Non-financial reporting as an opportunity for the board of directors

By Barbara A. Heller, Managing Partner at SWIPRA Services

The numerous discussions around ESG and corporate social responsibility (CSR) often neglect the role of governance in ultimately determining how a company puts social and environmental aspects into practice. Senior management bodies define the strategy, set the framework for corporate culture and are responsible for the future-oriented sustainable management of a company. A company with fundamentally good governance will not suddenly treat its people, supply chain or resources poorly. Conversely, a negative corporate culture is a sign of inadequate governance.

Non-financial reporting, and the future requirement to vote on it at the annual general meeting (AGM), is therefore an excellent opportunity for companies and their boards to make a positive difference to their reputation and cultivate trust. Internal and external stakeholders benefit from a detailed explanation of what is important to the board and executive committee in managing the company; how the company intends to meet strategic goals, i.e. through approaches, behavior and corporate culture; and how business model opportunities and risks are assessed and managed, taking into account shifting conditions and especially environmental aspects. Non-financial reporting is also a chance to actively address growing stakeholder activism on social and environmental issues. Now is the time to decide how to position the company and communicate on these topics. Specifically, organizations will need to fundamentally rethink their established processes in strategic communication and external reporting through closer involvement of the board of directors.

ESG[1] – stakeholder focus and board expectations

In general, we can expect an even stronger focus on the "E" and the "S" from all stakeholders, not just shareholders. Responsibility for the "G" is clearly seen to lie with the board of directors. As SWIPRA's 2020 Corporate Governance Survey revealed, two-thirds of institutional investors from Switzerland and abroad expect the board of directors to take a more prominent role in integrating a company's strategy with CSR/ESG (see figure 1). This is related to the fact that shareholders seem to be missing transparency on how the two are connected and the role of the board of directors. If even professional investors struggle, then other stakeholders will understand the connection even less.

There is a general expectation that the board of directors should exercise even greater oversight over the way the company is managed, its corporate culture, its financial and non-financial incentive systems, and its overall HR management. The board's role in defining and monitoring non-financial (CSR) processes takes on a new dimension against a backdrop of increased requirements around these processes and their influence on achieving strategic goals. This means that the board of directors and its committees – especially the nomination and compensation committees but increasingly also the audit and risk committees – face a growing range of topics within this area, and these vary depending on the situation.

There is no doubt that this focus on social responsibility and non-financial, qualitative aspects makes sense. It is not really anything new either, as the basis of a company's strategic success or failure. However, it is not always easy for outsiders to understand what the board is already doing in terms of corporate management and process monitoring, through its strategy process and strategic risk management, for example, or by establishing the three lines of defense. This means we can expect even more intensive shareholder activism on ESG issues, be it from members of the public or the media, shareholder proposals at general meetings or the increasingly important dialogue between shareholders and the board of directors.

In Switzerland, the hurdle for shareholder proposals will be significantly lowered at many companies as part of the corporate law reform (expected to enter into force from 2023). An international trend is already emerging toward more frequent shareholder motions – and broader support for those relating to the long-term development of a company. A good example is the case of Vanguard, now on average the second-largest shareholder of Swiss companies[2]. At the same time, the vote on non-financial reporting at Swiss AGMs, which is set to become mandatory, is a good opportunity to buffer shareholder criticism and counter the risk of even more shareholder proposals. It is now up to companies themselves to develop a reporting system tailored to their needs, and to strengthen their communication on the topic. This mechanism is well established and has proven effective in dealing with questions about remuneration, with many companies already holding a voluntary vote on the remuneration report. Shareholder criticism tends to be voiced mainly in connection with this agenda item rather than during binding votes on the actual compensation amounts.

1 Environment, Social, Governance
2 "Vanguard evaluates each shareholder proposal individually, case by case and with great care. We view the funds' votes as being not 'for' or 'against' a company, but rather in the best long-term interest of the company's shareholders. We have found that our practice of discussing a shareholder proposal with both its proponents and the recipient company can lead to greater shared understanding and better outcomes for long-term investors, regardless of a vote's result." Source: Vanguard, 2021

Figure 1: SWIPRA Corporate Governance Survey 2020 – board leadership and CSR

Question: Are boards of directors in Switzerland taking sufficient leadership in integrating a company's strategy with corporate social responsibility as well as incentives and capital allocation?

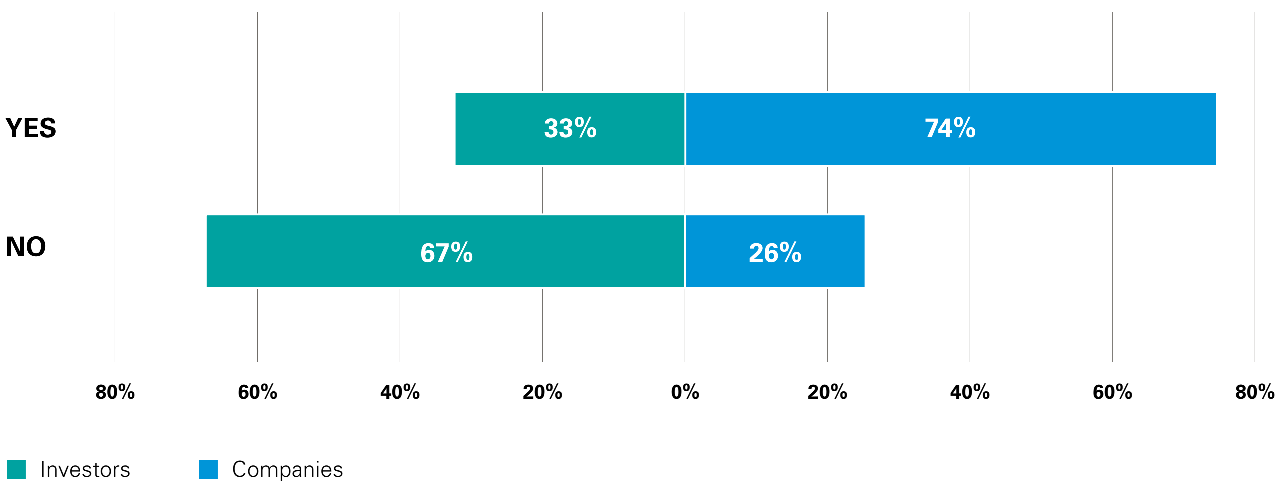
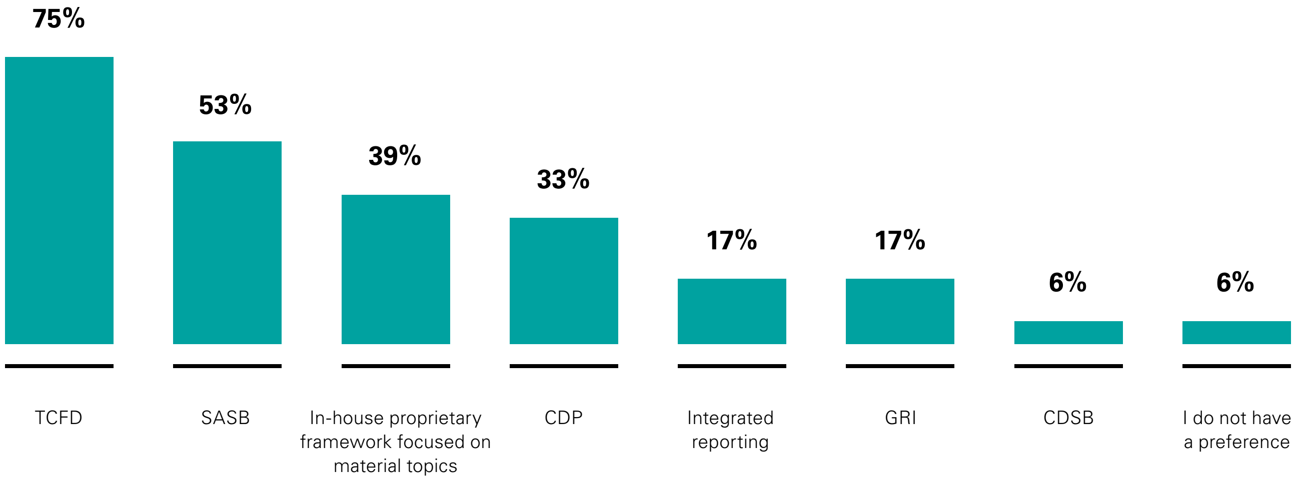


Figure 2: Morrow Sodali Investor Survey 2021 – ESG frameworks

Question: What is your preferred ESG framework for companies to best disclose their material ESG topics?



Non-financial reporting: Quo vadis? – Board leadership

What should this future reporting look like, then, and how can companies embed it in their strategic communication? If it were up to international institutional shareholders, non-financial reporting would follow the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB), as confirmed by Morrow Sodali's latest Investor Survey 2021 (see figure 2). What is new compared to last year, however, is the finding that some investors will also rely on their in-house proprietary frameworks focused on material topics.

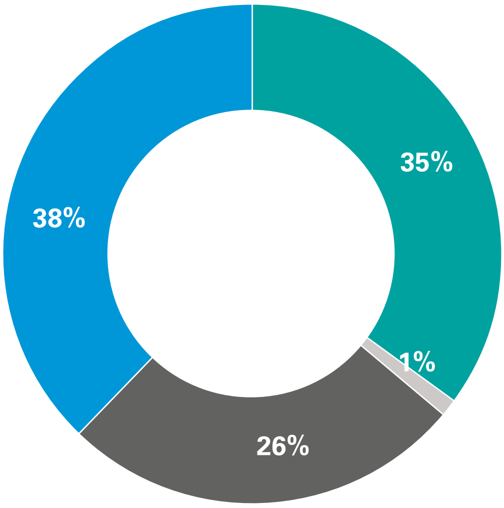
Each company must decide for itself which type of non-financial reporting is most appropriate. Applying one specific set of rules is at best useful, for example, in ensuring comparability of politically relevant information, meeting certain ratings or other stakeholder requirements, or comparing certain key indicators over time. However, standards in and of themselves are not sufficient to present or support an understanding of how ESG factors impact a given corporate strategy and, following on from this, how the company aims to operate the business sustainably.

Many companies have therefore reached a critical point in the development of their future communication and reporting. On the one hand, the current situation in Switzerland can be seen as an opportunity to develop tailored voluntary disclosures on all non-financial and qualitative aspects. On the other, this reporting needs to be developed with an awareness that shareholders will one day be able to vote on it. It is conceivable, and in my view desirable, that a new type of reporting will emerge. Reporting should be future-oriented and highlight the strategic journey of a company, focusing on the individual opportunity/risk profile while the traditional financial reporting sets out information on the past and gives an account of the decisions made.

Board leadership is vital if these various factors and requirements are to be integrated and addressed – in a timely and effective manner – within the established processes of strategic communication and reporting. As is well known, the board makes the relevant decisions on strategy and should now reconsider and articulate its communication requirements, including those around financial and non-financial reporting specifically. The board should then initiate appropriate processes. In future, non-financial aspects – and reporting – will be among the most important pillars of a company's reputation management. Ultimately, this affects the board of directors at its very core.

Figure 3: Morrow Sodali Investor Survey 2021 – Say on sustainability

Question: Do you support the concept of a shareholder 'say on sustainability' or an annual vote on sustainability reports?



- Yes, introduce 'say on sustainability' – as an advisory vote
- Yes, introduce 'say on sustainability' – as a separate binding vote (and independently assured)
- Yes, but only on the robustness of the reporting, not on actual non-financial performance
- No, shareholders have the option to vote against directors if they have concerns regarding a company's sustainability

Independent audit of non-financial aspects?

The indirect counter proposal to the Responsible Business Initiative does not provide for an external, independent audit of non-financial reporting (with the exception of a review in accordance with Article 964^{sexies}(3) CO). Nevertheless, various stakeholders expect some assurance on published information. As SWIPRA's 2020 survey showed, institutional investors (predominantly global institutions) support the say on sustainability due to be introduced in Switzerland. They also favor an advisory vote, although only a minority believe independent assurance is necessary (see figure 3, Morrow Sodali Investor Survey 2021).

At the same time, credibility and trust in disclosures will depend on how well the public, policymakers and investors in particular understand how the information has been verified and assessed, and what role the board of directors plays in the process. This includes how the board determines, monitors and controls the underlying processes and verifies the disclosed information, i.e. how it meets the due diligence requirements along the value chain and decides on any necessary, corrective or new measures.

Accordingly, it will be important from the board perspective not only to provide transparent information about non-financial aspects, but also to explain in much greater detail than is currently the case how the board manages and monitors the relevant processes. A governance report detailing the working methods of the board and its committees should therefore account for a sizable portion of non-financial reporting, and certainly more than we see today.

In SWIPRA's 2019 Corporate Governance Survey, 72% of companies believed that an external audit, particularly on human rights compliance and environmental aspects, would generate little benefit. At that time, 41% of institutional investors also shared this view. However, over 70% of investors, compared to just under half of companies, saw an effective benefit in external assurance on the compliance management system (CMS). Companies therefore need to better communicate the role of the various assurance functions within the strategy processes and the three lines of defense in monitoring and controlling both financial and

non-financial aspects. An external audit is not required by law and no specific standards are yet mandatory in Switzerland. Companies should note, however, that a majority of institutional investors see a benefit in independent assurance on certain aspects, and less so in a comprehensive audit.

Independent assurance will serve as a complementary tool to increase confidence in non-financial reporting. With reporting being qualitative in many respects, the company itself must ensure a relevant link between disclosures and strategy.

Consequences for strategic communication and reporting

Boards of directors and their companies should use the current situation to develop transparent non-financial reporting tailored to their needs. And they should take a bold approach. Now is a good opportunity for boards to work actively and purposefully on improving communication not only as a whole, but also in terms of how they present long-term corporate objectives and their work on non-financial aspects, i.e. social and environmental issues, and, related to this, reputation. This is what really matters now, not when the AGM gets to vote on the topic.

Barbara A. Heller
Managing Partner, SWIPRA Services

About Barbara Heller

Barbara Heller is co-founder and managing director of SWIPRA Services AG, a Swiss corporate governance specialist and consulting firm for Board of Directors and institutional investors in the area of responsible investment. Barbara Heller also serves as a member of the Strategy of Counsel Committee of Graubündner Kantonalbank, Chur (SIX: GRKP), a member of the Chairwoman Committee of Transparenta Collective Pension Foundation, Aesch/BL, and Vice-Chair of the Swiss CFO Forum, Rotkreuz. She is also Chairwomen of the Swiss CFO Awards and Of Counsel at Lemongrass Communications AG, Zurich. Until the end of March 2021, Barbara Heller was a member of the Board of Directors and Chair of the Audit Committee of Bank Cler Ltd.

This article is part of the KPMG Board Leadership News. To receive this newsletter for board members three times a year, you can register here.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center offers support and guidance to board members. We equip you with the tools and insights you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business. In addition, we help you to connect with peers and exchange experiences.

Learn more at kpmg.ch/blc