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Sustainability and the Board's Governance Role

Global research indicates that companies in North America are less committed to environmental, social and governance (ESG) engagement than those in Europe and Asia-Pacific. What steps should boards seeking to improve their ESG engagement take?

Findings from a University of Oxford and Protiviti global survey[1] suggest that North American companies are lagging behind their counterparts in Europe and Asia-Pacific in terms of ESG engagement. For example, only one in four surveyed business leaders in North America is of the view that ESG strategy will be extremely important by 2032. But that number jumps to nearly six in 10 in Europe and seven in 10 in Asia-Pacific. In addition, less than 40% of North American leaders expect greenhouse gas emissions to *decline* over the next 10 years, whereas 81% and 88% of leaders in Europe and Asia-Pacific, respectively, have such expectations.[2]

There may be many reasons why the data suggests different levels of commitment, including that some North American organizations may be underrating the importance of stakeholder expectations and regulatory developments that drive companies in other regions to advance their environmental and social sustainability contributions. Is this possibly a lost opportunity? Would an ESG focus serve as a catalyst for embracing a longer-term view toward sustaining the enterprise and building trust in the marketplace? Answering these questions affirmatively to justify near-term ESG investments is not easy in the face of a possible global recession.

[1] "Protiviti-Oxford Survey Shows North America 'Enthusiasm Gap' About ESG's Future Impact," University of Oxford and Protiviti, October 2022: https://vision.protiviti.com/insight/protiviti-oxford-survey-shows-north-america-enthusiasm-gap-about-esgs-future-impact.

[2] Ibid.

Would focused ESG oversight help position boards as more effective stewards of long-term value creation for all stakeholders? Below are 10 steps for boards desiring to elevate their game on the ESG oversight front to consider. These steps leverage the interest that exists in at least part of the C-suite.[3]

Engage stakeholders. Boards should consider employee, customer, supplier, investor and other stakeholder interests in the context of maintaining financial vibrancy, sustaining the organization's strategy and business model, and delivering long-term shareholder value. Interactions with shareholders, employees and other key stakeholders are opportunities to learn about their respective interests and concerns and build relationships based on trust. With increasing demands for transparency from customers and employees, it is best practice for boards to engage with management timely on major decisions that could negatively affect critical stakeholders so they can understand the impact, alternative courses of action and mitigation strategies. Likewise, directors should work with management to determine whether, and in what circumstances, the company must engage the board in taking public positions on matters of importance to key stakeholders.[4] A company's commitment to all of its stakeholders and its commitment to its shareholders are not to be viewed as mutually exclusive; rather both are integral to the purpose of generating sustainable long-term shareholder value.[5]

Set the context for the ESG agenda with organizational purpose. Directors should develop a shared view with executive management regarding the organization's purpose, including the promises for which its brand stands. Purpose focuses on why the organization exists and how it will benefit the markets it serves. It lays the foundation for establishing sustainability targets and priorities while framing a narrative to the street that will resonate with stakeholders.

Integrate ESG considerations with strategy and capital allocation. ESG should be integrated with the overall corporate operating strategy rather than rendered to a mere compliance, check-the-box disclosure activity. The pace of change in the marketplace behooves directors to be well-informed about market forces, so they can be adaptive and agile in adjusting decision-making and information-gathering structures and can pivot in response to significant market developments. It also helps to allocate sufficient agenda time and funding to strategic issues that relate to key environmental and social issues in the context of assessing strategy, risk and capital deployment.[6]

[3] Protiviti's Global Finance Trends Survey reports strong interest on the part of chief financial officers and finance teams in taking on ESG risks and issues as part of their roles: www.protiviti.com/us-en/survey/2022-global-finance-trends-survey.

[4] Ibid.

[5] "One Year Later: Does the Business Roundtable Statement Matter?" *Board Perspectives*, Issue 130, Protiviti, September 2020: www.protiviti.com/us-en/newsletter/one-year-later-does-business-roundtable-statement-matter.

[6] "NACD Launches The Future of the American Board Report: A Framework for Governing into the Future," National Association of Corporate Directors (NACD), September 27, 2022, available to subscribers at www.nacdonline.org/about/press_detail.cfm?ItemNumber=74141.

Boards are stewards of capital, and ESG initiatives are under increased financial pressure as CEOs and investors focus more sharply on risk and reward.[7] Ultimately, directors must view ESG considerations the same way they view everything else that involves the allocation of capital and the future (e.g., understand the strategic opportunity and purpose, inquire as to the risks, and measure and monitor return on capital).

Strategic conversations regarding ESG priorities often lead to outside-of-the-box thinking around new approaches, processes and business models that can push the organization to the forefront of disruptive innovations benefiting customers and other stakeholders. They also frame the storyline the company aspires to convey to the street. It is best practice to inform these conversations with an understanding of how the company's ESG initiatives compare to those of its competitors.

Assess board ESG capabilities. The board chair and committee chairs should periodically evaluate the board's expertise with respect to environmental and social matters and the organization's changing needs to set a context for planning board succession and onboarding new members.[8] Board refreshment is about maintaining currency with respect to knowledge, experience and perspectives in the boardroom.

Evaluate the board's ESG oversight process. ESG-related opportunities and risks, supported by data and metrics, should be included within the scope of the board's overall oversight process. To that end, it may make sense for directors to review the board committee structure (including the need for a separate ESG- or sustainability-focused committee) to ensure coverage of ESG priorities while also retaining a "whole board" view of the full picture with respect to ESG strategy and reporting. Based on the review's results, committee charters should be revised accordingly.

Set board reporting protocols. To set the foundation for ESG oversight, the board should establish the content and frequency of the ESG reports it is to receive from the company. This determination should include periodic briefings regarding management's assessment of material ESG issues and the company's current ESG market ratings and rankings as well as their implications. Directors also need to work with management to define the board's involvement in significant decisions regarding environmental and social matters, including company positions on sensitive social and political issues.

Integrate ESG matters into risk management. As a noted author pointed out, ESG "is … a collection of … disparate risks that corporations face, from climate change to

[7] "CEOs Cutting Back or Pausing Their ESG Efforts: KPMG Study," by Tyler Durden, ZeroHedge, October 31, 2022: www.zerohedge.com/geopolitical/ceos-cutting-back-or-pausing-their-esg-efforts-kpmg-study.

[8] Ibid.

human capital to diversity to relations among the board, management, shareholders, and other stakeholders."[9] The board should ascertain that these risks are added to the scope of the enterprise risk management (ERM) process, with incorporation into enterprise risk assessments, integration of risk with strategy-setting and performance management, and — if critical to the enterprise — periodic reporting to the board. Other related points:

- It is desirable that ESG-related risks be incorporated into public disclosures related to risk (e.g., the disclosure of risk factors).
- Note that there is guidance on how to integrate ESG objectives and activities within the company's ERM activities.[10]
- With signs emerging that insurers are connecting the dots between robust ESG risk management and fewer or less severe director and officer (D&O) losses,[11] it follows that those organizations addressing the ESG landscape with superior ESG frameworks are in a position to impact the D&O underwriting process. Thus, management and board oversight of ESG-related risks can potentially reduce D&O exposures and costs.

Pay attention to ESG external reporting. High-quality and transparent ESG reporting to the public is a board priority. It is recommended that directors do the following:

- Establish an understanding and reach agreement with management on the nature and extent of the board's review of draft ESG sustainability reports prior to issuance.
- Engage management regarding the effectiveness of the company's disclosure controls and procedures, including the role and composition of its disclosure committee as well as the interactions of that committee with management's ESG committee structure, if any.
- Be better informed regarding data collection processes and systems by requesting periodic management briefings.
- Inquire as to whether the company's ESG storyline is resonating in the market and impacting the company's valuation.
- Ensure coordinated disclosure decisions around key issues for consistent messaging and alignment with core values.

[9] "ESG, Stakeholder Governance and the Duty of the Corporation," by Martin Lipton, Harvard Law School Forum on Corporate Governance, September 18, 2022: https://corpgov.law.harvard.edu/2022/09/18/esg-stakeholder-governance-and-the-duty-of-the-corporation/.

[10] "Improving Organizational Resiliency: New Guidance Addresses Environmental, Social and Governance-Related Risks," Committee of Sponsoring Organizations of the Treadway Commission and World Business Council for Sustainable Development, October 23, 2018: www.wbcsd.org/Programs/Redefining-Value/Making-stakeholder-capitalism-actionable/Enterprise-Risk-Management/News/environmental-social-and-governance-related-risks.

[11] "New Marsh D&O Policy Enhancements Launched Globally," Marsh, June 30, 2022: www.marsh.com/uk/about/media/directors-and-officers-policy-enhancements.html.

- Understand management's preparations for new regulatory requirements (e.g., the U.S. Securities and Exchange Commission's forthcoming climate change disclosure enhancements in the United States) affecting the nature, extent and timing of ESG disclosures.
- Request periodic comparisons of the organization's ESG reporting relative to its peers to ascertain whether there are potential deficiencies to be corrected.

Finally, some companies are disclosing the board's oversight role with respect to ESG matters.

Focus on sponsorship and accountability related to compensation. The board should agree on the senior executive designated with responsibility for ESG and understand how the organization is driving a collaborative focus on the ESG priorities essential to the organization's long-term success. Desirably, ESG performance measures are integrated with financial and operational performance monitoring to avoid becoming an appendage that would likely receive curt treatment in the C-suite. Performance expectations and the related metrics linked to incentive compensation plans are the means to ingraining accountability for results and commitment to progress within the culture. It also makes sense for the board to set agenda time for the dedicated ESG sponsor to discuss the company's progress toward ESG targets in the context of the company's overall strategy.

Consider help from outsiders. Board governance sets the tone for effective corporate stewardship of environmental and social issues. To that end, the board may want to consider the need for engaging outside experts, as well as the importance of educating directors, on selected ESG topics.

Notwithstanding that organizations vary in size, financial wherewithal, intellectual capital, regulatory requirements and market constraints, boards and their chief executives should be proactive with respect to managing ESG priorities. The above 10 steps are not intended to suggest a fixation on ESG in the C-suite or boardroom, as there are certainly other fundamental issues that must be managed. Rather, the point is that leaders have a fiduciary responsibility to address the opportunities and risks posed by ESG matters as they ensure the *long-term* viability and well-being of their companies. Accordingly, they should focus on appropriate sustainability objectives while keeping an eye toward delivering expected financial results. In this context, board governance sets a constructive, balanced tone for effective corporate stewardship over environmental and social issues.

A resilient, ethical and trust-based culture founded on values best equips companies to face the future confidently. Companies that balance shareholder interests with the interests of employees, the communities in which they operate and other stakeholders are likelier to possess the resilience to adapt to inevitable longer-term change than those focused solely on maximizing profits. They also may realize increased innovation, improved employee retention and lower production costs over the long term.

How Protiviti Can Help

Sustainability presents multidimensional and complex challenges, with varying levels of understanding across industries and companies. Protiviti works closely with organizational leaders to effectively evaluate what ESG means for their organizations, with an emphasis on helping to build, implement, execute, monitor and report on ESG objectives that will evolve and grow with the business. Our focus is on helping clients understand the bigger picture and clearly identify where they can have the greatest impact on society and the environment while maximizing performance.

Our global ESG solutions enable sustainability in a way that positively impacts the organization and the communities in which it operates. Protiviti offers a holistic and integrated approach: ESG strategy and planning; operations, ESG performance and improvement; and ESG governance and reporting. For more information, see www.protiviti.com/us-en/sustainability-consulting.

Protiviti partners with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on https://blog.nacdonline.org/authors/42/. Twice per year, the six most recent issues of *Board Perspectives* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.