ESG GOVERNANCE: SIX WAYS FOR BOARDS TO LEAD THE SUSTAINABILITY TRANSITION

Practical insights from experts

CORPORATE GOVERNANCE
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FOREWORD

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Accountancy Europe in collaboration with Chapter Zero Brussels, ECIIA and ecoDa has issued a paper that provides six ways for boards to drive the sustainability transformation within their companies. This publication comes at a critical moment.

At the beginning of the 21st century research showed that we were using natural assets faster than nature was regenerating them. That equation equaled disaster for planet Earth.

This had an impact on the market capitalization of companies on the great stock exchanges of the world. Research showed on the S&P 500, for example, that only 20% of the market capitalization of companies listed on that exchange was expressed as additives in a balance sheet. What was making up the balance of value in the mind of the investor?

Right through the 20th century corporate leaders had steered limited liability companies on the basis of the primacy of the shareholder. Increased profit, increased share price and increased dividends were the hallmarks for success. But many of these so-called successful companies had increased bottom lines by being subsidized by society and the environment. Clearly not a sustainable scenario.

As chairman of the United Nations Committee on Governance and Oversight, I met with the leaders of the International Federation of Accountants (IFAC), and we came to three conclusions. Firstly, financial reporting was critical but on its own was not sufficient to discharge the duty of accountability. Secondly, a sustainability report had become critical but without the financial statements clearly not sufficient to discharge the duty of accountability. Thirdly, to report the financials and sustainability or ESG factors in two silos was divorced from reality because operationally, these non-financial factors and financial capital were integrated on a daily basis.

This led to the establishment of the International Integrated Reporting Council (IIRC) and the issuing of integrated reports to show how the financial and non-financial aspects were integrated and how value was being created, preserved or eroded.

The global institutions such as the IFRS Foundation established the International Sustainability Standards Board (ISSB) as a sibling to the International Accounting Standards Board (IASB). The ISSB has already issued two standards: firstly, the general requirements for sustainability reporting and secondly, sustainability reporting on climate change.

After the collapse of Lehman Brothers there was an impact on the balance sheets of virtually every limited liability company and on their operating performances. The realization was that sustainability, like a coin, had two sides. The Global Reporting Initiative (GRI) had focused on how the company produces its product and in doing so the impact it had on the three critical dimensions for sustainable development, namely the economy, society and the environment. In turn, the Sustainability Accounting Standards Board (SASB) of America focused on how those three critical elements impacted on the company. So the GRI standards were driven from inside out and the SASB standards from outside in.

From the brief outline above, one can see the complexity in sustainability reporting around the world as the EU has now legislated their sustainability

reporting standards on a double materiality basis, that is both inside out and outside in. The ISSB standards are based on the outside in principle but with a principle of interoperability so that the company can adopt a GRI standard, for example, to report on a matter that is material.

The great standard setters and framework providers in the world are of a mind that sustainability reporting should be mandated within the next two years. Regulators in different countries will adopt different standards. This will add to the complexity of sustainability reporting of a holding company in the European Union following the legislated double materiality standards.

Accountancy Europe, Chapter Zero Brussels, ECIIA and ecoDa have seen that the "what" is now common cause namely that there should be a sustainability report but "how" to do it is another matter.

Large listed companies will be able to hire external consultants to get advice on mining the required data and also in the reporting itself. Medium and small companies will not have that luxury. Building on the interviews with several practitioners, this paper offers guidance to the boards of companies. Accountancy Europe has interviewed several informed practitioners and recorded insights and examples to inspire the sustainability transition.

The interviewees have made it clear that efforts to do a sustainability report starts with the collective mind of the board, integrating sustainability into strategy, purpose, operations and the culture of the company in order to generate behaviour changes across the whole of the company.

The paper asks what the board's competencies on ESG issues are. Does the company have in-house sustainability expertise? Should a company have sustainability expertise on its audit committee? The paper also correctly says that sustainability should be integrated into the company's business model.

The publication's issuers should be lauded for their publication because it has shown that how to do a sustainability report needs some learning. *The Good Governance Academy* has also recognized this and started an initiative, the *ESG Exchange,* the concept being to issue playbooks free of charge showing how a company can go about collecting the relevant data and do a sustainability report according to whatever standard is adopted by a regulator in a particular jurisdiction.

Accountancy Europe's and its partners' paper is extremely helpful in driving the sustainability transition which will be mandated globally over the next two years.

HIGHLIGHTS

As public concern about the climate crisis, environmental degradation and social inequalities is growing, businesses are under increasing pressure from regulators to address their impacts on society and the environment. Sustainability also offers new value creation opportunities for businesses. Companies' boards play a crucial role in steering this transition in their organisations.

Issued in cooperation between Accountancy Europe, Chapter Zero Brussels, ECIIA and ecoDa, this paper provides advice and examples to support board members with effective ESG governance within their organisations. It is based on interviews conducted with board members and sustainability experts where interviewees shared success stories, challenges and lessons learned.

This publication draws on these conversations and offers key insights to support and inspire other board members.

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INTRODUCTION

The climate crisis, stakeholder expectations and new legislation put pressure on companies to transition to sustainable business models. Sustainability also offers new value creation opportunities for businesses. Companies' boards play a crucial role in steering this transition in their organisations.

This publication provides advice and examples to support board members[1] in achieving an effective ESG governance within their organisations. It complements the paper *ESG Governance: questions boards should ask to lead the sustainability transition (2023)*.

The paper, co-published by Accountancy Europe, Chapter Zero Brussels, ECIIA and ecoDa, is based on interviews with board members and sustainability experts[2] to learn from their experience[3]. Drawing on these conversations, it shares success stories, challenges and lessons learned to inspire other board members in implementing the sustainability transition in their organisation.

The document elaborates on six ways for boards to drive change towards more sustainable businesses. These are however examples from peers and should not be taken as general advice applicable to every organisation.

The paper contains quotes without attributing them to a specific contributor. The full list of interviewees who shared their experiences for this paper can be found in the annex on page 23.

[1] There may be differences in board structures i.e. one-tier (unitary) and two-tier board, depending on the national jurisdiction and applicable corporate governance system. In this publication, we use 'board' as a general term. The paper does not take into account national legislative differences or market practices that might affect the corporate governance environment, and readers should adapt the paper's insights into their respective jurisdictions.

[2] The overview of the interviewed experts is included in the Annex.

[3] The views in this paper are a collation of insights provided by individual experts and board members, which do not necessarily represent the official views endorsed by the four organisations. Moreover, not all of the content is necessarily endorsed by each of the interviewees, apart from their own contributions. Furthermore, the views expressed are not necessarily a common practice across most companies as they represent individual examples rather than a quantitative study on what practices are most frequently used by companies.

1.

ASSERT YOUR LEADERSHIP ON SUSTAINABILITY

Organisations' sustainability transformation requires leadership through strategic direction, awareness building, and engagement throughout the organisation to drive the necessary mindset changes. This can entail potential shifts in the company's strategy, vision of the future, risk management, and governance practices including how the CEO and management lead and set examples. This is why the sustainability effort starts with the board, as the driver of an organisation's culture and practices.

What is needed for boards to assert their leadership and effectively lead this fundamental transformation?

DRIVE A MINDSET CHANGE

"I see the mindset problem as the biggest challenge in ESG implementation. It starts with leadership." Many boards and their companies need a mindset change to fully understand the impacts of climate change, environmental crises and societal challenges on the company and the company's own impact on these factors.

Good practice examples and peer advice are powerful tools to change mindsets and move beyond "business as usual" in any organisation. This change can happen through interactions with organisations such as ecoDa[4] and Chapter Zero[5] , and drawing on real case examples of companies that have understood the financial and commercial pitfalls of not addressing sustainability issues. The risk management function and internal audit also play an important role in creating awareness and building knowledge within companies.

Integrating sustainability in company's strategy, purpose, operations, and culture is necessary to generate behaviour changes across the organisation. A good starting point is to identify specific individuals who can help drive the discussion in the board and start asking relevant questions on what sustainability means for the company's viability and resilience. According to one of the interviewees, *"identifying and engaging a chair, board secretary, or board members who might be more receptive to make change happen will be key. By asking [the right and difficult] questions, you can check the board's level of readiness."*

BUILD SUSTAINABILITY CAPABILITIES

Boards' competencies must include environmental, social and governance (ESG) skillsets to understand how sustainability can impact the company's financial performance. First and foremost, board members must identify which sustainability skills and competencies they need given the organisation's business line, risk profile, location, etc. According to the interviewees, upskilling can be done through adaptations to the board composition and increasing the board members' collective maturity of ESG topics by:

[4] ecoDa is an independent actor and a unique umbrella organisation representing the main national institutes of directors in Europe. Being the voice of European Directors, ecoDa contributes to the continued improvement of the good corporate governance practices in Europe.

[5] Chapter Zero Brussels engages and empowers Board Directors by providing them with the network, knowledge, skills and tools to have strategic discussions on the risks & opportunities of Climate Change for their companies. Chapter Zero Brussels believes that climate competent board members have a crucial role to play in guiding their companies towards a sustainable, net zero future.

- (collaborative) training and education programmes, including information sessions, workshops on specific aspects of ESG
- leveraging tools issued by Chapter Zero, ecoDa, business schools, institutes of directors, investor associations, professional accountants and their national institutes
- drawing on internal expertise such as the sustainability office(r), risk management and internal audit or external consultants
- learning from companies in a similar sector that went through the same journey

Boards' sustainability upskilling needs to be regular and consistent. It will also be important to ensure training consistency between different functions within the organisation. Consistency will be key to reach company goals and Key Performance Indicators (KPIs), break organisational silos, and ensure everyone speaks the same language and understands their mutual interests.

Board members' training

One of the interviewees explained how they put ESG into the board training programme. That included learning from climate scientists on how climate risks can affect business. Another interviewee elaborated on the format of the training sessions: *"we offer regular information sessions for board members where we bring external experts for a two-hour session and it's very informal. We want these to be relaxed sessions where boards can ask very candid questions e.g. I don't understand this or that – please tell me what it means."*

The training should relate to matters close to board members' day-to-day considerations such as demonstrating climate change's impact on the company's viability. One interviewee highlighted that *"there are certain risks that are no longer insurable. Being aware of these creates an accelerated awareness at the board level."*

In-house sustainability expertise

External sustainability expertise is available, but this alone will not be enough. Boards should have access to relevant sustainability expertise within their own organisation to advise them on the way forward. This includes involving internal sustainability experts from the corporate sustainability office, risk management and internal audit in the board decision making through briefings or as standing observers on board committees. With time, sustainability expertise should become internalised throughout the company.

One interviewee highlighted that *"calling in [external] advisors or consultants is an avenue to complement internal knowledge, but this alone is not sufficient. Instead, boards should consider the value of in-house resident climate expertise as part of the senior management regime. Managers should have personal responsibility for anything ESG related that they can control in their function."*

The interviewee also underlined the importance of sustainability expertise in audit committees: *"we need resident climate expertise in the audit committee so we can understand the climate dimensions of impact materiality, financial materiality, asset longevity, products lifecycle, cashflow, finance ability, credit worthiness etc."*

CREATE A PROGRAMME TO DELIVER CHANGE

Implementing sustainability has strategic, governance, operational, reporting, and culture related implications. The board's role is to set the tone for the company culture and decision-making throughout the organisation. One way to achieve this is to set up a systematic project-based programme for the sustainability transition. This will require to:

- embed ESG considerations in all business lines
- set objectives, targets, timelines, and controls
- understand and address potential pain points.

One interviewee highlighted that in their organisation, *"the board with the management team and sustainability office set ambition statements for each element of ESG against which all the KPIs are constructed. This sets the framework for how we manage the implementation process. We manage this process as a program internally with a program manager and a project manager – just like with the introduction of a big piece of software."* Companies should strive to involve internal experts from risk management and internal audit functions to advise from the outset of the project.

2.

BREAK DOWN SILOS

"ESG is business as usual, it needs to be business as usual, so embedding it is what you need to do. It needs to become a part of who you are and what you do. If it's a separate project, it will probably not be successful."

Sustainability transformation is a cross-company issue. It requires all parties across the organisation to join in. However, many companies are still organisationally silo based. The big challenge is how to get the sustainability mindset to every department and team. That is why it is so important to start from the top.

As one of the interviewees underlined, *"there is a danger that the sustainability office is seen as the first line for sustainability just like product management is the responsibility of a product manager. But sustainability is not done just by the sustainability office – it should be done by absolutely everyone."* [6]

[6] See ECIIA's three lines model as an example of the governance bodies across which sustainability should be integrated.

The interviewee explained that it is pivotal *"to get people to understand that the sustainability office does not own sustainability. This is something that the whole organisation and every individual must embrace and deliver, and it is about behaviour and corporate values."* The tone at the top is important but the tone at the middle is likewise crucial.

Below are some case studies and examples highlighted by the interviewed individuals. Naturally, what works for one organisation may not work for another, but some common threads are visible.

ADOPT A HOLISTIC APPROACH TO THE BOARD'S SUSTAINABILITY OVERSIGHT

In one of the companies, the board had already recognised its sustainability oversight role, but the question was how they should exercise that oversight. One interviewee explained: *"our nominations and governance committee (NCG) together with the board assessed a range of options e.g.:*

- *set up a separate sustainability committee*
- *appoint an additional board member with sustainability expertise to support the board*
- *embed ESG in the existing board structures"*

The board ultimately decided it wanted to embed ESG into its existing governance structure. *"The board did not want to create a separate structure because having a dedicated board member or a sustainability committee would dilute the full board's overall responsibility for sustainability oversight"*, the interviewee explained.

Embedding ESG into existing governance structures can be done in many ways. In one example, the interviewee asked their company to go through the yearly board agenda, check all issues that could have a sustainability dimension, and subsequently report sustainability impacts, risks, and opportunities to the board: *"it's a complete reverse thinking of how the board works"*. Another interviewee noted that *"the internal audit function can help the board in this exercise, given their holistic view of the organisation"*.

ENGAGE THE ENTIRE BOARD IN ESG INTEGRATION

The entire board should be conscious of the ESG challenges and exposed to the practical difficulties of implementing ESG, instead of merely delegating it to dedicated members.

For example, in one company, several board members volunteered to act as reference directors on ESG directly engaging with management. *"One lesson learned was that these volunteers were not sufficiently specialised in ESG matters. Another lesson was that they did not find the right level of communication with the management team. They wanted to obtain detailed information and files relating to ESG matters. To get it, they were disturbing the management team too often."*

After some time, the board concluded that having an additional or intermediate layer between the management team and the board was not effective. They decided to stop that practice and to tackle ESG directly at the full board level. *"Members of the management team are invited to join board meetings to explain to the whole board the progress on ESG to obtain a global view of the company progress in relation to the targets set."*

CONSIDER THE PROS AND CONS OF A DEDICATED SUSTAINABILITY COMMITTEE

Whether it makes sense to set up a separate sustainability committee is a question that emerged frequently in the interviews. The general feeling was that a dedicated sustainability committee can be a good first step. However, some warned against delegating such a key strategic matter as sustainability to a separate committee. This risks undermining the objective of empowering the board, board committees, the C-suite and management as well as employees to integrate environmental and social concerns into every business decision.

One interviewee expressed it in stronger terms: *"it's nonsense to have a separate sustainability committee or a separate sustainability strategy or a separate sustainability agenda. It must be the board that reports to all of the committees whatever the issue is, be it compliance, audit, risk, product, customer experience, innovation and transformation, people engagement, talent management or others. All these issues related to human capital need to be part of board activity as they are sustainable business issues."*

But for others, there can be circumstances where either temporarily or on a longer-term basis it might be appropriate to attribute certain sustainability-related responsibilities to specific committees for different aspects of the topic. *"You want those with a deeper set of expertise than the overall board to spend more time on a specific topic than you can at the board level"*, one interviewee highlighted.

This view was echoed by another interviewee who believes that all committees, especially risk, audit[7] and remuneration need to consider and incorporate relevant ESG issues in their work. However, it is beneficial to have a committee that looks at the matter holistically, provides coordination and consistency, and ensures that *"nothing is lost between the cracks".*

Integrating ESG across all board committees entails for example asking the audit, risk, and compliance committees to discuss which sustainability risks and opportunities the company is considering, why and how e.g. what processes they put in place to embed ESG risks in the current risk framework, and what the impact is.

One interviewee explained that *"sustainability must not be treated in a silo and should be fully incorporated in the company's strategy and agenda. However, it is a complex, new, and evolving issue. A dedicated committee can provide specific support*

[7] Accountancy Europe explored the evolving role and responsibilities of audit committees in relation to sustainability in its 2022 publication ESG Governance: Recommendations for Audit Committees.

to the board. They can delve deeper into the issue and interact with management with more focus than the board as a whole can do."

Regular inter-committee communication and coordination overseen by the board chair is also very important. The company secretary's role in communicating the cycles of each committee to ensure they are in sync on environmental and social issues is also a crucial factor.

LEVERAGE THE CHIEF SUSTAINABILITY OFFICER

ESG should be clearly defined and communicated for all senior executives' responsibilities and priorities to ensure sustainability is properly integrated into the company's strategy and business model. Some companies may choose to appoint a Chief Sustainability Officer (CSO) to facilitate the transition. However, this role needs to be carefully designed. One interviewee highlighted that while their company was quite mature on their sustainability awareness, they could not progress in reaching their sustainability targets. *"The issue was the structure. It did not work because the CSO was seen as just another line in their business lines chains."*

In this case, with the help of a consultant, the board reviewed the structure, elevating the CSO function just below and next to the CEO followed by all other business lines. *"And it works now because the CSO is no longer on the same level as the business lines but at a higher level and can influence and work together with all the other business lines."* This change allowed the company to make real progress in reaching its sustainability targets.

The interviewee shared another piece of advice: *"I recommend that if you put the CSO in place, take someone who understands the sector/industry, who knows the company, is aware of the issues and provide that person with sustainability training. The other way around — may not work."*

3.

MAKE MOST OF THE EXECUTIVE AND SENIOR MANAGEMENT

Although board oversees the strategic direction and decisions of organisations, they are advised, and their decisions are implemented by executives and management. These functions thus play a crucial role in rolling out the company's ESG efforts. The interviewees had several examples, challenges and possible solutions to share in that area.

GET YOUR CEO ON-BOARD – AND BE SERIOUS ABOUT IT

The CEO and the management team are responsible for implementation of the company's strategy into day-to-day activities and risk management. This includes setting targets, driving the desired culture and behaviour, measuring, and reporting on ESG performance. However, it may not be enough to fully rely on the CEO and the management team for ESG implementation.

One interviewee highlighted: *"The board should guide, accompany, support, and make sure that the CEO acts. The CEO and the board will need to decide how much time, budget, and resources need to be dedicated to the sustainability effort. Similarly, as with the creation of a new product or service line, there needs to be a clear sense why we are doing it, how it will benefit us and what the risk is if we do not do it."*

However, this process may not always be smooth. In one example, the board grasped the importance of the sustainability agenda, but they faced resistance from the CEO and the management team. *"The CEO focused on obstacles that prevented him to take ESG considerations on board e.g. lack of resources, the need for investment, potential negative impact on the bottom line etc."*

This heavy resistance from the CEO forced the board to consider changing the CEO - *"it is a very difficult and disruptive decision, but it proved the board's commitment to take the sustainability agenda seriously"*. The board decided not to change the CEO in the end, but the question was on the table. *"If the board is committed to what they believe in, they need to be ready to change the management of the organisation if they refuse to cooperate."*

UPGRADE THE CFO FUNCTION

Sustainability reporting is likely to land under the Chief Financial Officer's (CFO) remit. The CFO should understand what is driving the business' performance and hence is well placed to oversee sustainability and its impact on the company.

CFOs may need to be trained on sustainability and the respective reporting specifically. *"CFOs are often not trained for this as their key focus is on the financial aspects of the company. ESG and consideration of stakeholder interests have not been part of their culture and development"*, one interviewee said.

For starters, the CFO *"must consider sustainability reporting as a driver of transformation and not as a compliance exercise. Sustainability reporting will be as important as financial reporting. This needs to be properly reflected in the respective governance structures to ensure the right data is captured. Otherwise, the culture will not be infused with these new priorities. It will be more as a nice to have but not properly implemented."*

Another noted in this context the importance of collaboration: *"over time, finance teams will own sustainability data because it's just like financial reporting – same structure, controls, and audit process. They have a lot of experience on how to manage such data. That is why our sustainability office is working very closely with the finance team."*

QUESTION, CHALLENGE AND ENGAGE WITH MANAGEMENT

Many interviewees recalled that the board's responsibility is not just to validate a strategy or proposal coming from the management team, but to ask questions and challenge them[8]. One noted: *"as a board member, you have an inherent responsibility to enter into constructive and challenging discussions with management on the strategic direction the company is taking and whether the right avenues on ESG are pursued".*

This is specifically pertinent for capital allocation and investment decisions. The board should request management to present business cases for sustainability investments. They need to lay out clearly how returns on investments are realised as well as their financial, social, and environmental impacts. Ultimately, maintaining natural, social, and human capital will yield the flows of benefit that business success depends on. This requires a systems-thinking mindset.

Understanding how ESG is embedded in the governance structure is key. This involves its integration in the risk management, internal processes, controls as well as across the roles of each line of governance.

Another interviewee urged board members to *"take a critical look at the information coming from the management team, advisors, or consultants, and provide their own perspective. This includes asking the management to explain how they quantify and measure the ESG risks or present this in a qualitative way. From the perspective of trade-offs and strategic choices - you need to look at what best fits with our purpose, our risk appetite, what fits with our capacity to invest."*

Finally, board members must have the courage to not only question and challenge the management, but to also ask questions that may appear simple or even ignorant. *"Even asking very naïve questions may raise bigger questions"*, one interviewee reminded.

A powerful way for the board to make an impact to influence the decisions is to hold off-site sessions during the strategic planning period between the board, management, and external advisors. Risk management professionals, and internal and external auditors should also be part of these discussions.

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[8] For examples of questions the boards can ask the management team, please refer to this joint Accountancy Europe, ecoDa, ECIIA paper *ESG governance: questions boards should ask to lead the sustainability transition (2023)*.

The interviewees also recommended to work closely with the sustainability assurance provider. The relationship with the assurance provider is essential because they have in-depth knowledge and expertise. One interviewee noted – *"as a member of the board or audit committee – do not limit yourself only to assurance by the statutory auditor, but also work with them to understand what they do, how they do it, what value it brings to you"*. Another highlighted that *"the internal audit function can support in this process"*.

AVOID COMMUNICATION GAPS BETWEEN THE MANAGEMENT AND THE BOARD

One interviewee encouraged to bear in mind that board members and the management team are not at the same level of understanding on sustainability technical aspects: *"managers focus on very specific and technical matters and tend to give too much information to the board. Board members, having a global view of the topic, risk getting lost and disconnected from the presentation after 10 minutes. This happens very often. At the end of the day, it's a waste of time … a lost director is a frustrated director."*

The interviewee recommended management to ensure that the ESG matters' presentation is well framed, and that the background and context are well explained to prevent gaps in communication between board members and the management team.

The board should work with the management team and ask for the draft presentation in advance to review, reframe, and make sure there are not too many acronyms. During the presentation, the manager should check with the board if the level of explanation on the new sustainability topics and the level of detail they are sharing is appropriate to make sure people are still following.

The interviewee also highlighted the proliferation of sustainability information that management provides to the board, which is often too lengthy and too detailed. They recommended to provide less detailed and technical information. One possible approach proposed by the interviewee is to ask *"the manager's immediate boss to join the presentation to act as an intermediate communication person e.g. by explaining the broader context of the presentation. Since this is usually a more senior person who is more exposed to board meetings, they can explain and answer questions from a different level than the technical manager."*

USE DASHBOARDS TO TRACK ESG PERFORMANCE

Interviewees encouraged boards to use practical tools such as dashboards to support their decision-making and challenge management: *"boards should ask management to share dashboards with them regularly e.g. on a quarterly basis"*.

One interviewee explained that *"the dashboard should capture the material matters for the business and the industry trends e.g. generational change, gender balance, emissions, circular economy, waste disposal. The dashboard should illustrate where the company stands with each of the ESG risk indicators, how the indicators are moving since the last quarter and what the trends are since the last year - it's important to show that indicators have a history but also targets."*

The interviewee also shared that some boards are asking for more aggressive targets and details on how the KPIs are built and dashboards can help them with this. *"In one company, the board asked the management to update the dashboard by going into more granularity i.e. to split the aggregated KPIs into specific elements related to recycling and supply chain. This helped the board to take decisions*

on projects related to waste management, e.g. in which materials to invest to change the production to reduce waste."

The interviewee also recommended integrating ESG factors in traditional dashboards rather than having a separate ESG dashboard. This will allow to get a holistic picture of the company's performance to understand ESG impacts, risks, and opportunities. Supplementing dashboards using scenarios will help to get projections of possible climate change impacts on the industry.

SHIFT FROM 'DATA PROVIDERS' TO 'CHANGE AGENTS'

Companies are gathering sustainability data from operational, supply chain, human resources, and finance departments to manage their sustainability impacts, risks, and opportunities as well as for reporting purposes. One interviewee observed that *"this way, data providers are created. They have passive attitude - they provide data but do not consider themselves as actors of the transformation. They often do not think they can act proactively to change that data and help their colleagues change the data they are going to report at the end of the year."*

The board and management play a key role in shifting this passive attitude to reposition 'data providers' to 'change agents'. In practice, this means for example empowering a head of the supply chain to realise the potential that they have in their hands to drive the supply chain's transformation. Strategy should realise this transformation, translating the company's sustainability impacts, risks and opportunities into targets, policies, and procedures. The board and management will play a key role in this.

Another interviewee had a similar point: *"the sustainability office that I run is about setting strategies, policies, reporting, communications, and training. But I don't own gender diversity statistics. This must be done elsewhere in the organisation. I cannot change our scope 3 emissions on my own – that must be done by our IT, procurement, and suppliers."*

One interviewee advised to engage with the operations team or engineers by asking questions that would directly resonate with their day-to-day work e.g. *"how can you take into account social aspects and environmental concerns as part of the work you do?"* He clarified that *"if you explain the ESG and sustainability requirements to the operational team, they might think this is something that does not concern them. Instead, directly linking sustainability issues to their day-to-day work will help make sure these issues better resonate and bring them closer to the management and operations teams."*

INCORPORATE ESG FACTORS IN EXECUTIVE AND MANAGEMENT PERFORMANCE SCHEMES

The interviewees were aligned in underlining that delivery on ESG objectives – whether in risk assessment, opportunities analysis, setting targets and KPIs or others – needs to be consistently reflected in incentive plans. One interviewee noted: *"if you say ESG is core to my operations, then ESG indicators need to be*

reflected in the management's performance management systems – both short-term bonus and long-term incentive plans". This concerns not only the executive management but also throughout the organisation - *"everyone needs to be accountable for it"*.

According to one interviewee, boards play a key role to ensure consistency between strategy, company targets, and targets for individual management team members. They need to make sure that remuneration is not too complex. It needs to be tangible and measurable, and easy for the management team to understand and act on.

One interviewee observed that *"when it comes to long term incentives you see a lot of resistance and scepticism – we are hiding behind a fact that it's very difficult to define the right criteria, but the point is that these are long-term matters. It's important to set ambitious targets and not the targets that we will easily overshoot to benefit bonus."*

SET METRICS AND TARGETS

The board should ask management to set targets and KPIs to monitor ESG performance. These KPIs must be visible to the board and externally, enabling them to be challenged, tried, and tested to ensure accountability. This will also help ensure transparency about the trade-offs.

One interviewee shared: *"our management committee approved 26 KPIs and objectives of which 16 are absolutely core, which we use to measure our progress and report. We prepared a roadmap towards net zero pathway, set challenging but credible carbon emissions reduction targets, and applied for an external Science Based Targets initiative (SBTi) accreditation and made that public. It was important to make sure that the board and the management committee were externally committed to delivering on carbon reduction."*

4.

CONSIDER STAKEHOLDERS AS STRATEGIC PARTNERS

Companies and their boards need to map and listen to their stakeholders much better than they often currently do, and understand that valuable insights may come even from the most antagonistic groups.

BRING STAKEHOLDERS' VOICE CLOSER TO THE BOARD

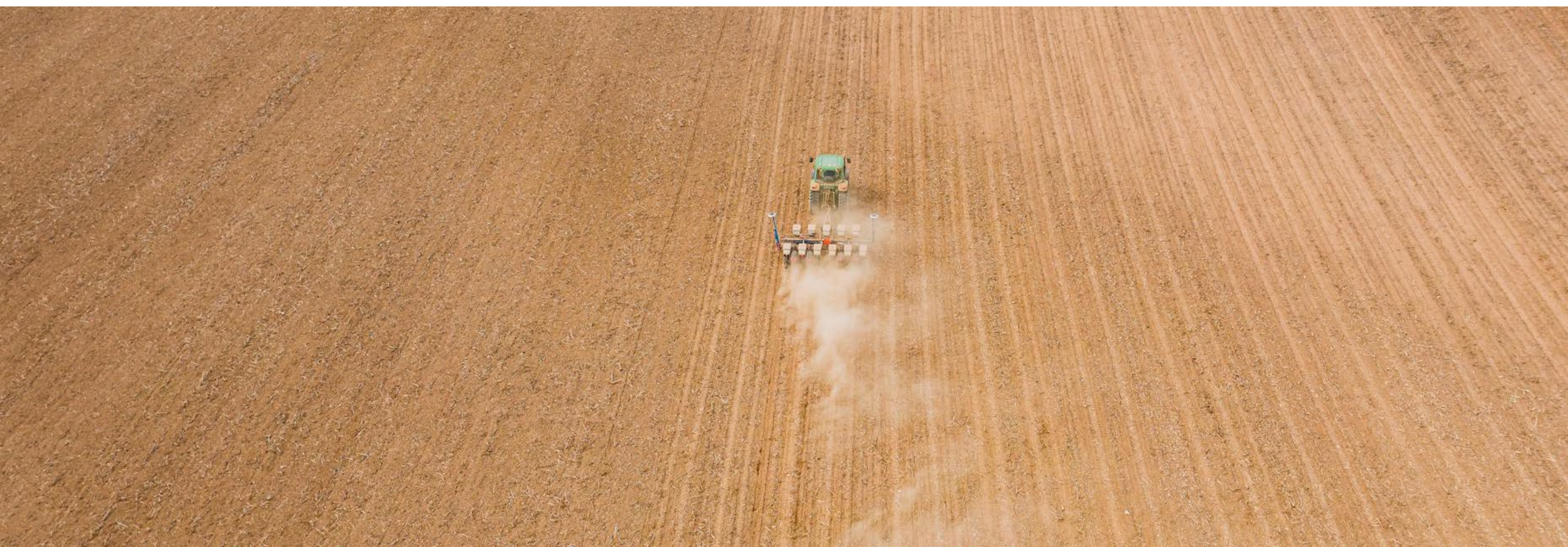
Many interviewees felt that board members need to dedicate more time to dialogue with stakeholders. One interviewee highlighted that *"the preparatory work including surveys and dialogues is very much managed by the internal functions. The management comes with already prepared proposals on stakeholder engagement and it's not easy for the board to assess them. I believe the board should have more say in the engagement with stakeholders, we need to be part of the discussion with employees, communities, investors. The board should guide more the direction of the stakeholders' engagement".*

Another interviewee shared that for their company stakeholder engagement is a strategic tool. They used to do it on the management level but now they bring the stakeholders' voice closer to the board: *"we held a 'stakeholder listening' session during the kick-off of the board's strategic planning process. The interviews were well prepared, stakeholders were asked powerful questions. The value that came from this strategic planning session was incredible."*

APPROACH STAKEHOLDER ENGAGEMENT WITH AN OPEN MIND

Several people interviewed insisted on approaching stakeholders, even most difficult ones, with an open mind. For example, one interviewee shared the example of a 'leadership activation event': *"two days of concentrated work looking at their realities from different stakeholders' perspectives helped the board realise different stakeholders' value added".*

Some stakeholders were raising difficult issues including some very antagonistic views: *"the question was – what do you do with these antagonistic stakeholders? Would you leave them out or would you listen to them? At the start of the session, half of the board members wanted to leave them out and half wanted to listen to them. After two days, the same question was raised*



and 90% were on the listening side. They realised the potential of even the more difficult stakeholders."

The interviewee noted that *"if you do a real stakeholder engagement and involve the top management in the stakeholder engagement interviews or focus groups, you will realise they are not antagonistic but so-called spies for the future. But if you ask a consultancy to do a stakeholder engagement for you – it will be a missed opportunity."*

ENGAGE WITH STAKEHOLDERS FOR GOOD DOUBLE MATERIALITY ASSESSMENT

According to one interviewee, *"listening to stakeholders is an important part of the double materiality assessment, which can bring enormous value to the organisation's strategic thinking."*

Another interviewee shared how they involve stakeholders in double materiality assessment: *"we are working with a consultant to help us structure that work. We will be engaging with our big suppliers and customers including public sector institutions to get their views on what is important to us financially and what is important related to our impact on society and environment."*

Another strongly felt that stakeholder engagement should be performed by a company itself, with close involvement of the board: *"stakeholders can help discover issues that company board or its management did not even think of."*

BALANCE STAKEHOLDER PRIORITISATION

Boards should be more rigorous in trying to understand different stakeholders' expectations. As one interviewee put it, *"we have to set priorities on stakeholders underpinned by methodology e.g. to analyse pros and cons, costs and benefits of different options. This includes what it may cost for the company if we decide today to prioritise a specific stakeholder group e.g. employees and if we lose perspective of a different stakeholder group e.g. customers."*

The main purpose is to enable making informed, strategic decisions on stakeholder engagement: *"boards need to consider what it could cost in a few years if we lose sight of certain stakeholders. Prioritisation should be based on what is important for us as a company in light of our purpose. We should always have a long-term view."*

Another interviewee explained that *"the board should be clear that they cannot meet expectations of all stakeholders. The board will have to make arbitration, and this is a very practical challenge for the board and where a good board can make a difference. They will need to explain how they made the decision, what the arbitration is based on. They need to base that decision on robust information, processes, this needs to be an informed decision."*

5.

APPROACH THE MATERIALITY ASSESSMENT AS A STRATEGIC TOOL

Boards will play a key role in overseeing the company's material sustainability impacts, risks and opportunities. The interview participants emphasised the importance for boards to approach the double materiality assessment as a tool to inform strategic direction rather than simply for reporting or compliance purposes.

One interviewee highlighted that *"assessing the implications of double materiality for the company's business model and its operations is the foundation of strategic planning. It will guide priorities setting, resource allocation to ensure that the company focuses on what matters most. This will also lead to challenging the company's operations, management structure and how the processes are run."*

SET UP STRONG BASICS AND GET STARTED

Understanding the company's business model, its operations and value chains is key to the materiality assessment, but it is not an easy exercise. *"It's a tough thing – you have to go under the skin of the company, it requires time and resources, you really need to understand the nature of the business"*, one interviewee noted.

It is key to understanding the transition and physical risks to be able to measure what is material for the company: *"If you don't understand that, you have a problem to incorporate these types of risks within your existing framework. This is the basis to setting metrics and targets."*

An interviewee advised the board to ask *"the CEO and managers to determine materiality and then price it. To price it, you can use carbon price. Ask an insurance company how they price physical and transitions risks. Engage your external and internal stakeholders in this exercise."*

Board members need to understand how impacts, risks and opportunities are identified, assessed and managed. Existing risk management processes used to evaluate the company's overall risk profile and risk management could be adapted to capture and address sustainability impacts, risks and opportunities as well.

Another interviewee warned that asking a consultant to perform the materiality assessment in place of the company's top management will be a missed opportunity: *"In a multinational enterprise I work with, we held an off-site deep dive workshop with senior management facilitating them to perform a materiality assessment and mapping. This empowered the supply chain director to realise that he had most of the key issues for future opportunities and risks in his hands. Out of this two-day meeting we came up with a proper materiality assessment and a proposal to the board of directors to invest in supply chain transformation. The company came 5 or 6 years ahead of all their competitors."*

Boards are also encouraged to be mindful that double materiality assessment is not just a matter for the management team, internal auditors and risk managers but also for the board and external auditors – *"they need to be aligned about what is material, what is critical, what needs to be reported. Therefore, the board needs to consider having this discussion between these parties."*

The board should not only understand the outcome of the double materiality assessment but also of the process followed. Current practice indicates that boards look at and challenge the results of double materiality assessment, but they may not be as interested in challenging the process.

Leverage the benefits of materiality assessment

Interviewees were aligned in maintaining that the double materiality assessment is a huge opportunity. It gives companies a view on their competitive advantages and can help position themselves strategically, in addition to being the tool that identifies material sustainability impacts, risks and opportunities for reporting purposes. This can mean venturing into new markets, making a unique selling proposition, or changing operational procedures.

One interviewee pointed out that the new rules resulting from the Corporate Sustainability Reporting Directive (CSRD), including the double materiality assessment can help companies to ask the right questions, reflect if their business model is still viable and consider whether they should wind down any business lines that may not be viable in the future.

Another interviewee shared an example of how double materiality assessment led a company to review their business strategy: *“commercial real estate was a big segment in the business portfolio of this financial institution but there were also significant ESG risks involved. Materiality assessment helped them see that they had a high-risk concentration related to scope 3 emissions linked to their lending. They identified both physical risks (houses in regions where the sea level can rise) and transition risks (related to scope 3 emissions). When the company included these ESG risks in the standard risk matrix alongside risks such as market or liquidity risk, this helped them realise that the number of houses with a very low insulation score was quite high. This meant their value may decrease over time, or they could even become a stranded asset.”*

This led the financial institution to completely review their business strategy, products, and business model. *“They used scenario analysis for their portfolios that considered transition and physical risks under different scenarios e.g. increasing sea levels.”*

6.

PREPARE FOR CHALLENGES, TRADE-OFFS, AND DIFFICULT DISCUSSIONS

Integrating sustainability considerations systematically is a challenge for many companies. As one interviewee put it: *"it's a challenge to ensure ESG is not seen as an optional extra, but as absolutely core to the values and strategy. Otherwise, there is a danger that ESG is seen just as a compliance project. And if there is a choice between investing in compliance project and a new carbon intensive product which will generate millions in revenue – the balance is likely to be shifted in favour of the latter."*

Our interviewees shared examples of trade-offs that come with implementing ESG objectives in day-to-day activities, and how to approach them.

TIME HORIZON

The trade-off between short term operational pressures and the long-term strategic perspective the board needs to take was mentioned as one of the key issues. One interviewee summarised one of the main psychological obstacles on trade-offs: *"this problem will not hit us today but in 10 years, we will stay with the company for 3 years, why bother?"*

Another observed that if you don't manage your business for the long run, you won't be in business in the long run: *"I think there is a big misunderstanding about how crucial it is to tackle climate issues today. It's about your resilience, making sure that your company is still there within 5 or 10 years. If you see you cannot continue like that, you should also review your business strategy. We all agree that climate change is a major issue but then we also say - I have more urgent things to think about."*

"Being an ultimate custodian of the company's long-term success, the board needs to be much more active and involved in implementing sustainability transition in their company", the interviewee stressed.

BUDGET

Sustainability transformation requires investment. One interviewee shared an example of internal struggles some companies go through related to balancing financial and ESG performance: *"we set up governance, strategy and risk management structures to channel ESG issues to the board, and it failed. It failed because it was very difficult for that company to decide between the long-term ESG related issues and short-term financing needs. They were not able to make a proper trade-off between the current urgent business needs and what is important in the long term."*

The company took on a climate transition expert to advise the board, but the expert felt left alone in the board and progress was very slow. *"It seemed that the company was very much entrenched in the business-as-usual mindset and was not ready to invest in sustainability."*

To better balance internal trade-offs, one interviewee advised to rely on double materiality assessment (see previous section) to understand where the company's risks and opportunities lie. One interviewee stressed that *"materiality assessment needs to be as quantifiable as possible. This will make it concrete to allow to price risks e.g. insurance, carbon, water related risks and will help prioritise by urgency, by materiality, by investment needed. That will determine your materiality and from there you decide if I have enough money – should I divest, should I do my mergers and acquisitions and change my mix, what my options are."*

To achieve this, the board needs to:

- know what is happening in the company as well as in its value chain
- go several layers down in the organisation to get information from different sources
- monitor closely the ESG implementation execution including asking executives to explain what ESG risks they considered, why and why not
- put forward recommendations and ensure these are followed through

ALIGNMENT BETWEEN FINANCIAL AND ESG KPIS

Growing and expanding a business often means acquiring carbon emissions. One interviewee underlined: *"boards need to assess whether it's worth acquiring those emissions. This means that the company's net zero pathway must be as important to management as the return on equity pathway."* Another explained that the main difficulty is to *"persuade people that decisions have to be made not on the basis of shareholder value, profitability, but on the basis of the impact on society and environment."*

That is why aligning financial and ESG KPIs is crucial. One interviewee shared how their company does this in practice: *"companies usually split financial and sustainability KPIs. However, the real discussions start when you try to connect them and set the targets."* The interviewee explained: *"to ensure alignment between financial and ESG KPIs, the Chief Sustainability Officer (CSO) is in regular contact with different board committees e.g. audit, risk, remuneration and nomination committees. The CSO also attends all the business lines e.g. sales meetings, and sits on the executive committee, next to the head of sales etc."*

This is because in these meetings, relevant KPIs are discussed. *"Usually, these discussions happen in silos. However, if this is not coordinated, you have two conflicting KPIs e.g. 3% sales increase but on the other hand you have an increased CO2 footprint. You see a lot of contradictions if you split traditional KPIs from ESG KPIs. So, we embedded ESG KPIs in the sales KPIs. When you link them and set the targets – this is where the real discussion starts. Most of the time these are not easy discussions - at the end of the day, you must be profitable."*

These discussions are only a starting point towards a bigger cultural and mindset change that will need to take place and the board's role in keeping a long-term perspective, which includes sustainability and ESG matters. As one of the interviewees noted: "when a company's market *share is dropping, it mobilises everything at its disposal to improve the situation. This pressure trickles down to all business units. But when you have an ESG related issue, nobody feels the urgency for action. This links to the change of culture. The cost of tomorrow is not well appreciated, but we do know what market share is."*

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