# On the 2023 ESG committee agenda

## KPMG Board Leadership Centre

How companies address climate change, diversity, equality and inclusion (DEI) issues, and other ESG risks is now viewed – by investors, research and ratings firms, activists, employees, customers, and regulators – as fundamental to business and critical to long-term sustainability and value creation. Especially when facing a cost of living crisis and economic headwinds, oversight of these risks and opportunities will be a significant challenge, involving the full board and potentially multiple board committees. Now is the time for boards to 'hold their nerve' in doing what's right over the long-term.

2022 Analysis of ESG Practice Disclosure[1] by the Hong Kong Exchanges and Clearing Limited (HKEX) shows that over 95% of the sample issuers disclosed how the board oversees and manages ESG issues. Sample issuers provided information on (i) the ESG governance structure; and (ii) where there is a designated working group or committee for ESG matters, the roles and duties of such working group or committee.

Our research shows that around 71% of the Constituents in Hang Seng Index are now having some form of ESG committee – whether that be described as an ESG committee, a corporate governance committee, sustainability committee, governance committee, sustainable development committee or environmental campaign committee, etc.

While each ESG committee will have its own specific terms of reference, drawing on insights from our interactions with directors and business leaders, we highlight seven issues for ESG committees to keep in mind as they consider and carry out their 2023 agendas.

### Clarity of purpose

Oversight of ESG risks and opportunities is a significant challenge, involving the full board and potentially multiple board committees. For example, elements of climate such as disclosure and DEI are overseen by the ESG committee, with assistance from other committee such as Nomination and Governance committee. Guidance on Climate Disclosures[2] by the HKEX recommends two governance structures that organisations can follow, the integrated approach and the dedicated approach. In the integrated approach, management of climate-related issues is integrated into existing standing board committees (e.g. audit, governance, nomination, remuneration and risk committees). While a standalone committee is established in the dedicated approach.

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

### An ESG competent board

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

Individual member of ESG committee may have different expertise on different topics. The ESG committee can play an active role in educating not just the committee members, but the whole board, on ESG issues including the landscape of stakeholder expectations and demands and its opportunities. Ask:

[1] "2022 Analysis of ESG Practice Disclosure", HKEX, November 2022
[2] "Guidance on Climate Disclosures", HKEX, November 2021

- Is the board ESG literate and is it structured to engage meaningfully on ESG issues potentially as diverse as modern slavery and human rights, energy efficiency and renewable energy transition, scope three emissions and other supply chain issues, and reporting.
- Proposed reporting standards (e.g., the ESG Reporting Guide of HKEX, Sustainability Accounting Standards Board of International Sustainability Standards Board (ISSB), Sustainability Reporting Standards of Global Reporting Initiative and Task Force on Climate-Related Financial Disclosures (TCFD)) will require boards to report on how they ensure that the appropriate skills and competencies are available to oversee strategies designed to respond to sustainability-related risks and opportunities.
- Does the board evaluation process assess whether the board has the right mix of skills and whether the ongoing development activities are sufficient?
- How does the board get ESG literate?
- Are ESG matters (including issues around DEI empathetic leadership, etc.) a factor when hiring directors and the executive team?

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

## Engage proactively with shareholders and other stakeholders

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

And beyond the investor community, other stakeholders, whether that be employees, customers or the communities that provide companies their licence to operate, are also voting with their feet against companies they perceive to be paying insufficient attention to ESG issues – whether that be related to climate change matters, diversity and inclusion issues and the treatment of individuals, or the company's contribution to society through (say) responsible taxation.

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

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

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

In short: Is the company providing investors and other stakeholders with a clear picture of its ESG performance, its challenges, and its long-term vision (or ambition) – free of "greenwashing"? (Investors, other stakeholders, and regulators are increasingly calling-out companies and boards on ESG-related claims and commitments that fall short – and all indications are that they will continue to do so.)

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

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

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

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

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

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

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

On behalf of the board, the ESG committee could consider:

- How is the ESG lens applied to the organisations strategic thinking?
- Is ESG thinking incremental to Business as Usual (BAU) (a bolt-on to the existing strategic thinking) or is it transformative?
- Is the board playing an active role in developing and supporting any transition plan? Is it an iterative process – with milestones and opportunities to recalibrate – and does it bring in perspectives from throughout the organisation and beyond?
- Does the process challenge the validity of the key assumptions on which the company's strategy and business model are based? Is there a case for taking a 'clean sheet' approach to the strategy / business model, asking what our business would look like if we started up today?
- How does the board establish a culture that supports the transition towards a more purposeful ESG oriented organisation?
- How does the board address the tensions between the 'E' and the 'S'? For example, failure to put in place an energy transition plan while retiring a fossil-fuel reliant asset could introduce imbalance in labour markets, cause disorientation of social priorities and promote less than ideal work environments, which may result in increased social inequality, strikes, civil unrest or reduced productivity, etc.
- Could you explain what happened if your company ceased to exist in 10- or 15-years' time? What didn't you see coming that caused you to go under?
- Are the incentives connected with executive compensation and the compensation philosophy of the organisation as a whole a fit for purpose? When compensation becomes intertwined with something like ESG, other systems and processes quickly fall in line: recruitment, training and development, strategic planning, performance management.
- What metrics are monitored and reported to ensure the organisation is on track?

## Driving the transition towards a more purposeful ESG oriented organisation through culture

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

- Does the board understand the culture it wants within the organisation?
- Are key processes aligned with desired culture? Hiring, promotion, reward, etc., and how poor behaviour is addressed.
- Is culture embedded into decision-making processes? An organisation is not truly living its values until it costs it money. There has to be a price to pay such as turning down a profitable business opportunity because the customers/clients values or modus operandi are at odds with your own organisational culture. It is at this point that the culture is seen as truly embedded and operational.
- How does the board measure the culture and get assurance that it is what they think it is? What are the different inputs? How can the board pull them together?
- Is the board leading the charge from the top? Are the board and the senior executive team presenting a unified front? Culture starts with the board and it is often the little things that matter.

## Systems, controls and data

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

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

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

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

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

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

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

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

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

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

## Reporting to investors and other stakeholders

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

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

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

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

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

Some critical questions for the ESG committee to consider include:

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

Lastly, stay alert to local regulatory bodies' (e.g. HKEX and Hong Kong Monetary Authority (HKMA)) developments they finalise in relation to new ESG-related reporting standards and disclosure requirements e.g. in June 2022, HKMA issued a circular which sets out the two years plan on supervision of climate risks integrate climate risk into the supervisory processes.

## About the KPMG Board Leadership Center

The KPMG Board Leadership Centre offers support and guidance to non-executive directors, whether managing a portfolio non-executive career or embarking on a first appointment. Membership offers you a place within a community of board-level peers with access to topical and relevant seminars, invaluable resources and thought leadership, as well as lively and engaging networking opportunities. We equip you with the tools you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business.

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