The ESG journey: Lessons from the boardroom and C-suite

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It is now widely recognized that environmental, social, and governance (ESG) issues factor into corporate performance and can no longer be seen as "soft" reputational issues to be handled by public relations or marketing. Indeed, investors are recognizing that poor ESG practices pose environmental, legal, and reputation risks that can damage the company and the bottom line and that positive ESG practices can contribute to improved company performance.

The Securities and Futures Commission (SFC) discovered that 660 firms, or 83%, of those actively involved in asset management in the Hong Kong, considered at least one ESG factor to facilitate better investment decisions and risk management.[1] Investors increasingly are aware that companies with strong ESG performance have a better brand image, a more loyal and stable customer and employee base, lower cost of capital, better access to financing and, ultimately, a greater focus on long-term value creation.

ESG issues also matter to an ever-broadening swath of stakeholders, including millennials and iGens—who are increasingly influential and discerning consumers and employees—and, of course, many of the world's largest investment managers. In September 2018, the SFC published its Strategic Framework for Green Finance, which covers three major areas: (i) enhancing listed company, asset manager and investment product disclosures and their consideration of ESG factors, especially environmental and climate risk; (ii) facilitating the development of green or ESG-related investment products, and supporting investor awareness and capacity building, and; (iii) promoting Hong Kong as an international green finance centre.[2]

Leadership by the world's largest asset managers—BlackRock, Vanguard, and State Street, among others—on matters such as climate change, workplace diversity, executive compensation, and even board composition has placed traditional ESG factors front and center. In his 2018 letter to CEOs, BlackRock's Larry Fink emphasized sustainability and a more expansive view of governance and accountability, "Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth."[3]

Martin Lipton of Wachtell Lipton said that Fink's letter "sets out the type of engagement between corporations and their shareholders that BlackRock expects in order to secure its support against activist pressure… [and] needs to be carefully considered in developing investor relations engagement practices."[4]

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$35.3 trillion (36%) of AUM globally shows continuing prevalence of sustainable investment.

Global Sustainable Investment Alliance report, 2020

[1] The Securities and Futures Commission, Survey on Integrating Environmental, Social and Governance Factors and Climate Risks, in Asset Management, 16 December 2019.

[2] The Securities and Futures Commission, Strategic Framework for Green Finance, 21 September 2018.

[3] Larry Fink's Annual Letter to CEOs, BlackRock, 2018.

[4] Martin Lipton, Engagement—Succeeding in the New Paradigm for Corporate Governance, 2018.

ESG, strategy, and the long view: Five-step framework

Detailed descriptions of these framework elements are included in *ESG, strategy and the long view*.

1. Level setting

Agree on definition of ESG and its importance to the company.

2. Assessment

Determine which ESG risks and opportunities are of strategic significance to the company.

3. Integration

Encourage integration of strategically significant issues into the business strategy.

4. Stakeholder communications

Shape the company's key ESG messages to investors and other stakeholders in the context of strategy and long-term value creation.

5. Board oversight

Ensure that the board has the right composition, structure, and processes to oversee ESG in the context of strategy and long-term value creation.

Each company will have its own mix of ESG issues, but for purposes of this paper, "ESG" encompasses those that are prominent on investors' and other stakeholders' agendas today and commonly cited in corporate responsibility and sustainability reporting:

- Climate change impacts
- Water and waste management
- Natural resource scarcity
- Product and worker safety
- Supply chain management
- Workplace diversity and inclusion
- Talent management
- Employee relations
- Human rights
- Health
- Labor practices
- Executive compensation
- Political contributions
- Board independence, composition, and renewal

Given the importance of these issues, in October 2017 the KPMG Board Leadership Center published *ESG, strategy and the long view*, which offers a five-part framework for boards to consider as they help guide their companies in addressing ESG issues as a strategic imperative for long-term performance. In subsequent months, we conducted a series of one-on-one interviews with directors and officers of major corporations—all recognized leaders in addressing ESG and sustainability issues. As we found in these interviews, even for conscientious CEOs and boards, integrating ESG into corporate strategy isn't easy. ESG often means different things to different people. Transforming it from an ancillary issue siloed in a distant corner of the enterprise to a broad core competency requires significant and sustained effort. And there's no single model for organizations to follow.

Conducted under Chatham House rules, our interviews with directors and officers of companies that are well along their ESG journeys revealed important insights about their efforts to define and assess, integrate, and communicate their ESG activities to investors and other stakeholders. Following are highlights from the interviews—as well as insights we've gathered from conversations with other directors and business leaders.

68% of asset management firms saws **ESG factors**

having an impact on their investment portfolio

The SFC 2019 ESG Survey

Level setting: How issues are framed impacts our understanding of why they matter and how we address them. By agreeing on a definition of ESG and its importance, managements and boards can set the stage for progress. And by framing the discussion in business terms—risk, opportunity, efficiency, and financial performance—they can help short-circuit preconceptions, politics and personal views.

Q. What has been the driving force behind the company's decision to focus so intensely on these environmental, social, and governance issues?

KPMG observation: *The catalyst behind the company's decision to focus so intensely on ESG issues is generally some combination of (i) people understanding the importance of ESG and driving the company's focus; (ii) an increasingly intense focus by the board and management on enterprise risk management (ERM) and strategy, which has opened people's eyes to the strategic importance of ESG issues, both as a risk and as an opportunity; and (iii) expectations of investors, customers, and employees.*

As to the people driving ESG, "I think it is both top down and bottom up. From the top, a founder or CEO recognizes the mutuality principle and determines that the purpose of the company is to create mutuality of services and benefits for all stakeholders—shareholders, employees, customers, and suppliers. Basically, the founder or CEO believes that we can only be successful in the long term if everybody we touch is also being successful. This is core to the company's strategy; we can only be successful in the long term if we are taking care of the people in our supply chain, our customers, our employees, and the environment. So it's not altruism—it's business and it's a win-win."

"The bottom up piece comes from a number of passionate individuals who have seen the light over the past 10 or 15 years and have been working out what the mutuality principle really means for us and how we live up to our responsibilities. What is the right target for us on carbon? What is the right target for us on water? And how should we think about human rights? Talented and passionate individuals often at mid levels of management have wrestled with and grasped different pieces of this puzzle and made sense of it. And that then has led to targets and programs."

"I would identify ERM and industry disruption as two of the driving forces. ERM helps you focus on key risks of strategic importance to the company, and some of these risks are ESG-related. In effect, ERM serves as a catalyst for getting the conversation going around ESG issues. And industry disruption is what gets people thinking a lot more about trends, what's happening in society, and the need for innovation. This focus on industries experiencing a lot of disruption—such as consumer products, oil and gas, and automotive industries—forces the board and management to take a hard look at strategy and the ESG issues critical to that strategy. And so I think that the combination of ERM and industry disruption has really spurred this ESG conversation in a lot of industries."

How difficult is it to get buy-in from the board and management on ERM? "This is not about doing good for the world. This is about business strategy. So you get buy-in when you can present a business case for the investment. And that business case is made up of cost savings, cost avoidance, growth, and reputation. In general, you're not going to get a good ROI if you only look at the first three or five years; The returns are typically in the 5- to 15-year range. So if you're guided by short-term horizons, you likely won't focus on ESG."

"One of the biggest challenges to getting buy-in on ESG is when a company is going through a major turnaround and you're focusing on day-to-day survival. Many ESG issues tend to be more long term in nature. When a company is in survival mode, the short term becomes more of the focus and some long term issues such as ESG take a back seat. There are times in a company's history when certain ESG issues do need to take a back seat to short-term day-to-day survival issues."

Q. How did the board and senior management determine which environmental, social, and governance issues to focus on? Was it obvious or was there a significant effort to identify issues that were of strategic significance?

KPMG observation:
Recognizing that the strategically significant ESG risks and opportunities will vary by industry and sector, most companies undertake an inventory to identify and assess all ESG issues material to the business, such as environmental degradation, product and worker safety, waste generation, etc., that could affect the business or its stakeholders. From this list, they then identify the two or three ESG issues that are core to the business strategy and key to the long-term health and viability of the business.

"Once the material ESG issues are identified, they become an accepted part of the metrics and scorecards. But the highly strategic ESG issues will also become part of strategy and risk discussions. You need to clearly understand your most important strategic vulnerabilities, and if you don't, an activist or analyst will. Increasingly embedded in ESG, depending on the industry, are highly strategic issues. And they deserve far more agenda time, whether it's climate change if you are an energy company or talent management if you are a service business."

"And it's not always so clear what the critical strategic issue is. When we started on the ESG journey at my company, we wanted to better understand our carbon footprint, which we thought was our truck fleet. But when we mapped it out, it wasn't the truck fleet but was power consumption in electronic devices we deployed in homes. That changed the whole discussion. But again, it's all so dynamic. Things that weren't strategic before all of a sudden become strategic."

"ESG issues are not static—they evolve. And if you look at our sustainability committee agendas, you will find that it's been a totally evolutionary process. The implications of climate change for our strategy, including fuel efficiency and our carbon footprint, have been on the board and committee agendas for some time. But with industry disruption, the agendas have evolved to include the impact of new technologies on human capital and skill set needs and the need for innovation."

"I think you have to parse ESG. For most boards, the G, or governance, is handled by the nominating/governance committee and the committee should have a pretty clear idea of what best practices are and where they're coming up short from a governance benchmarking standpoint. As to the E, or environmental issues, in some industries this is highly strategic and a key priority for management and the board. For companies in industries where it's not so strategic, it's pretty easy to identify material environmental issues and benchmark your progress. The Sustainability Accounting Standards Board (SASB) and other standard setters have provided good guidance. So, at most companies, the E gets addressed."

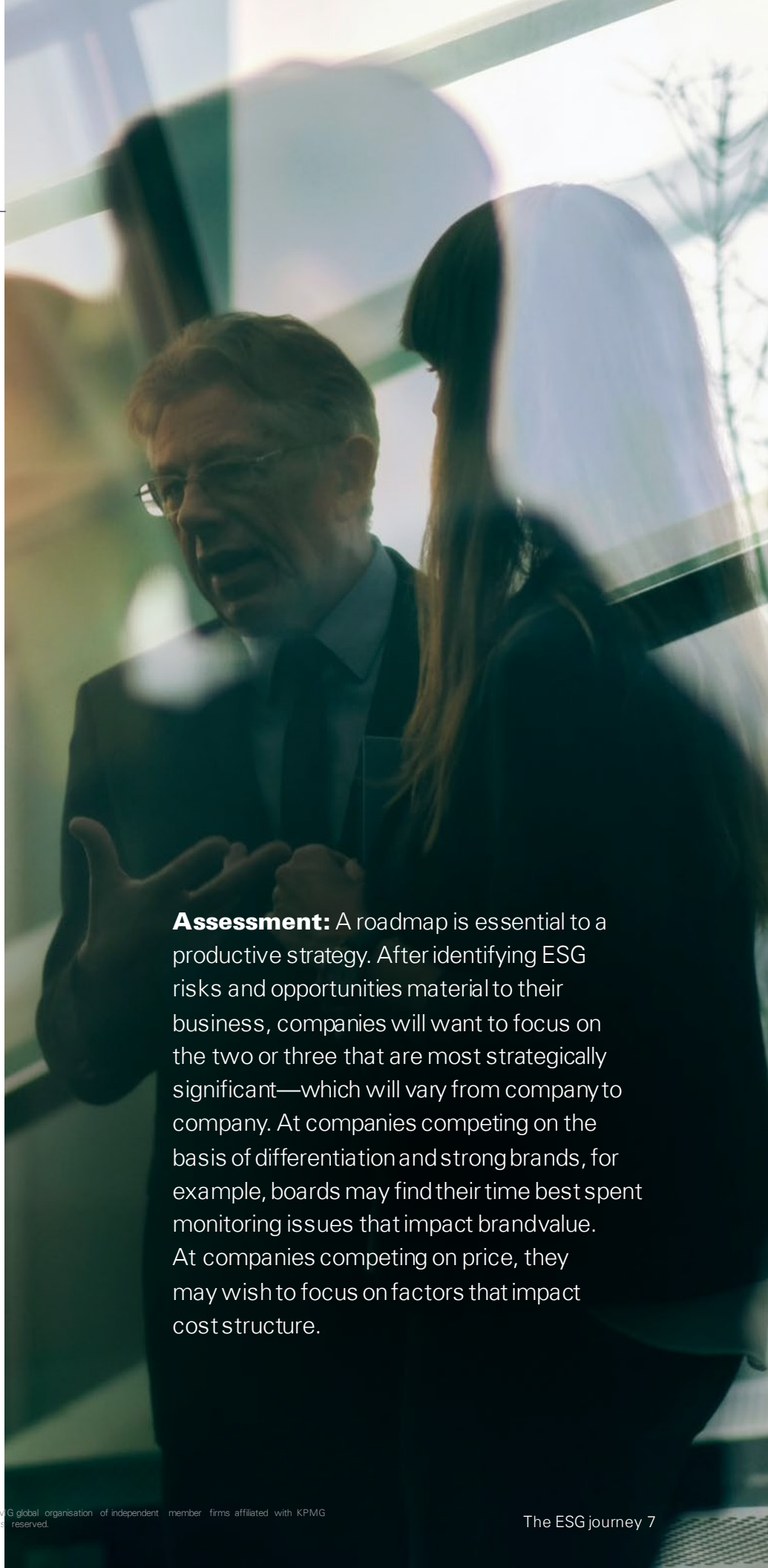
Incorporation of ESG factors into investment and risk management process reached

35% in 2019.

The SFC, 2019 ESG Survey of 794 asset management firms in HK

"But I think the one wild card is the S or social, and that is difficult for most companies. What do you mean by social? Does it include culture and talent management? What do your employees and customers think it means? Is it your profile on social media? The boards of some of the social media companies probably had a different view of the S issues two or three years ago than they do today. And with artificial intelligence and big data, the privacy and other social issues are going to increase in importance in the coming years."

"I think boards have to do a better job and be better educated about how to think about the social piece of ESG because it is going to be increasingly important. And more and more happens on social media. How good are we at monitoring social media and figuring out what to do about it? Social media is a whole new area that deserves and warrants more understanding and discussion and focus by boards."



Assessment: A roadmap is essential to a productive strategy. After identifying ESG risks and opportunities material to their business, companies will want to focus on the two or three that are most strategically significant—which will vary from company to company. At companies competing on the basis of differentiation and strong brands, for example, boards may find their time best spent monitoring issues that impact brand value. At companies competing on price, they may wish to focus on factors that impact cost structure.

Q. ESG initiatives are often disconnected from the core business strategy and don't directly contribute to competitive advantage. How did or does your company integrate its major ESG initiatives into its strategy?

KPMG observation:
Integrating the company's one, two, or three major ESG initiatives into strategy is important because it enables the board and management to bring the same focus and discipline to the management and oversight of these initiatives as they do for other strategic initiatives aimed at creating long-term value. How to achieve that integration, however, is complex and will vary from company to company. But two broad areas of focus include employee selection and behavior—including talent, compensation, and employee empowerment—as well as organizational processes and routines, such as ESG metrics and targets, performance monitoring, capital allocation decisions, as well as consideration of ESG issues when making marketing, financing, and investment decisions.

Integration: Too often, ESG initiatives remain peripheral to core corporate activities and so do not contribute directly to a company's competitive advantage. By integrating ESG programs into business strategy and the incentive programs driving it, companies can bring the same focus and discipline to them as they do to other strategic initiatives. Integration efforts should include two broad areas: employee selection and behavior, and organizational processes and routines.

"It's critical that you connect your finance organization with your sustainability organization when developing metrics because almost every ESG metric needs to come back to a financial metric, even attrition. Yes there is a cost, a productivity cost, of employee turnover and attrition. The data and analytics tend to fall within your finance organization, and finance is the one with the street cred. Your chief sustainability officer (CSO) and chief financial officer need to be joined at the hip in developing these metrics so that you can monitor performance over the short and long term and measure continuous improvement."

"The ESG language needs to be translated to the financial language or else you're just talking to the wall. We all need to be speaking the same language, and it's the language of finance. It's the language used in business cases, setting goals and metrics, and capital allocation and investment decisions."

"Your CSO needs to be 'empowered' and reporting to the CEO and not buried within the organization. The CSO needs to be involved in strategy, risk, capital allocation, and M&A decisions across business lines."

"And that's one of our biggest challenges, deciding what we are going to measure. What are going to be our goals? Who are we going to partner with because, in some cases, you're partnering with entities that are experts in this? What third-party entities, including suppliers, are we going to get to help us in this process? Those became the nitty-gritty, which is what I call the 'execution part,' once you identify the strategic ESG issues that you want to focus on."

"And you've got to recruit executives and managers who believe that ESG is important—managers who buy into it—because you're not going to get where you have to get if you don't have that. Managers who are more traditional or old school may not be able to grow into this. And so it's really, really important that you recruit people—at all levels of the organization—who want the company to have an impact on society and who see value for the bottom line. But your traditional old boys' club may not really buy into these things."

"Making a sustainability program successful requires a business mind set, partnering with operating groups, and real governance. When we started, we had to find projects that made financial sense—easy wins. The sustainability group became an opportunity partner for the operating groups as opposed to compliance. We find ideas that we think might work for them, do the homework and the math, and they get to decide whether to go forward. If the ROI is high, they keep the savings."

"When these issues go before the chairman and CEO, the sustainability group doesn't make the presentation. Each operating group details their projects and their savings. Most projects come to the board now. And many of these operating groups are empowered, previously toiling in obscurity. They get the exposure and the recognition. They take ownership and want the projects."

22% of directors surveyed by KPMG at the 2018 NACD Global Board Leaders' Summit **said ESG is directly linked to corporate strategy.**

Q. Employees, consumers, regulators, and investors all seek information about the company's ESG efforts—and they all have somewhat different information needs. How does your company communicate to investors and other stakeholders about ESG?

KPMG observation:
The first step in crafting ESG messages that resonate is understanding the varying information needs of the company's stakeholders. Employees, consumers, communities, regulators, and investors will frequently seek different ESG information. For example, the information in an annual "corporate citizenship" report addressing issues such as employee engagement and diversity and corporate philanthropy may appropriately address the concerns of employees, consumers, and communities, but it may not fully address the information demands of regulators, such as the SEC, or the needs of investors focusing on the impact of ESG on the company's long-term performance—and how the company is managing key ESG risks or capitalizing on related opportunities.

"On earnings calls—which most of our directors listen in on—one of the things that is very apparent to me is that [the calls] really don't touch on ESG issues. I've never heard a question about an ESG issue. So the only way that we're going to be able to communicate effectively with stakeholders is going to be outside of formal earnings communications. One way is through a sustainability report. But I think more important than these reports are the meetings that take place between institutional investors and our management team. I think these meetings are essential. And I also think that it's an excellent exercise to have board dinners where you invite some institutional investors to meet with the board, and it gives you the chance to talk about issues that are not ever covered in earnings calls."

"It's not enough to provide only the ESG information that is required in securities filings. What other information do our stakeholders want? What metrics do they want to see? Do they want the information in public filings or on the company website? And how is management answering these questions?"

"What I find with the two boards I serve on is that companies want to communicate in a very factual way. They don't want to get ahead of themselves. They're not interested in just stating goals. They're interested in delivering the performance and then communicating, which is probably why you find the disclosures conservative or less robust than you might expect. But they do know that our customers are asking for the information."

50% of CFA Institute members surveyed believe **independent verification of ESG information should be similar to an audit.**

2017 ESG Survey, CFA Institute

Stakeholder communications: Shaping the company's key ESG messages in the context of strategy and long-term value creation can reinforce the connection between ESG and corporate performance. Although no single framework has emerged for reporting ESG information, boards should understand how management decides what to disclose and how its accuracy is verified—and ensure that progress updates, results, linkage to strategy, and an explanation of how ESG initiatives benefit the company and its stakeholders become part of the company's communications. Keeping ESG front and center is particularly important in competing for talent because it matters to employees—from rank-and-file workers to senior executives.

Q. What is the board's role in overseeing the company's ESG activities? How does it oversee ESG?

KPMG observation:
The structure and processes a board creates to oversee ESG issues will vary based on a number of factors, such as the size and complexity of the company's operations (including its supply chain and whether operations are international), its industry, the magnitude of the company's ESG risks and opportunities, the degree to which these issues are central to the company's strategy, and the level of director expertise regarding relevant issues. But boards of companies dealing with truly strategic ESG issues have learned two critical lessons. First, the board needs the right composition to understand the ESG risks and opportunities and to oversee management's handling of these issues. Second, the board needs to assess the adequacy of its structure and oversight processes.

Board oversight: Make sure there's a "home" for ESG oversight, whether it's the governance committee, an ESG committee, or somewhere else in the board structure. Effective oversight hinges on having the right people in the boardroom, supported with quality information to enable appropriate oversight.

Ultimately, "the board will determine whether ESG is a sideshow or a strategic, mainstream issue. And it will only be treated as strategic and mainstream if the board has directors who understand the company's ESG issues and are committed to making the company have a positive impact on society in a way that creates long-term value."

"At the boards that I'm on, the lead directors are much more empowered and active today than they were 10 years ago. And they are particularly active in facilitating a dialogue about the board agenda, and whether the agenda is properly focused on ESG issues or priorities that directors may be worried about, want to talk about in more depth, or want management to come back with more information."

"It's really important who you have on your board—and the skill sets and the mentality. If you're a board that's targeting somebody with deep financial expertise and that person's financial expertise is embedded in more traditional valuation models where ESG wasn't even taken into account, that's a problem. It's going to be harder to get that person to realize that when they're thinking about strategy, there may be an ESG issue that the company can address in a way that adds real value—where there is going to be a multiplier effect in synergies. So, unfortunately, sometimes the skill sets that we're looking for are not always compatible with the skill sets or mentality required to understand the value of ESG. I think that as board composition keeps evolving, there's a certain amount of generational turnover, attrition, more diversity; I think that will help."

"From the board's perspective, I think there are two things the board can do to gain proper insight and oversight of ESG issues. As President Reagan used to say, 'trust, but verify.' So we don't just trust management to be doing what they should be doing. We really are, as a committee and as a board, demanding accountability. And that means agreeing on ESG goals and metrics, monitoring performance, and compensating based on performance."

As to whether the board should establish a separate committee to assist the board in the oversight of ESG, there is some difference of opinion. "I can't imagine ESG—such an important strategic issue for the company—getting the attention that it needs without there being a designated committee assisting the board in providing oversight." On the other hand, "it's easy for ESG to become compartmentalized and separated from strategy discussions if it is buried in a committee. If ESG is a core strategic issue, it requires the attention of the full board."

"Key to board oversight of ESG is to ask questions, probe, and listen—really listen. Ask the CEO and CSO what's on their worry list. Almost always, there is an item on the list that is highly strategic. A strategic ESG issue can often be picked up that way."

"You have to make it real, and by making it real, the board can become highly engaged and help build the ESG plan. I remember a board meeting several years ago when I spoke for the first time about our extended global supply chain. I took into the boardroom a map of the world and showed the board that we sourced all our raw materials from 30 to 40 underdeveloped countries where some one million workers were at the start of our supply chain. And many of these workers lived in extreme poverty, making less than $1 a day. And there was just silence in the boardroom. And then many discussions followed about how to address the problem and make our supply chain sustainable. We've since made progress."

"But this made it real. When the worker is living in extreme poverty, he has no loyalty to you. So we have no security in the supply chain. And I would argue this is true for many industries."

"We also made it real in terms of carbon. Once we got our arms around our carbon footprint—the size of a small country like Panama—we had many more board conversations about what to do about it. And by making it real, the board became highly engaged and helped build the plan."

50% among 64 Constituent stock of the Hang Seng Index have setup dedicated board-level ESG committees as of 31st December 2021. KPMG Research

123 companies in the S&P 500 have a board-level sustainability or responsibility committee. Bloomberg LP

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ESG, strategy, and the long view:

A framework for board oversight*

*Excerpted from *ESG, strategy and the long view*, KPMG Board Leadership Center, 2017, developed in collaboration with Professor George Serafeim of Harvard Business School.

The role of the corporation in society is an abstract, politically polarizing question that is not high on the priority list of most boards. Yet, embedded in this question are strategic and operational issues critical to long-term value creation. And these issues are attracting heightened attention from investors, consumers, and other stakeholders.

From our perspective, many of these issues fall under the broad rubric of environmental, social, and governance (ESG), from climate change impacts and worker safety to workplace diversity, executive compensation, and board composition. Given the significant opportunities and risks associated with ESG, companies that excel at identifying and incorporating these issues into their strategy enjoy a competitive advantage in the marketplace and among institutional investors. It is increasingly clear that ESG and ROI are connected.[1]

So why isn't ESG top of mind in every boardroom? Too often, the pressures of short-termism—from quarterly earnings reports to investment vehicles valued daily or monthly to management compensation incentives—cause companies to neglect ESG issues, which, by their nature, tend to be more long term-oriented in the context of strategy and performance. Language can also present barriers, and the subject is often difficult to define. Is it corporate social responsibility (CSR)? Shared value? Conscious capitalism? Triple bottom line? Responsible business? Corporate citizenship? Sustainability?

And context matters. How ESG issues are framed for discussion in the boardroom—and across the company—will influence whether they are viewed as business issues that are essential to long-term value creation or soft topics that are more marketing and brand/reputation-driven. For example, a company's approach to the topic of "climate change" might be considered politically fraught and relevant primarily to the company's reputation. But a discussion of how long-term risks to manufacturing operations and the supply chain created by severe weather patterns is likely to be more meaningful and productive.

In addition to the challenges of short-term pressures and finding a common language, there is no cookie-cutter approach to ESG. The strategic importance of specific ESG issues can vary widely by company and by industry. A company's ESG profile may change as the company's business changes, and a company's philanthropic activities captured in a glossy report can create the perception (and complacency) that ESG is being addressed—that the company is "doing its part." In fact, addressing ESG as the long-term strategic issue that it has become and embedding it into the company's core business activities (strategy, operations, risk management, and corporate culture) is a formidable challenge—requiring an understanding of why ESG matters to the company's long-term performance, a clear commitment and strong leadership from the top, and enterprise-wide buy-in.

Companies—and boardroom discussions—are moving at different speeds in addressing ESG issues today. But wherever a company is on this journey, the board can help lead the organization forward by focusing on the big picture. Which ESG issues are of strategic significance to the company? How is the company managing ESG-related risks and opportunities and embedding ESG into the strategy and culture to drive long-term performance? How is the company telling its "ESG story" to investors and other stakeholders?

To help boards understand and shape the total impact of the company's strategy and operations externally—on the environment, the company's consumers and employees, the communities in which it operates, and other stakeholders—and internally, on the company's performance, this paper presents a five-part framework:

- **Level setting:** Agree on definition of ESG and its importance to the company.
- **Assessment:** Determine which ESG risks and opportunities are of strategic significance to the company.
- **Integration:** Encourage integration of strategically significant ESG issues into the business strategy.
- **Stakeholder communications:** Shape the company's key ESG messages to investors and other stakeholders in the context of strategy and long-term value creation.
- **Board oversight:** Ensure that the board has the right composition, structure, and processes to oversee ESG in the context of strategy and long-term value creation. **1**

Each company will have its own mix of ESG issues, but for purposes of this paper, "ESG" encompasses those that are prominent on investors' and other stakeholders' agendas today and commonly cited in corporate responsibility and sustainability reporting:

- Climate change impacts
- Water and waste management
- Natural resource scarcity
- Product and worker safety
- Supply chain management
- Workplace diversity and inclusion
- Talent management
- Employee relations
- Human rights
- Health
- Labor practices
- Executive compensation
- Political contributions
- Board independence, composition, and renewal

Level setting

Agree on definition of ESG and its importance to the company.

While we use the term "ESG" to cover the broad range of environmental, social, and governance issues that are meaningful to investors, employees, customers, and other stakeholders, others may use terms like CSR, sustainability, or corporate citizenship. These terms often mean different things to different people, even those who believe they are speaking a common language. An important first step is for the board to reach an understanding with management not only on language but also what that language means as a practical matter. A case in point: Companies often conflate ESG and charitable giving, but giving is just a narrow aspect of the much larger, strategic ESG equation.

How ESG issues are framed and discussed has a big impact on understanding why they matter to the business and how to address them. Given the pitfalls and barriers that ESG language can create, it is important to (re)frame the discussion in business terms—particularly risk, opportunity, efficiency, and financial performance. As in our earlier example, "climate change" can be framed as a discussion about the risks water shortages and droughts pose to a beverage company's manufacturing operations, the potential financial impact these risks pose, and how the company might mitigate these risks in a way that improves bottom-line performance. This strategic approach can help short-circuit preconceptions, politics, and personal views while setting the discussion on the right course at the outset.

Importance of ESG to corporate performance

ESG issues continue to rise on investor agendas for good reason. Poor ESG practices or ignoring ESG issues pose environmental, legal, and reputation risks that can damage the company and have a lasting impact on the bottom line. By contrast, firms with strong ESG performance tend to have a more stable and loyal investor base, lower cost of capital, and better access to financing, as numerous research papers have now documented.[2] For example:

— Calvert Research and Management's 2017 paper, "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," found that material ESG issues impact a company's financials in terms of revenues, costs, and the cost of capital.[3] Because ESG data is slow to be incorporated into stock prices, investors who accurately understand ESG implications typically have time to take advantage of opportunities and generate alpha.

— Bank of America Merrill Lynch's June 2017 paper, "ESG Part II: A Deeper Dive," found that ESG investing would have offered long-term equity investors benefits in mitigating price and earnings risks and avoiding 90 percent of bankruptcies in the period studied (2002–2015).[4] The paper found that ESG attributes "have been a better signal of future earnings volatility more than any other measure we have observed at a market level."

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— A 2012 Deutsche Bank review of more than 100 academic studies of sustainable investing around the world found that ESG factors are correlated with superior risk-adjusted returns at a securities level.[5]

And the benefits that accrue to these companies are not limited to favorable capital markets. Studies also show benefits in terms of employee engagement and customer purchasing behavior—both of which are vital to competitive advantage and long-term performance.[6]

For many years, investors have focused on the "G" in ESG—governance issues, such as executive compensation, board leadership and composition, and the ability of shareholders to include their director candidates on management's proxy card. But institutional investors are increasingly turning their attention to a range of environmental and social issues that they view as critical to the long-term financial health of the company.

According to Gibson Dunn,[7] over 40 percent of the 827 shareholder proposals submitted in 2017 dealt with environmental and social issues, making it the largest category of shareholder proposals during the 2017 proxy season. (This included 201 social proposals—up from 160 in 2016—related primarily to diversity, discrimination, and gender pay gap issues; and 144 environmental proposals—up from 139 in 2016). The level of shareholder support for environmental issues was notable, with climate change proposals receiving majority support at large-cap companies ExxonMobil, Occidental Petroleum, and PPL, and climate change proposals generally garnering one-third of votes cast.

The 2017 proxy results are perhaps not surprising, given that a number of the largest institutional investors—including BlackRock and State Street—have been so outspoken in emphasizing the importance of environmental and social issues (along with governance issues) in corporate strategy and generating long-term value.

In his recent letters to CEOs of Fortune 500 companies, Larry Fink, chairman of BlackRock,[8] asked them to lay out for shareholders a strategic framework for long-term value creation and emphasized that over the long term, ESG issues—ranging from climate change to diversity to board effectiveness—have real and quantifiable financial impacts and can provide essential insights into management's effectiveness and thus a company's long-term prospects. In its engagement priorities for 2017–2018, BlackRock identified "climate risk disclosures" as one of its five engagement priorities and emphasized the importance of a "climate competent board" for companies that are significantly exposed to climate risk. BlackRock also stated that "we will engage companies to better understand their progress on improving gender balance…If there is no progress within a reasonable time-frame, we will hold nominating and/or governance committees accountable for an apparent lack of commitment to board effectiveness."[9]

In its January letter to directors, State Street Global Advisors emphasized the importance of sustainability in long-term corporate strategy and stated, "In 2017, we will be increasingly focused on board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent management, some or all of which may impact long-term value." State Street attached a framework to its letter to help boards focus on ESG issues, including a list of questions that boards can use as a starting point to begin work with management to incorporate a sustainability lens into long-term strategy.[10]

In 2017, Vanguard updated its proxy voting guidelines, stating that it will evaluate each environmental and social proposal on its merits and may support those with a demonstrable link to long-term shareholder value. Subsequently, in connection with negotiating the withdrawal of a climate change shareholder proposal submitted to certain of Vanguard's own funds, Vanguard announced that it had prioritized climate risk on its engagement agenda, noting: "It is crucial to our fund investors that market participants have access to consistently comparable information to incorporate these risks and opportunities into market prices."[11] And Fidelity Investments revised its proxy voting guidelines to say it may support shareholder proposals calling for reports on sustainability, renewable energy, and environmental impact issues and may also "support proposals on issues such as equal employment, and board and workforce diversity."[12]

Activists, too, are sharpening their focus on ESG factors. While activist investors have largely focused on board/governance issues in recent years (board composition, executive pay, and proxy access), social and environmental issues are featuring more prominently in the investment process. For example, in its recently revised policy statement, Trian Partners notes that environmental and social issues "can have an impact on a company's culture and long-term performance and that companies can implement appropriate ESG initiatives that increase their sales and earnings." Trian also indicates that it "will report periodically on the progress on ESG matters at our portfolio companies in communications with our investors."[13]

Taken together, 2017 ESG proxy season results and recent pronouncements from major institutional investors and activists send a clear message to directors that ESG issues are a priority for investors and should be a priority for companies.

As we look to 2018 and beyond, we expect these issues will remain a priority and perhaps even grow in importance as the Trump administration's pullback on environmental and social issues may cause investors to step in to fill a perceived void.

Corporate America appears to be listening. Some of the largest U.S. corporations are publicly emphasizing the strategic importance of ESG to their businesses, and the Business Roundtable (an association of CEOs of leading companies[14]) addressed the importance of ESG in its *Principles of Corporate Governance 2016*.[15]

— "Companies should strive to be…responsible stewards of the environment and to consider other relevant sustainability issues in operating their businesses. Failure to meet these obligations can result in damage to the company, both in immediate economic terms and in its longer-term reputation. Because sustainability issues affect so many aspects of a company's business, from financial performance to risk management, incorporating sustainability into the business in a meaningful way is integral to a company's long-term viability."

— "A company should conduct its business with meaningful regard for environmental, health, safety and other sustainability issues relevant to its operations. The board should be cognizant of developments relating to economic, social and environmental sustainability issues and should understand which issues are most important to the company's business and to its shareholders."

Other leading organizations—including CECP (the "CEO Force for Good") and its Strategic Investor Initiative, the Committee on Economic Development, and the Organisation for Economic Co-operation and Development—are also sharpening their focus on, and advocacy for, ESG as a critical factor in long-term corporate performance and the long-term health and sustainability of capitalism. **1**

Assessment

Determine which ESG risks and opportunities are of strategic significance to the company.

Identifying the strategically significant ESG risks and opportunities for a company is complex, as they vary by industry and sector, and even within industries. Generally, however, a two-step process is helpful:

Identify and assess all the ESG issues that are material to the business, such as environmental degradation, product and worker safety, waste generation, etc.—issues that could materially affect the business or its stakeholders. Part of the identification and assessment process should involve analyzing the likelihood and magnitude of ESG risks and opportunities, knowing that these variables may shift and thus need to be revisited.

From the broad inventory of material ESG issues, identify the two or three ESG issues that are strategically significant. Which ESG issues are truly core to the business strategy and key to the long-term health and viability of the company? In addition to internal assessment and dialogue, which ESG issues do customers, suppliers, and other external stakeholders view as key to the company's long-term strategy? While it is common to coalesce around six to eight issues that could affect the operating efficiency of the company, in most cases, only two or three issues will affect the company's strategic advantage. The board should concentrate on these topics as they fundamentally affect a company's ability to remain competitive. For example, companies that compete on the basis of differentiation and strong brands should focus on issues that would affect the brand value of the firm. For companies competing on the basis of price, the emphasis should be on factors that have the potential to further decrease the cost structure or to prevent any unexpected cost increases. Other companies identify one overarching ESG initiative—for example, to generate X percent of new product revenues from environmentally friendly product materials—which serves as the basis for various business units and functional groups to develop supporting ESG goals and initiatives. In short, when deciding which ESG issues to focus on in the boardroom, less is more.

Indeed, making the distinction between *strategically significant* ESG issues and other material ESG issues is important to bring discipline and structure to how these ESG issues should be governed. While management needs to focus on all ESG issues, the board should focus its limited time on the most strategically important ESG issues.

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Once the strategically significant issues are identified, the board should work with management to establish metrics and key performance indicators (KPIs) that enable the board to monitor management's performance against goals. At the same time, the board should monitor stakeholder communications that address these strategically significant issues in the context of strategy and long-term value creation. Other material ESG issues that may well be ancillary to strategy must still be managed by the company and its ESG team, as these issues will also be the subject of stakeholder communications—both mandatory Securities and Exchange Commission (SEC) filings as well as voluntary disclosure that may be of interest to investors, employees, customers, and other stakeholders. (See more on this in Stakeholder communications). And regardless of whether ESG issues are categorized as material or strategically significant, they all should be appropriately addressed in the company's risk management processes—about which the board should receive regular briefings.

Oversight of management's assessment process

Boards need to understand and oversee management's identification and assessment process. A broad and inclusive process that includes key stakeholder perspectives is valuable in several respects, including the following:

— Ensuring that management of the ESG issues is embedded in wider business processes

— Identifying issues and trends on the horizon—such as technological disruption, scarcity of water and other natural resources, or changing weather patterns—that could significantly impact the company's ability to create long-term value

— Enabling different functions of the business to be ready to take advantage of opportunities to develop new products or services and stay ahead of competitors

— Prioritizing resources for the ESG issues most important to the company

— Helping to identify where the company is creating, or reducing, value to society.

There is no standard approach for inventorying and assessing material ESG risks and opportunities—or for condensing this broad assessment to a short-list of strategically significant ESG issues. However, the Sustainability Accounting Standards Board's (SASB) provisional sustainability accounting standards may be a helpful reference. SASB currently maintains provisional standards for 79 industries in 11 sectors. The standards focus on industry-specific sustainability factors that are reasonably likely to have material impacts. The SASB Materiality Map, an interactive tool that identifies and compares likely material sustainability issues across different industries and sectors, may also be helpful.[16]

An important caveat: Many ESG efforts inside companies start with a process focused on ESG issues as risks. In fact, many of the leading companies embed the ESG inventory and assessment process into enterprise risk management or other existing processes. While this can be an efficient process and a good starting point, it is important to avoid focusing only on risk, as this may cause the organization to miss the "opportunity train." The board should also encourage management to focus on the potential for innovation, disruption, and value creation posed by ESG activities and demands in the marketplace, such as:

— Solutions for a low-carbon world, including energy storage, energy efficiency, and renewable energy generation

— Access to education, affordable housing, and financial services to decrease inequality

— Health and well-being, including healthy food consumption, activity services, and healthy lifestyle choices

— Infrastructure in cities to support increasing levels of urbanization

— Technologies that accelerate the sharing economy. **1**

Integration

Encourage integration of strategically significant ESG issues into the business strategy.

While many companies have developed ESG initiatives, they are often disconnected from the core business strategy and remain peripheral corporate activities that don't directly contribute to the company's competitive advantage.

Companies that recognize the strategic importance of ESG are embedding these issues—particularly those aligned with the company's business interests and long-term viability—into their strategy and how they think about long-term performance.

Indeed, by integrating strategically significant ESG issues into the strategy, management and the board will bring the same focus and discipline to the management and oversight of these ESG initiatives as they do to other strategic initiatives aimed at creating long-term value. How best to achieve such integration, however, is complex and will likely vary by company based on business models and strategy processes. From our perspective, integration efforts should include two broad areas—employee selection and behavior and organizational processes and routines.

Employee selection and behavior

— Are we hiring the right talent and is our selection process compatible with building an inclusive and talented workforce that reflects our business needs?

— Do we tie compensation and promotion decisions to the metrics that advance performance on the critical ESG issues that we face?

— Are we empowering people and giving decision rights to teams that can make decisions by taking into account ESG information reflecting local knowledge?

— Is our culture promoting employee behaviors that are consistent with our priorities rather than providing perverse incentives that could actually *deter* employees from exhibiting the behavior management and the board hope to see?

Organizational processes and routines

— Do we have the right ESG metrics to monitor performance, set targets, and incentivize action?

— Are the metrics reliable, comparable over time, and credible for decision making? What are the mechanisms to help ensure these qualities?

— Have we integrated these metrics into capital allocation decisions to help determine which projects to invest in?

— Are corporate functions considering ESG issues when making marketing, procurement, hiring, financing, and investment decisions? Are business unit leaders aligned with the corporate vision?

— How are we achieving harmonization of ESG practices across a diverse set of geographies while at the same time adapting to local culture and laws?

Effective integration of ESG into strategy and operations will also hinge on ensuring that the entire C-suite—not only the chief diversity/sustainability officer, head of marketing, and chief risk officer, but also the CEO, CFO, COO, head of human resources, investor relations, and other key players—understands the importance of ESG to the company's strategy and long-term performance, and how ESG issues impact their respective functions and areas of responsibility. ESG is an enterprise-wide issue, and enterprise-wide buy-in is essential.

Of course, the board has a pivotal role to play in the integration process. For example, Nike's board provides guidance to management on ESG impacts and "the integration of these impacts into Nike's business, including innovation, product design, manufacturing and sourcing, and operations."[17] Moreover, recognizing the strategic importance of brand and human capital, the board "provides guidance regarding the involvement of significant corporate responsibility issues in major business decisions to protect Nike's valuable goodwill and human and intellectual capital."[18]

Similarly, Coca-Cola's Public Issues and Diversity Review Committee provides guidance on the three issues the company has identified as critical competitive drivers: women, the vast majority of buyers of the company's products; water, a key ingredient of the products; and well-being, an important competitive attribute given the shift towards healthier lifestyles.[19] **1**

A note on "purpose"

The board's oversight of ESG would be incomplete without considering the importance of purpose, which adds an important dimension to the ESG/strategy discussion.

Many business leaders—Richard Branson (Virgin Group), Indra Nooyi (PepsiCo), Paul Polman (Unilever), and others—have emphasized the role of purpose in business. Beyond defining and giving a company direction, the intangibles of a clear corporate purpose—motivation and commitment, quality and integrity, values, and culture—are all essential to long-term performance. In our own initiative to articulate KPMG's purpose, nearly 95 percent of KPMG employees who told us their leaders discuss the firm's "higher purpose" said KPMG "is a great place to work" and are "proud to work for KPMG" compared to about 65 percent among those whose leaders *do not* discuss purpose. Not surprisingly, we also found actual turnover among these two groups to be dramatically different—5.6 percent versus 9.1 percent.[20]

Yet research has shown that most organizations today are struggling to create a sense of purpose throughout the organization—and to connect purpose with better future financial performance.[21] Creating a purposeful organization where employees feel that they contribute to the mission of the organization and its positive impact on customers, communities, and other stakeholders is a challenging and often long-term undertaking.

We consider purpose to be a significant lever for fully and effectively using the five-part framework we've outlined in this paper. In organizations where employees feel a strong sense of purpose, developing a common language to talk about the company's major ESG challenges and opportunities—and to focus squarely on those that are most strategically important—will be an easier task. Integrating these issues into the organizational processes of the company will also face fewer hurdles when employees share a common purpose.

Finally, clarity of purpose helps to drive consistent and compelling messaging from senior leadership and the boardroom about the strategic importance of ESG to the company's long-term success.

Thinking long-term: ESG and strategy

Unilever

Global consumer products company Unilever, under CEO Paul Polman, has made "sustainable living" central to how the company operates, and the company says that its brands under that aegis grew 50 percent faster than the rest of the business and accounted for 60 percent of growth. Some examples of ESG-related strategic goals include cutting water use associated with its product use by 50 percent from 2010 to 2020; a goal of 100 percent sustainable sourcing of agricultural raw materials; and a 50 percent reduction in waste associated with consumer product disposal and an even greater cut in manufacturing waste.[22]

Pfizer Inc.

In an industry that garners more than its fair share of critical press, pharmaceutical company Pfizer Inc. counts earning greater respect from society as a strategic imperative. The company views a commitment to corporate responsibility as central to earning that respect. Like many organizations that provide goods or services that are fundamental to human life, Pfizer sees an intrinsic connection between its core business activities and doing good for society—and it does not take that link for granted. As Caroline Roan, the company's vice president of corporate responsibility and president of the Pfizer Foundation noted, "Our license to operate very much depends on our ability to build that trust and that respect with society."[23]

Starbucks Corp.

For years, coffee retailer Starbucks Corp. has pursued corporate responsibility programs aimed at, among other things, helping coffee farmers sustain their businesses while simultaneously improving the resilience of Starbucks's supply chain and ensuring the company a long-term supply of high-quality coffee beans. Starbucks has invested more than $70 million in such efforts. In 2008, amid the financial crisis—and despite sales slowing for the first time in its history and its net income and stock price each falling by more than half—the company stayed the course on its corporate responsibility programs, which it views as core to its long-term business strategy.[24] From the end of 2008 through November 30, 2016, Starbucks's stock significantly outperformed the S&P 500 stock index. Notably, in May 2016, the company issued a $500 million sustainability bond to enhance coffee supply chain management programs around the world. The company's announcement stated that the move "demonstrates that sustainability is not just an add-on, but an integral part of Starbucks, including our strategy and finances."[25]

Stakeholder communications

Shape the company's key ESG messages to investors and other stakeholders in the context of strategy and long-term value creation.

Addressing the information needs of different stakeholders

The first step in crafting ESG messages that resonate is understanding the varying information needs of the company's stakeholders. Employees, consumers, communities, regulators, and investors frequently seek different ESG information. For example, the information in an annual "corporate citizenship" report covering issues, such as employee engagement and diversity, corporate philanthropy, and reducing energy consumption, may appropriately address the concerns of employees, consumers, and communities, but it will not fully address the information demands of regulators, such as the SEC, or the needs of investors focusing on the impact of ESG on the company's long-term performance—and the basic question of whether to invest.

The board's role

Investors expect directors to be competent in ESG matters and to help ensure that the company provides disclosure that translates ESG into the language of the portfolio manager—finance, efficiency, risk, strategy, and long-term performance. Since an increasingly large number of investors view strong ESG performance as an indicator of a well-managed company, a board should ensure that the company's disclosures proactively tell its ESG story.

In addition to disclosing strategically significant ESG matters, companies should disclose other material ESG issues and any additional information necessary to put material information in context. Progress, results, linkage to strategy, and an explanation of how ESG factors benefit the long-term interests of the company and its stakeholders should be part of the company's communications—and reinforced in tone and communications by senior management and the board. GE, Goldman Sachs, Intel, and Unilever are among the companies that have been in the forefront in effectively communicating ESG messages.

The need to put information into context means that providing only the information required in public securities filings may not be enough. The board should work with management to determine whether additional disclosures are appropriate and whether such information should be in securities filings, annual sustainability reports, integrated reports that include both financial and nonfinancial information, the ESG section of the company's website, or elsewhere. For example, if ESG metrics are included in SEC filings, they may be easier for investors to "scrape" and put into their models, but publicly filed information carries a greater litigation risk than information posted on a website.

As part of its oversight, the board should also understand the process management uses to determine the ESG information to be disclosed and how it verifies the accuracy of that information. In that regard, independent review or verification adds another level of rigor, accountability, and reliability to ESG reporting. Clorox, for example, obtains assurance from its auditor on certain nonfinancial ESG metrics included in its integrated reporting. Bristol-Myers Squibb uses third-party reviewers to assess its ESG program and the systems for collecting and reporting data from its worldwide facilities.[26]

Materiality and ESG standards

"Materiality" is central to understanding the ESG information investors want, and there are clear reasons why. As we noted earlier, companies with good ratings on material ESG issues demonstrate less volatility, a lower cost of capital, and, according to some studies, significantly outperform firms with poor ratings on these issues.[27] Moreover, immaterial ESG information is not correlated with superior performance[28] and may be dismissed by investors as "greenwashing." That said, it is important to recognize that materiality can change over time; therefore, the assessment and determination of material versus nonmaterial issues should be an ongoing process.

Under U.S. securities laws, information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision or, put another way, if a reasonable investor would view the information as significantly altering the total mix of information made available. Climate change is one of the ESG issues that has attracted the most attention from the SEC. Guidance provided by the SEC in 2010[29] indicates that unless a company's management can determine that known ESG uncertainties (such as changes in the severity of weather due to climate change) are not reasonably likely to have a material impact on its financial condition or operating performance, disclosure is required.

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But providing material ESG information in a manner that allows comparisons among companies in the same industry and across industries has been elusive, and the quality of ESG disclosure to date has been weak. Approximately 82 percent of the S&P 500 published corporate sustainability or responsibility reports in 2016, according to a 2016 Governance and Accountability Institute report. However, the most common form of disclosure was generic boilerplate that is inadequate for investment decision making. Also, in the less than 24 percent of cases where metrics were disclosed, they were non-standardized.[30]

To date, over 100 ESG standards-setting initiatives have been developed, creating a confusing alphabet soup. Among the most prominent standard setters that employ some type of materiality filter are as follows:

— **SASB** is an independent nonprofit that currently maintains provisional sustainability accounting standards for 79 industries in 11 sectors. The standards focus on the industry-specific sustainability factors reasonably likely to have material impacts, identifying an average of five topics and 13 metrics per industry. Materiality is based upon the materiality framework of existing U.S. securities laws. Companies can use the standards to disclose information to investors in SEC filings, such as annual reports on Forms 10-K and 20-F. Some U.S. public companies, such as Jet Blue[31] and Kilroy Realty,[32] are already issuing SASB reports or implementing SASB provisional standards; and Bloomberg LP, a private company, reports on its sustainability initiatives using SASB standards (the first company to do so).[33]

— **The Global Reporting Initiative (GRI)** is an independent, international organization that seeks to help businesses, governments, and other organizations understand and communicate the impact of business on ESG issues such as climate change, human rights, and corruption. The GRI factors are not limited to investment-related issues. Of the world's largest 250 corporations, 93 percent report on their sustainability performance and 82 percent of these use GRI's standards to do so.[34] SASB and GRI have developed a partnership in an effort to foster harmonization.[35]

— **The Financial Stability Board's Task Force on Climate-Related Financial Disclosure (TCFD)** employs a disclosure regime, based upon other existing climate disclosure frameworks, that is intended to support the reporting of consistent, forward-looking climate-related risks and opportunities to investors, lenders, insurers, and other stakeholders.[36]

Demand for data

We believe that investors will increasingly seek standardized disclosures and metrics so they can analyze comparable data, particularly within industries. As a result, we anticipate there will be a consolidation among raters as winners are selected and comparability prevails. In the interim, public companies will continue to receive numerous questionnaires, surveys, and requests for information from standard-setting organizations and the many organizations that gather ESG data. Some companies will choose to ignore some or all of these requests, since they can be time-consuming and expensive to answer. The problem, however, is that data providers and analysts/raters may nonetheless gather data or supply a rating—and without information directly from the company, the data or rating on which it is based may be inaccurate.

Low ESG scores can have real-world consequences that a board must understand. For example:

— Company-issued requests for proposals (RFPs) may include minimum ESG "score" requirements.

— Some funds are restricted from investing in companies with low scores.

— ESG scores can prompt stockholder proposals and affect investor loyalty in activist situations.

— Some clients will not use asset managers with low ESG scores.

— ESG scores are now being used in the worlds of fixed income, lending, and insurance.[37]

As a result, companies and their boards should focus on effectively telling their ESG story and understand issues that could result in negative ratings from data or ratings providers used by their investors.

Since comparable metrics-based data is prized by investors, what should the board do to help facilitate such disclosure? One option is to use metrics proposed by SASB (or another widely recognized standard setter); another is for companies in the same industry that are not inclined to use existing frameworks to work together to craft meaningful industry metrics. The latter creates the opportunity for a direct dialogue with investors on the usefulness of the chosen measures and then refinements to those metrics based on feedback.

In addition to standard-setting bodies and regulators focused on disclosure, several investor initiatives are defining how ESG matters align with investment returns. Established in 2005 and supported by the United Nations, Principles for Responsible Investment (PRI) counts nearly 2,000 investment managers, asset owners, and service providers as signatories who strive to include PRI's six principles in their investment processes. In 2015, Ceres, a nonprofit focused on leadership and sustainability, worked with BlackRock to create a guide for institutional investors on how to engage with corporations on ESG issues.

While mandating ESG disclosure may not currently be a priority for the SEC, the reality is that investors will continue to push for useful information. ESG is no longer just a negative screen for socially responsible investors; it is increasingly a component of mainstream portfolio managers' investment analysis. In that regard, Bank of America Merrill Lynch's June 2017 report found that 50 percent of the institutional investors with investment horizons of more than five years that responded to its annual survey employed ESG factors, compared to 11 percent with "months" as their time horizon.[38]

As a practical matter, a stockholder base that includes long-term investors should be attractive to boards and management—and aligns with the underlying concept of long-term value creation. **1**

Board oversight

Ensure that the board has the right composition, structure, and processes to oversee ESG in the context of strategy and long-term value creation.

The structure and processes a board creates to oversee ESG issues will vary based on a number of factors, such as the size and complexity of the company's operations (including its supply chain and whether operations are international), its industry, the magnitude of the company's ESG risks and opportunities, the degree to which ESG issues are central to the company's strategy, and the level of director expertise regarding relevant ESG issues.

In analyzing appropriate ESG oversight, we recommend directors consider the following factors.

Board composition

An important question for boards of all companies with exposure to material ESG risks and opportunities is whether they have the composition—including directors with the relevant experience and expertise—to understand ESG risks and opportunities and to oversee management's handling of these issues. In some instances, a specific issue may be so critical to the company that subject matter expertise will be important, such as in the example of investors calling for certain companies to have "climate competent" boards. Some high-profile boards, such as ConocoPhillips and GM, have recently added directors with strong ESG expertise and, by doing so, have sent a message to the market about their priorities.

To the extent the board lacks the necessary experience and expertise, directors should consider including it as a criterion for future candidates. As is the case with cyber expertise, a board should not look for a candidate who just possesses this one skill set. Rather, the goal is to find a well-rounded candidate who also has relevant ESG background. Whether or not the board includes a director with relevant ESG expertise, the full board will benefit from continuing education on the issues and may consider looking to third-party specialists for help.

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Structure and processes

In considering how to provide strong oversight in this area, the board's considerations should include:

— **Allocating oversight responsibilities.** Which activities should involve the full board and which are best handled by an appropriate committee? Given the importance of having everyone on the same page, level setting is best done at the full board level. In contrast, oversight of the assessment and the various types of stakeholder communications may require a significant amount of time and expertise that might more effectively be delegated to an appropriate committee. The determination of whether this set of responsibilities should be added to the agenda of an existing committee or housed in a more focused, newly created committee will depend on factors including the type and magnitude of the issues, the available bandwidth (if any) of the existing committees, and the culture of the board. For example, the board of Nike formed a Corporate Responsibility and Sustainability Committee, which includes in its charter the following responsibility: "Review and provide guidance to management on sustainability issues and impacts, and the integration of sustainability into Nike's business, including innovation, product design, manufacturing and sourcing, and operations."[39] According to Bloomberg LP's latest data in 2015, 123 S&P 500 companies had assigned responsibility for oversight of ESG/CSR to a board committee, up from 116 in the prior year.[40]

— **Information flow.** What information should management provide to the board? The board must work with management to determine what information the board will receive—for example, the KPIs and metrics to be used—and how frequently. In that regard, the board or appropriate committee should consider whether an ESG dashboard would help facilitate understanding and discussion of important ESG issues.

— **Incorporating ESG into the board's oversight of strategy.** For many companies, this is a *change management* effort. Adding an ESG lens to strategy, incorporating ESG risks into the overall ERM process, and establishing and tracking metrics that include the strategically significant ESG initiatives as part of assessing progress against overall company strategy, implications for compensation, talent and culture, etc., may require significant organizational change—not only for management, but also for the board. Whether it rests with the chairman, lead director, governance committee, ESG committee or somewhere else in the board structure, there should be a "home" for oversight of ESG integration.

As a bottom-line matter, finding the right mechanisms for board oversight is likely to be an iterative process, subject to change as the company and its ESG risks and opportunities change. Oversight of these issues, like oversight of any issue that significantly impacts long-term value creation, requires the right people in the boardroom, information to keep the board sufficiently informed and allow directors to track progress, processes that enable the board and its committees to exercise appropriate levels of oversight, and a commitment to continuous improvement. **1**

Moving forward

The drum-beat of "meet or beat the quarter" is increasingly being challenged by a chorus of investors, employees, customers, and other stakeholders calling for greater focuson the long term.

As ESG continues to move from the periphery to the center of corporate thinking—on strategy, risk and reputation, operations and efficiency, andlong-term performance—the board has a pivotal role to play in helping to set the contextand the drive the company's focus on these issues:

— **Articulating what "ESG" means** to the business and agreeing on common language

— **Identifying key ESG-related risks and opportunities**—particularly those that are strategically significant to the company

— **Integrating ESG issues** into the company's strategy, and helping to ensure alignment and buy-in across the enterprise through the right culture and incentives

— **Effectively communicating the company's "ESG story"** to investors and other stakeholders

— **Ensuring that the board** itself has the skills, processes, and information necessary to help guide thecompany forward.

Wherever the company is on the ESG journey, the five-part oversight framework outlined in this paper can help to drive a robust conversation about what ESG risks and opportunities may impact the company's key stakeholders, corporate strategy, and long-term performance and how they will be addressed.

Companies that identify and incorporate these issues into their strategy will clearly stand apart—to investors, customers, employees, and the communities in which they operate—as forward-thinking organizations, focused on long-term performance and value creation.

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Note: Survey data reported is based on 120 responses (from board directors and senior management) to an online survey conducted by the KPMG Board Leadership Center August–September 2017.

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