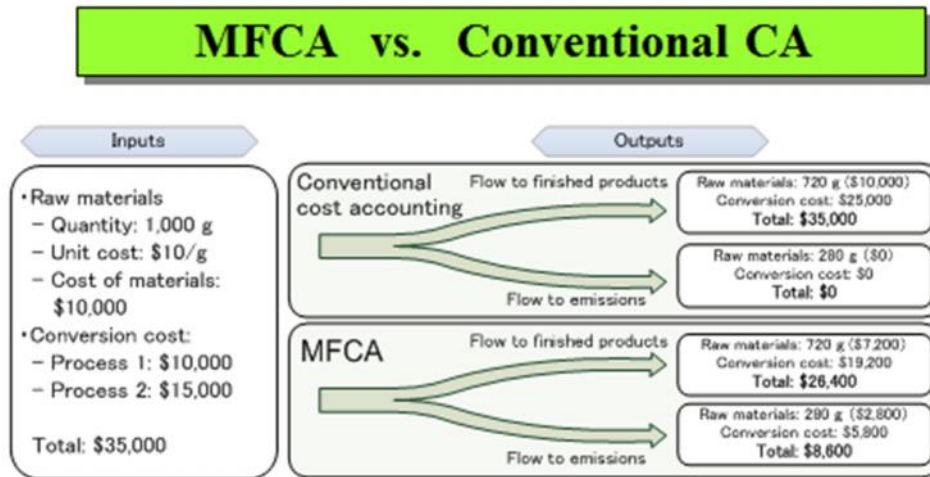


Figure I: Conventional Cost Accounting and MFCA (METI, 2011)

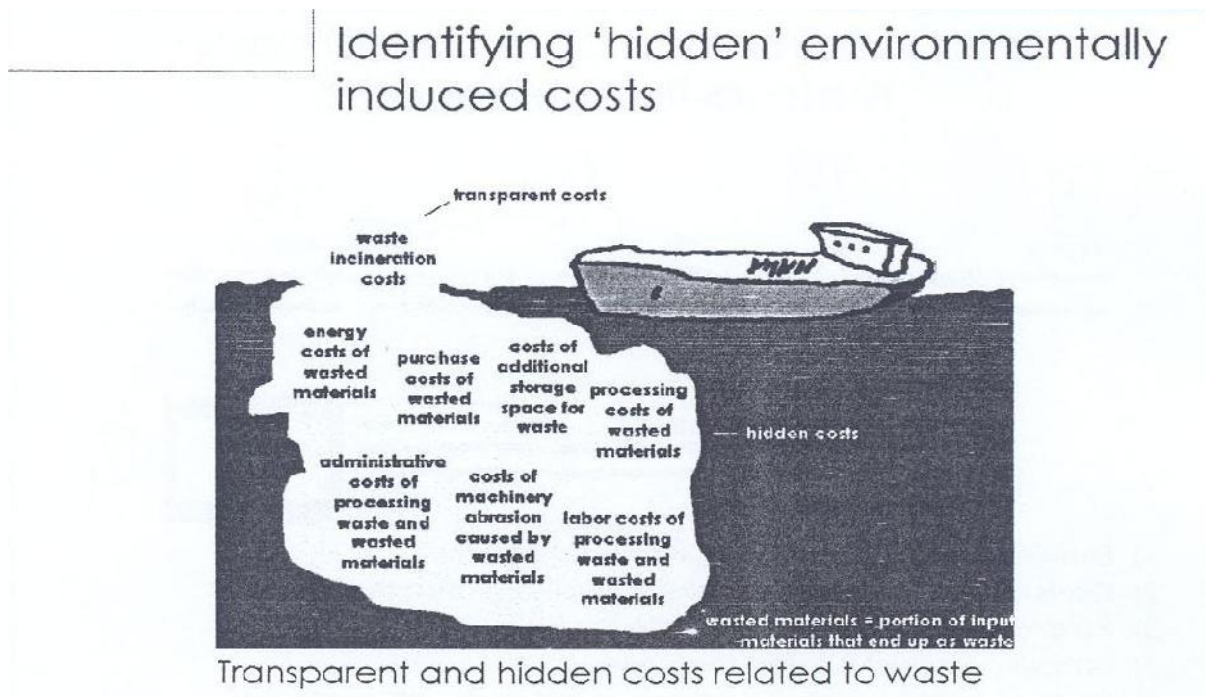


Figure II: “Hidden” costs of waste