ESG Oversight: The Board's Role and Focus

KPMG Nigeria Board Governance Centre

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A Company's position on climate change, Diversity Equality and Inclusion (DEI) issues, and other Environmental, Social and Governance (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 an array of factors slowing down economic growth, 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 is right and sustainable over the long-term. Environmental, Social and Governance are the key metrics used to measure Sustainability while Sustainability in itself is the responsible and efficient utilisation of resources that does not hamper with the availability of said resources for future generations. In this thought leadership, both ESG and Sustainability will be used interchangeably.

Research by Mattison Public Relations shows that ESG committees are becoming an increasingly common presence on FTSE 100 boards, with 54% of FTSE 100 companies now having some form of ESG committee – whether that be described as an ESG committee, a corporate responsibility committee, responsible business committee, sustainability committee or environments and communities committee.

However, in Nigeria, most boards do not yet have a dedicated ESG committee; they are beginning to delegate ESG oversight in whole or in parts to various committees.

While committees responsible for ESG will have elements of ESG in their specific terms of reference, drawing on insights from our interactions with directors and business leaders, we highlight eight issues for the board and any committee focused on ESG to keep in mind as they provide oversight on ESG matters.

Clarity of purpose

Oversight of ESG risks and opportunities is a significant challenge, involving the full board and potentially multiple board committees. For example, elements of climate and **diversity, equality and inclusion** (DEI) oversight likely reside with the audit, risk management, human resources and other relevant committees – as well as the ESG committee, where they exist.

Consideration needs to be given to the coordination between committees as well as the information flows to the committees from the corporate functions (risk, internal audit, operations, legal, etc.) and from the committees to the board itself. For example, climate change might initially appear to reside with an ESG-responsible 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

There is an argument that developing countries such as Nigeria do not contribute significantly to climate change and should not be held responsible for correcting the effects of climate change. As such, Board Directors may not deem climate change a necessary agenda item for board discussions. It is however worthy of note that we experience significant effects of climate change despite contributing lower emissions in Africa at about 3.8% of total global emissions, resulting in low emissions as a country, according to Our World in Data. A recent example is the floods of 2022 that wiped out lives and assets in at least 13 states in Nigeria. However, there are opportunities that are available for mitigating climate risks, and a key one is funding. It is important that organisations begin to consider the risks and create internal controls to mitigate them and harness the opportunities.

Oversight of ESG risk – and equally importantly, the opportunities – starts with an ESG-competent board. Not every board member needs to have deep expertise in ESG, yet it is recommended that ESG risk and its impact on long-term value creation should be prioritised in the event of recent trends such as the World Economic Forum yearly global risk reports 2021- 2023. Boards need to identify issues 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 committee responsible for ESG 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. Questions to be asked include:

- 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 3 emissions, waste and recycling, ESG supply chain issues, ESG reporting and assurance, etc

  Proposed reporting standards (e.g., IFRS S1) 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 deepen their knowledge of ESG?

- Are ESG matters (including issues around Diversity, Equity and Inclusion, empathetic leadership, etc.) a factor when appointing directors and hiring or promoting executive team?

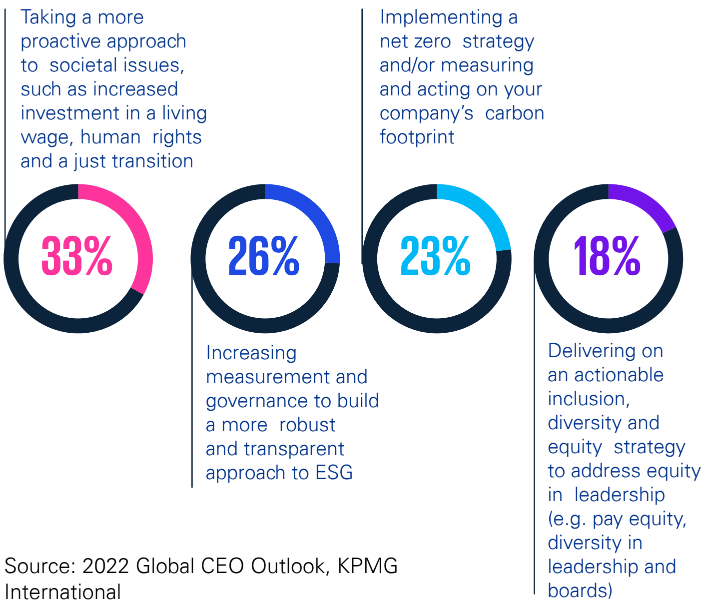
Zeroing in on ESG goals

Sustainability goals continue to be emphasised by CEOs, who say that the predominant source of pressure to promote more transparency about companies' ESG objectives comes from employees rather than investors. To accelerate their ESG strategy, they will take a more proactive approach to societal issues, such as increased investments in living wages and a focus on human rights.

"The recent economic dislocations have revealed more than ever that CEOs must think of their business model holistically. So, it is not possible to focus on one topic to the detriment of others; they're connected," says Stephane Souchet, Global Head of Industrial Manaufacturing, KPMG International. "There's a link, for example, between supply chain issues and ESG, when you think of responsible purchasing. Sometimes there are conflicting agendas, so CEOs might have to change their priorities if they want to achieve their strategic goals." To achieve this, companies need to take an enterprise-wide view of ESG.

The survey results shown below highlight the growing need for the board to adopt a more holistic approach to driving its strategic ESG agenda and priorities. This is

In 3 years, what do you believe will be the key driver to accelerate your company's ESG strategy?



Source: 2022 Global CEO Outlook, KPMG International

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 – these could be issues related to climate change matters, diversity and inclusion issues and the treatment

> "Effectively engaging social initiatives can create value, mitigate risk, build stakeholder trust and deliver a competitive advantage"
>
> **-KPMG 2022**

of individuals, or the company's contribution to society through responsible taxation for instance.

Good stakeholder engagement – particularly through the supply chain (a component of an organisation's circle of influence)–can also provide an opportunity for the company to encourage others to behave responsibly and do what is right over the long-term'.

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

- Does the company engage with, and understand, the ESG priorities of its largest shareholders and key stakeholders?
- Are the right people engaging with these shareholders and stakeholders – and how is the investor relations (IR) role changing (if at all)?
- What is the board's position on meeting with investors and stakeholders? Which independent directors should be involved?
- Will the organisation be open to criticism from activists? Does the board have a roadmap for defence against such criticisms?
- Does the company periodically assess the materiality of ESG topics relevant to its business, from the lenses of both internal and external stakeholder groups?

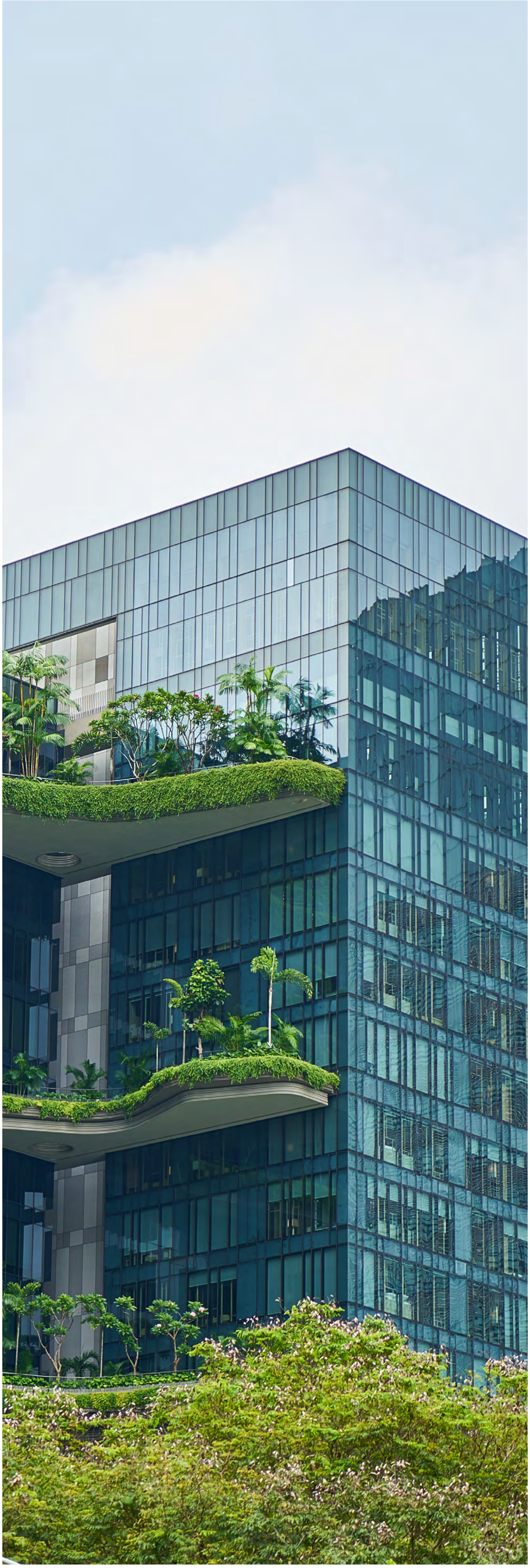
In summary, is the company providing investors and other stakeholders with a clear picture of its holistic performance (especially including non-financial performance such as ESG performance), the challenges, and its long-term vision (or ambition) – free of "greenwashing?" Investors, activists and other stakeholders are increasingly calling out companies and boards on ESG-related claims and commitments that fall short and all indications reflect that they will continue to do so.

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

ESG risks such as those relating to climate change have become fundamental and critical to long-term value addition. ESG risks such as those relating to climate change have become fundamental and critical to long-term value addition.

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

Rapidly emerging issues around the 'S' of ESG have raised concerns and has become key in the discussions of key stakeholders in recent years. These social (S) factors such as how a company manages its relationships with its workforce, the societies in which it operates, and the political environment, are also now central to a company's financial performance. The effects are seen



in recent skill migrations, economic brain drain and the demands of the new generation workforce.

Several fundamental questions should be front-and-centre in boardroom conversations about the company's ESG journey – including 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-responsible committee(s) should also encourage management to consider the potential for innovation, disruption and value creation posed by ESG activities. Businesses that see through effective ESG investments to 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 regulations.

After determining which ESG issues are of strategic significance, the company needs to embed them into core business activities (strategy, operations, risk management, incentives, and corporate culture) to drive long-term performance.

Key questions to consider in order to achieve this objective are:

- How is the ESG lens applied to the organisation's strategic thinking?
- Is ESG thinking incremental to business as usual (BAU) which is a bolt-on to the existing strategic thinking or is it transformative?
- Is the board playing an active role in overseeing 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.
- What will happen if your company ceases to exist in the next 10 or 15 years?
- Are the incentives connected with executive compensation and the compensation philosophy of the organisation a fit for purpose? When compensation becomes intertwined with ESG factors, 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 committees can play a role in helping the board take a more proactive approach in understanding, shaping, by considering the following questions:

- Does the board understand the culture it wants within the organisation?
- Are key processes aligned with desired culture - hiring, promotion, reward, etc.?
- Is culture embedded into decision-making processes? 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 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, data and assurance

The quality of data for both strategic decision-making and reporting is crucial and committee responsible for ESG 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 through a consistent and reliable 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 standard for reporting 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 it shows. The ESG-responsible committee can help reinforce the connections between metrics and financial performance and prospects. They 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 is critical for companies to begin to identify their priorities before pressure from customers, shareholders, and others push to accelerate the company's timeline.

Combined 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.

The committee responsible for ESG 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 companies should consider what matters in the short, medium and long term.

Principles differ between various sustainability reporting standards. Some key considerations include:

- The information investors require to understand the value of the business and its prospects.
- Other Information required by wider stakeholders
- Reporting in a way that includes investor-relevant information within the annual report, while avoiding unnecessary duplication with other broader communications
- To that end, the ESG-responsible committee can encourage management teams to reassess the scope and quality of the company's ESG reports and disclosures.

Other considerations for the ESG-responsible committee include:

- Company performance when benchmarked against peers
- Reporting frameworks considered
- Risk exposure and mitigation disclosures

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 their ESG efforts?
- Does the company's disclosures comply with the appropriate laws, regulations and sector best practices?
- Does 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?

About the KPMG Board Governance Centre

The KPMG Board Governance Centre (BGC) is a dedicated forum that provides Board members with insights and resources to keep abreast of current and emerging governance issues.

The KPMG BGC offer thought leadership and timely resources including periodic seminars and round tables to host the exchange of views and support Board members (including Board sub-committee members) in clarifying and enhancing their governance practices amid rapidly evolving corporate governance landscape in Nigeria.

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