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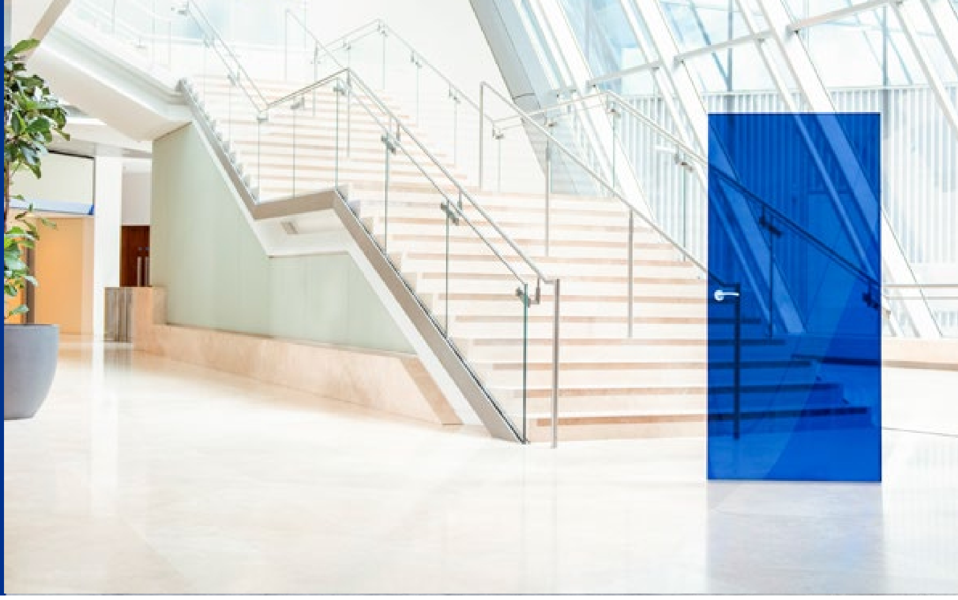
On the 2022 ESG committee agenda

KPMG Board Leadership Centre



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

Spencer Stuart's 2021 UK Board Index notes that of the largest 150 FTSE companies, six companies have set up dedicated board ESG committees as part of their governance structure: Entain, IG Group Holdings, International Public Partnerships, Marks & Spencer Group, Rotork, and Vodafone, mostly launched last year.

However, while not explicitly called an ESG committee, many more FTSE 350 companies have established some sort of ESG-related committee to oversee their environmental and social/community-related activities – albeit not necessarily called an ESG committee.

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 2022 agendas.

Clarity of purpose

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

Consideration needs to be given to the coordination between committees as well as the information flows to the board itself. For example, which governance body is taking responsibility for the data and the systems that produce that data? Which committee is looking at the various disclosures in the annual report?

Some overlap is to be expected, but this puts a premium on information sharing and communication and coordination among committees. It also requires that committees have the expertise to oversee the issues delegated to them.

An ESG-competent board

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

The 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. Ask:

- Is the board ESG literate and is it structured to engage meaningfully on ESG issues?
- 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 IDSE, 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 one-on-one 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.

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.

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

— Does the company engage with, and understand, the ESG priorities of its largest shareholders and key stakeholders?

— Are the right people engaging with these shareholders and stakeholders – and how is the investor relations (IR) role changing (if at all)?

— What is the board's position on meeting with investors and stakeholders? Which independent directors should be involved?

— Will the 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, current picture of its ESG performance, challenges, and long-term vision – 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 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.

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, ESG committees could consider:

— How is the ESG lens applied to the organisations strategic thinking?

— Is ESG thinking incremental to BAU (a bolt-on to the existing strategic thinking) or is it transformative?

— Is the board playing an active role in developing and supporting any transition plan? Is it an iterative process – with milestones and opportunities to recalibrate – and does it bring in perspectives from throughout the 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, applying the brake on fossil fuels too quickly could plunge entire countries into darkness.

— 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 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?

Supporting a culture that drives the transition towards a more purposeful ESG oriented organisation

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."

— 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? 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 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 often it should be reported among other criteria. The ESG committee can focus on understanding the procedures and controls in place.

The ESG committee can also play a role in questioning the level 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.

ESG committees might work in conjunction with internal auditors (and perhaps the audit committee) to understand which metrics 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 towards 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.

Materiality in the context of climate change and other ESG related topics takes into account stakeholder interests and therefore may differ from a purely financial materiality standard. Clarification up front can prevent misunderstandings arising. In any event, it is prudent to look at the spirit of any required regulations and beyond, particularly as TCFD is principle based.

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?

— 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 does it align 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 the developments of sustainability reporting standards by EFRAG and the ISSB, both of which have published some draft prototype standards. These are based on existing frameworks and standards, including GRI, TCFD and SASB and provide an indication of the disclosures that may soon be required.

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