On the 2023 ESG committee agenda

KPMG Board Leadership Centre

KPMG Lower Gulf Limited

How companies address climate change; diversity, equality and inclusion (DEI) issues; and other ESG risks is now viewed – by investors, research and ratings firms, activists, employees, customers, and regulators – as fundamental to business and critical to long-term sustainability and value creation. Oversight of these risks and opportunities will be a significant challenge, involving the full board and potentially multiple board committees.

Over the last few years, the UAE has implemented various measures to ensure that sustainability is at the forefront of its goals. The UAE has taken steps to prioritize sustainability in companies through key initiatives, such as:

- Holding the 28th United Nations Conference of the Parties (COP28) Climate Change Conference which aims to assess progress in tackling climate change and unite global efforts to reduce carbon emissions.
- The UAE Net Zero by 2050 strategic initiative is a nationwide initiative to achieve net-zero emissions by 2050. This would help make the UAE the first Middle East and North Africa (MENA) nation to do so.
- Initiatives such as the UAE Vision 2021, Dubai 2040 Urban Master Plan, and the UAE Green Agenda 2015-2030, Paris Agreement, and UN Sustainable Development Goals ("SDGs"). The UAE government regards climate change as a significant concern and has enhanced its global participation and internal policies, placing it among regional leaders in climate action over the past decade.
- Abu Dhabi Vision 2030 aims to build a sustainable and diversified economy with seamless integration into the global economy.
- The Securities and Commodities Authority (SCA) requires publicly listed companies to publish sustainability reports to disclose relevant information on sustainability, performance on relevant metrics, and how it impacts strategy and performance.
- The Abu Dhabi Global Market (ADGM) presented its Sustainable Finance Agenda Declaration at the Abu Dhabi Sustainable Finance Forum (ADSFF), recognizing the UAE and Abu Dhabi's commitment to tackle climate change and promote green, sustainable finance in the region.

Accordingly, many companies within the UAE have already established or are in the process of establishing either a separate ESG board committee or including the mandate of ESG in one of the existing board committee's terms of reference to adequately oversee their ESG related activities.

Drawing on insight from our interactions with directors and business leaders, we highlight seven topics for ESG or related board committees to bear in mind as they consider and carry out their 2023 agendas.

1. Clarity of purpose
2. An ESG competent board
3. Engage proactively with shareholders and other stakeholders
4. Embed ESG, including climate risk and DEI issues, into risk and strategy discussions
5. Driving the transition towards a more purposeful ESG oriented organization through culture
6. Systems, controls and data
7. Reporting to investors and other stakeholders

1 Clarity of purpose

Oversight of ESG risks and opportunities is a significant challenge, involving the full board and potentially multiple board committees. For example, elements of climate and diversity, equality and inclusion (DEI) oversight likely reside with the audit and other committees.

Consideration needs to be given to the coordination between committees as well as how information flows to the committees from the corporate functions (risk, operations, legal, etc.) and from the committees to the board itself. For example, climate change will also likely touch the audit committee (data, the systems that produce that data, and the disclosures within the annual report), the remuneration committee (management incentives), and the nomination committee (the skills and experience of board members and senior management). Overlap is to be expected, but this puts a premium on information sharing, communication, and coordination between the committees. It also requires that committees have the expertise to oversee the issues delegated to them.

2 An ESG competent board

Oversight of ESG risk – and equally importantly, the opportunities – starts with an ESG-competent board. Not every board member needs to have deep-dive ESG expertise, but the board, as a whole, needs to have ESG risk and its impact on long-term value creation, top of mind. They need to understand which issues are of greatest risk or strategic significance to the company, how they are embedded into the company's core business activities, and whether there is strong executive leadership behind the company's response to ESG matters.

The board can play an active role in educating not just the committee members, but the whole board, on ESG issues including the landscape of stakeholder expectations and demands. Ask:

- Is the board ESG literate and is it structured to engage meaningfully on ESG issues potentially as diverse as energy efficiency and renewable energy transition, scope three emissions and other supply chain issues, and reporting?
- Proposed reporting standards (e.g., Draft IFRS S1.13c) will require boards to report on how they ensure that the appropriate skills and competencies are available to oversee strategies designed to respond to sustainability-related risks and opportunities.
- Does the board evaluation process assess whether the board has the right mix of skills and whether the ongoing development activities are sufficient?
- How does the board get ESG literate?
- Are ESG matters (including issues around Inclusion Diversity and Social Equality (IDSE), empathetic leadership, etc.) a factor when hiring directors and the executive team?

The board should work with the company secretary and senior executives to determine how best to get up to speed and build a strong foundation for informed oversight. Consider one-on-one conversations with the key players in the business and deep dives within committee meetings, alongside in-house briefings and externally organized training opportunities.

3 Engage proactively with shareholders and other stakeholders

Investors are increasingly holding boards accountable for ESG matters and are eager to understand whether boards have sufficient knowledge and adequate processes to oversee the management of the key ESG-related risks and to provide informed, proactive guidance as stewards of long-term value.

Beyond the investor community, other stakeholders, whether that be employees, customers or the communities that provide companies their license to operate, are also voting against companies they perceive to be paying insufficient attention to ESG issues – whether that be related to climate change matters, diversity and inclusion issues and the treatment of individuals, or the company's contribution to society.

Good stakeholder engagement – particularly through the supply chain – can also provide an opportunity for the company to encourage others to behave responsibly and 'do what's right over the long-term'.

To best understand the views of its key stakeholders and the ability of the company to exert responsible influence, the board should request periodic updates from management as to the effectiveness of the company's engagement activities:

- Does the company engage with, and understand, the ESG priorities of its largest shareholders and key stakeholders?
- Are the right people engaging with these shareholders and stakeholders – and how is the investor relations (IR) role changing (if at all)?
- What is the board's position on meeting with investors and stakeholders? Which independent directors should be involved?
- Will the organization be open to criticism from activists? Does the board have a road map to defend themselves?

In short: is the company providing investors and other stakeholders with a clear picture of its ESG performance, its challenges, and its long-term vision (or ambition) – free of "greenwashing"?

4 Embed ESG, including climate risk and DEI issues, into risk and strategy discussions

How companies address ESG risks is now viewed – by investors, research and ratings firms, activists, employees, customers, and regulators – as fundamental to business and critical to long-term sustainability and value creation.

Climate change as a financial risk has certainly become more urgent over the last few years – not least because of the accelerating physical impacts of the climate crisis – the frequency and severity of floods, wildfires, rising sea levels, and droughts.

But for many, the associated "transition risks" are as important and arguably more immediate – whether that be tax and regulatory interventions, technological changes, or customer behavior. A challenge for the board and concerned board committee(s)is to help ensure that these transition risks are properly addressed as the company plots its future strategy – together with other climate change risks.

Equally, some of the challenges within the 'S' of ESG have rapidly risen up the agenda in recent years. Social factors such as how a company manages its relationships with its workforce, the societies in which it operates, and the political environment, are now central to a company's financial performance. Wellbeing and DEI issues have become mainstream.

Several fundamental questions should be front-and-center in boardroom conversations about the company's ESG journey – not least how material ESG risks are identified and assessed in line with the organization's risk appetite. Embedding ESG identification and assessment into the existing enterprise risk management process might be a good starting point. However it is important to avoid focusing only on the downside risks. The board and concerned board committee(s) should also encourage management to consider the potential for innovation, disruption and value creation posed by ESG activities. Businesses that see through effective ESG investments to realize transformative growth will have the upper-hand as economies strengthen, whereas delaying key ESG initiatives could leave businesses behind the curve and exposed to rapidly changing stakeholder expectations and regulation.

After determining which ESG issues are of strategic significance, leadership should consider how the company embedding them into core business activities (strategy, operations, risk management, incentives, and corporate culture) to drive long-term performance? Is there a clear commitment and strong leadership from the top, and enterprise-wide buy- in?

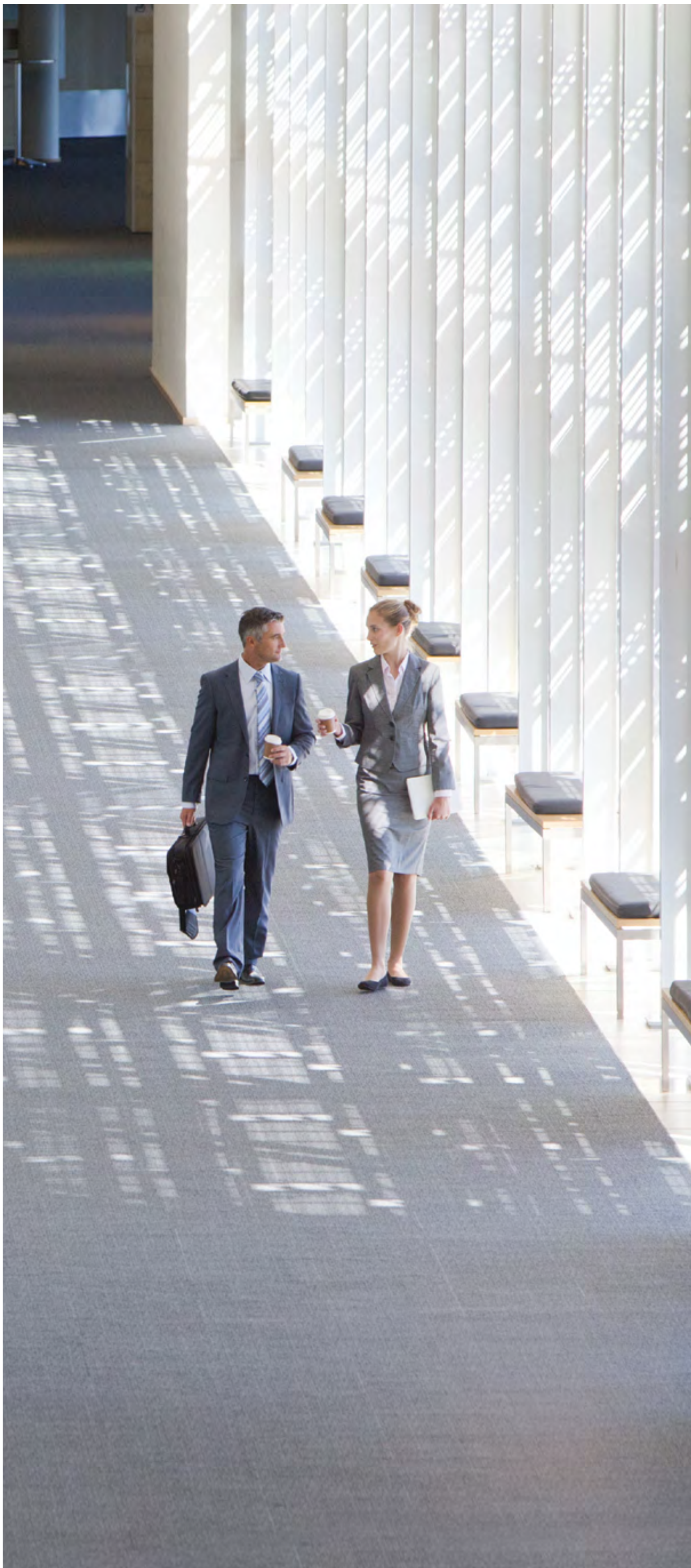
The board and concerned board committee(s) could consider:

- How is the ESG lens applied to the organizations strategic thinking?
- Is ESG thinking incremental to BAU (a bolt-on to the existing strategic thinking) or is it transformative?
- Is the board playing an active role in developing and supporting any transition plan? Is it an iterative process – with milestones and opportunities to recalibrate – and does it bring in perspectives from throughout the organization and beyond?
- Does the process challenge the validity of the key assumptions on which the company's strategy and business model are based? Is there a case for taking a 'clean sheet' approach to the strategy / business model, asking what our business would look like if we started up today?
- How does the board establish a culture that supports the transition towards a more purposeful ESG oriented organization?
- Could you explain what happened if your company ceased to exist in 10- or 15-years' time? What didn't you see coming that caused you to go under?
- Are the incentives connected with executive compensation and the compensation philosophy of the organization as a whole a fit for purpose? When compensation becomes intertwined with something like ESG, other systems and processes quickly fall in line: recruitment, training and development, strategic planning, performance management.
- What metrics are monitored and reported to ensure the organization is on track?

5 Driving the transition towards a more purposeful ESG oriented organization through culture

Given the critical role culture plays in integrating ESG factors throughout an organization, the board and concerned board committee(s) can play a role in helping the board take a more proactive approach in understanding, shaping, and addressing any necessary cultural changes by considering:

- Does the board understand the culture it wants within the organization?
- Are key processes aligned with desired culture? Hiring, promotion, reward, etc. And how poor behavior is addressed.
- Is culture embedded into decision-making processes? At times, there is a price to pay such as turning down a profitable business opportunity because the customers/clients values or modus operandi are at odds with your own organizational culture. It is at this point that the culture is seen as truly embedded and operational.
- How does the board measure the culture and get assurance that it is what they think it is? What are the different inputs? How can the board pull them together?
- Is the board leading the charge from the top? Are the board and the senior executive team presenting a unified front?



6 Systems, controls and data

The quality of data for both strategic decision-making and reporting is crucial and the board and concerned board committee(s) can play a role in challenging the relevance and propriety of collected data and the systems that produce it. Is there substance behind collected and reported data? What additional assurance might be required?

Collecting data in a consistent method is important, especially for businesses with global operations and multiple product lines. In some cases, there is an established standard that is accepted by almost all investor groups.

For example, the Greenhouse Gas Protocol is widely recognized as a way to report on emissions. Still, tracking greenhouse gas emissions means companies need to have all those responsible for collecting data to gather it in the same way.

Every level of the business should understand the metric, and how it is calculated and reported but also why the data is being collected and what does it show? The board and concerned board committee(s) can help reinforce the connections between metrics and financial performance and prospects.

The board and concerned board committee(s) can also play a role in questioning the scope and type of assurance the company is getting on ESG metrics; what is being assured, and by whom; and the value of the assurance received?

There's no single approach to ESG assurance. While it may be distinct for every industry and company, it's critical for companies to begin to identify their priorities before pressure from customers, shareholders, and others push to accelerate the company's timeline.

Assurance maps – which will be familiar to many audit committees – provide a visual and easy way to digest the effectiveness and completeness of a company's assurance activities.

Clarity over the assurance provided by the 'lines of defense' can also help identify any ESG risks or disclosures which require additional assurance to achieve the desired level of comfort, or any risks that are being excessively mitigated as a result of duplicated assurance activities.

The board and concerned board committee(s) might work in conjunction with a properly scoped, funded and trained internal audit function (and perhaps the audit committee) to understand which areas merit assurance. For example, labor in the supply chain could be a key area where a retail company's customers may want assurance. Or a consumer goods company's shareholders may want assurance on their claims of sustainable sourcing. Given its understanding of the rigor required to get the numbers right, the boards and concerned board committee(s) can help the company decide how far the journey goes, even potentially working toward assurance of a full sustainability report.

Understanding the current landscape and the company's way forward, coupled with strategic investment in data collection and integrity, not only responds to stakeholder demands, but also may expand an organization's perspective, exposing new risks to its business model along with opportunities for growth and transformation. This is the true significance of bringing standardization and rigor to ESG measurement (and reporting).

7 Reporting to investors and other stakeholders

Investors and other stakeholders want to understand which issues are of greatest risk or strategic significance to the company, how they are embedded into the company's core business activities, and whether there is strong executive leadership behind the ESG efforts as well as enterprise-wide buy-in.

Identifying what information to report (i.e. what is material) is more nuanced than for financial statements and should consider what matters in the short, medium and long term.

Principles differ between sets of sustainability reporting standards. What do investors need to know to understand the value of the business and its prospects? What other information do wider stakeholders need? How will you structure reporting to include investor-relevant information within the annual report, but avoid unnecessary duplication with other broader communications?

To that end, the board and concerned board committee(s)can encourage management teams to reassess the scope and quality of the company's ESG reports and disclosures.

How is the company benchmarking against peers? What reporting frameworks have been considered? Are risks explicitly stated and disclosure provided on how they are mitigated? Is the link to the strategy clear?

Some critical questions for the board and concerned board committee(s) to consider include:

- What are the ESG issues that align most closely to the company's and stakeholders' priorities?
- What are the ESG issues that drive the company's financial performance and prospects?
- Is the company currently reporting on its ESG efforts, and where?
- Do the company's disclosures comply with the appropriate laws, regulations and sector best practices?
- Do the company's disclosures reflect both what the company is doing now and where it is going, with accompanying metrics and goals.
- Is ESG-related data handled appropriately and aligned with corresponding regulations and the level of risk associated with the data.
- Is the ESG information included within the annual report monitored with the same rigor as conventional financial data?
- What are competitors measuring and reporting? Are there emerging regulatory requirements that a company should be aware of?

Lastly, stay alert to International Sustainability Standards Board (ISSB) developments as they finalize new IFRS Sustainability Disclosure Standards. Both are aligned with the Task Force on Climate-related Financial Disclosures (TCFD) framework, whilst the ISSB also incorporates Sustainability Accounting Standards Board (SASB).

The KPMG Board Leadership Centre

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KPMG Lower Gulf is part of KPMG International Cooperative's global network of professional member firms. The KPMG network includes approximately 236,000 professionals in over 144 countries. KPMG in the UAE and Oman is well connected with its global member network and combines its local knowledge with international expertise, providing the sector and specialist skills required by our clients.

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