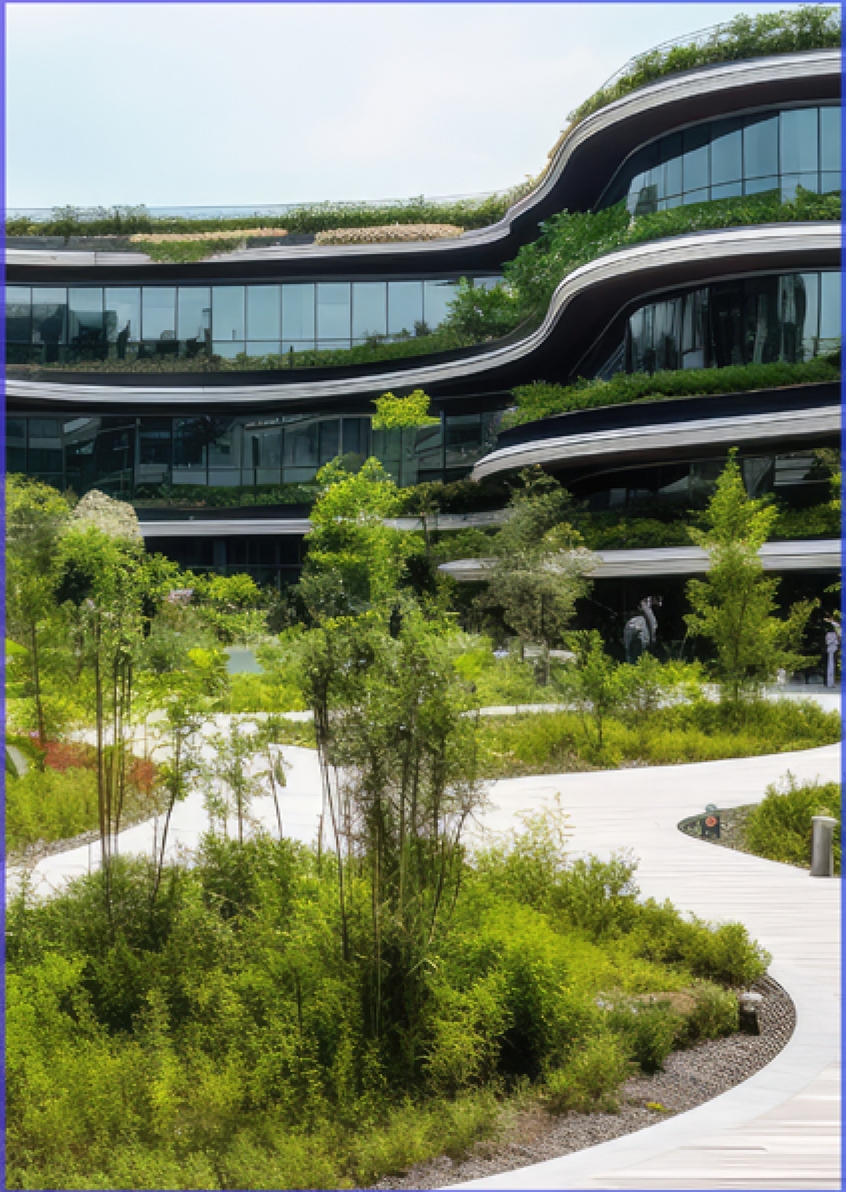
Anchoring ESG in governance

Taking a strategic approach towards corporate governance, board-level responsibility and reporting



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Contents

Foreword

Sustainability is growing in strategic importance for companies, with increasing reporting requirements on environmental, social and governance (ESG) as well as other demands on corporate structures regarding sustainability.

This creates challenges for the group sustainability units charged with ESG work. On one hand, such units must produce more material than they did in the past while strategically developing and implementing initiatives across a wide range of topics from climate to human rights. On the other hand, the framework conditions for this work have become much more complex and the standards for implementation, reporting, mandatory auditing and governance requirements increasingly require a robust approach.

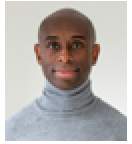
Shareholders and bondholders are focusing on governance as a guarantee that sustainability commitments will be maintained and delivered over the long term. At the same time, corporates require flexibility and agility to discover and develop business opportunities linked to sustainability.

KPMG has observed that both corporates at the beginning of their sustainability journey and those active in this domain for many years are asking themselves how they can best set up their sustainability focused organization to work properly at all levels of responsibility, including the management and supervisory boards, executive committee and business functions.

To understand this better, we conducted 50 interviews with chief sustainability officers and managers in this field to find out how sustainability focused organizations in general and group sustainability units in particular operate. We examined how such units are configured at present, what makes them successful and, above all, how they plan to develop in the future.

Businesses have the opportunity to embed robust ESG and suitability governance by ensuring effective connectivity between functions (e.g. Finance and other functions both in internal operations and supply chains) which can both enable compliance with reporting requirements and the identification of sustainable value creation opportunities through enhanced operational transparency and data driven insights. As one respondent put it in this survey — "if we want to exist as a company in 10 or 20 years from now, we need to transform"— we couldn't agree more and we encourage organizations to look at how their boards can lead the transformation journey through being equipped with the right knowledge and possessing the expertise to engage meaningfully on sustainability issues.

We hope you enjoy reading this report.



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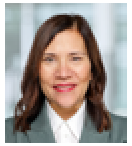

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Key findings

Sustainability has arrived at the top of corporate structures. It is a board-level responsibility, led by chief executive officers in almost half of the corporates in this research. Almost all have made it a strategic issue or adopted a purpose-driven approach.

Sustainability-focused organizations are still developing in maturity, with changes continuing to take place. Even the most advanced corporates are having to adapt to increasing ESG reporting requirements, such as the European Union's (EU) Corporate Sustainability Reporting Directive (CSRD).

Group sustainability units vary widely in structure, with some primarily functional and others more agile in their operations.

Just under half of the corporates in this research discuss ESG through either a dedicated board-level sustainability committee or another specific committee, such as audit.

Some heads of sustainability feel vulnerable alongside other departments that covet their increasingly high-status work. Group sustainability units usually lead on setting, monitoring and implementing ESG strategy and reporting. However, finance and accounting departments are becoming more involved in ESG reporting, with some taking some or all responsibility for the work.

Group sustainability units can adapt to ESG's increasing importance by taking a more strategic approach, working with other departments and no longer trying to do everything connected with sustainability themselves.

Despite its increasing importance, the corporates in this research tend to have relatively small teams working on non-financial reporting with just over half having three or fewer full-time equivalent staff.

The research finds that key performance indicators based on sustainability are mostly externally reported on an annual basis, although many corporates track them quarterly for internal purposes.

Just under half of the corporates in this research link between 16 and 25 percent of variable executive pay to sustainability indicators.

Source: Anchoring ESG in governance, KPMG International, 2024

Corporate ESG strategy

Almost all of those interviewed for this research have high ambitions for ESG. Half see it as a strategic issue that is embedded in core business and strategy, and most of the rest say their corporates are driven by purpose and seek impacts beyond growth, revenue and profitability. Only two of the 50 aim only to comply with the minimum requirements of ESG reporting.

Many respondents say their corporates are part-way through the process of becoming purpose-driven, with some seeing their future existence depending on this: “If we want to exist as a company in 10 or 20 years from now, we need to transform,” says one. However, several respondents say that progress varies based on topic, such as by doing what is strictly required in some areas and going further in others.

There are also differences within corporate structures, where in some cases senior management tends to show more interest in ESG than operational and local units. “We want to increase the positive impact we have on society,” says one respondent. “The difficulty is to have it embedded in the way we operate and make it part of the daily objective of the teams.”

Another respondent adds: “ESG is an enabler, not fully in-purpose everywhere but that is the strategic direction.”

Decarbonizing business models and reducing greenhouse gas emissions are the topics most often included in ESG strategies with almost all respondents saying it is present to a great or some extent. The next most-mentioned ESG topics are diversity, equality and inclusion and human rights in the value chain. Although not highly represented in strategy, a number of respondents recognized the increasing relevance of nature and biodiversity as a key ESG topic.

Asked about ESG business strategy topics beyond those listed, eight respondents mention health, safety and environment, four cite cyber security and data privacy, three include employee wellbeing and two list pollution. Topics mentioned once include water conservation, traffic safety, tackling homelessness and financial inclusion.

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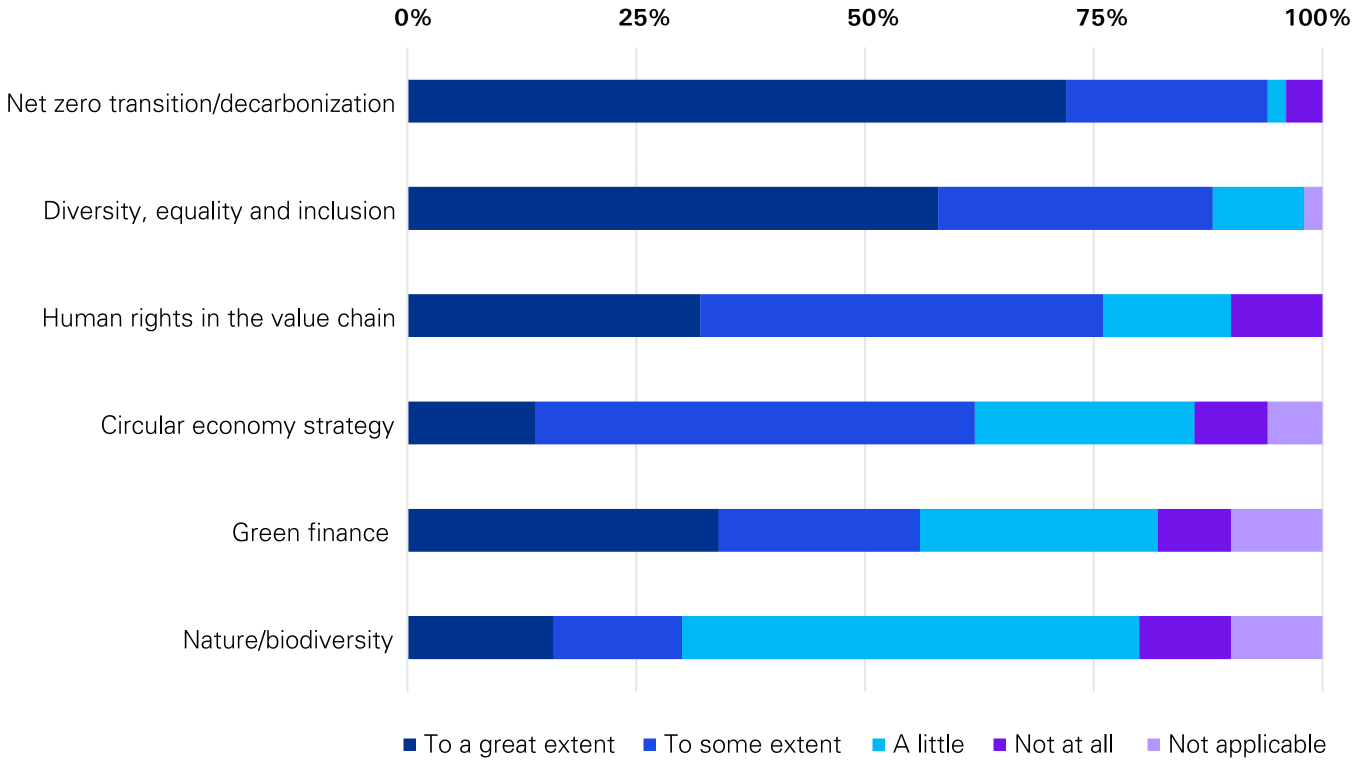
ESG topics in business strategy

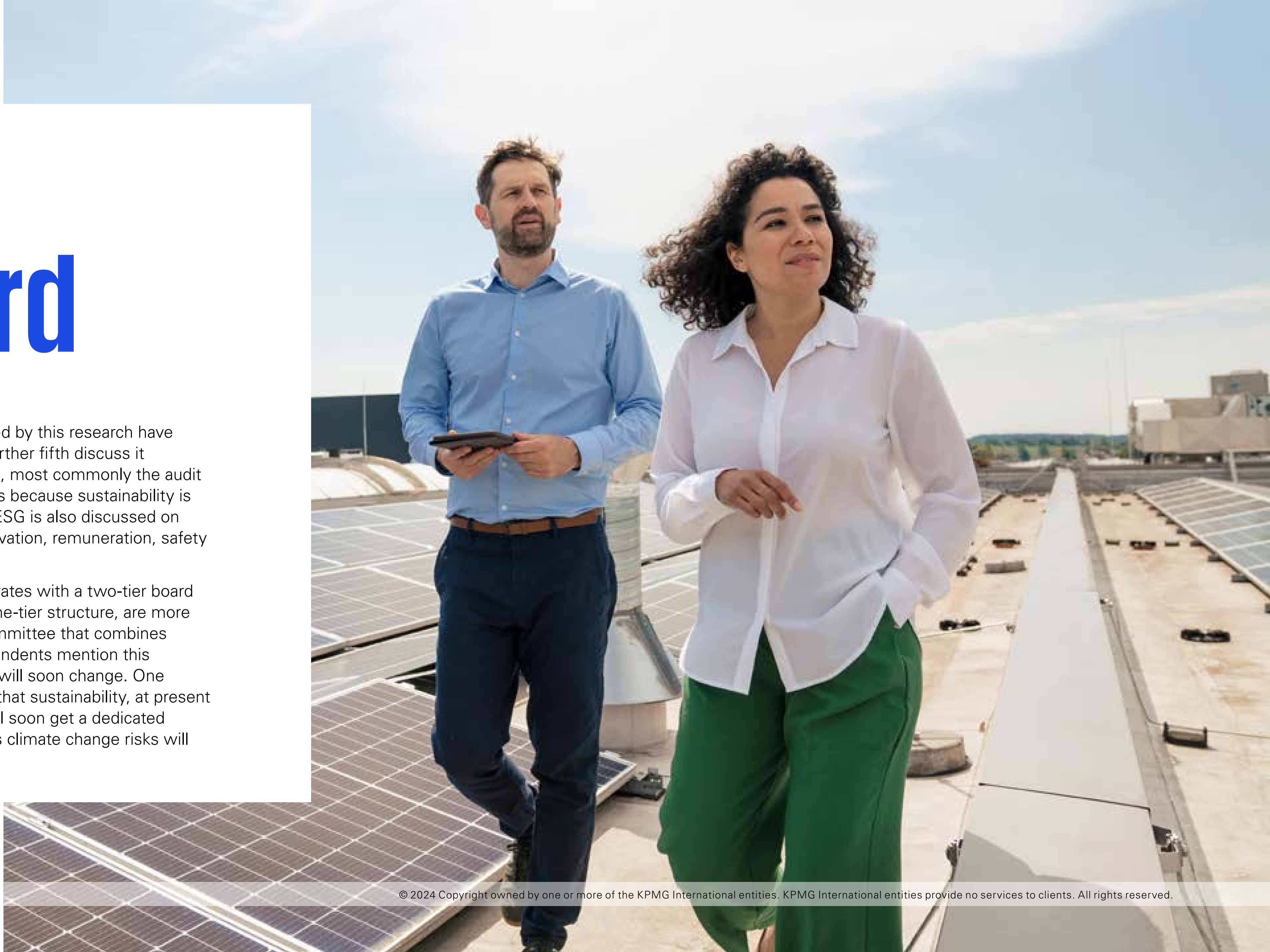


Source: Anchoring ESG in governance, KPMG International, 2024

ESG and the board

About one-quarter of the corporates covered by this research have a board-level sustainability committee. A further fifth discuss it through committees that cover other topics, most commonly the audit committee, with one respondent saying this because sustainability is seen primarily as a reporting requirement. ESG is also discussed on committees focused on management, innovation, remuneration, safety and culture.

Three-fifths of respondents work for corporates with a two-tier board structure which, unlike corporates with a one-tier structure, are more likely to discuss sustainability through a committee that combines it with other topics. However, several respondents mention this as something that has recently changed or will soon change. One respondent from a two-tier corporate says that sustainability, at present covered by an audit and risk committee, will soon get a dedicated committee, although some aspects such as climate change risks will remain where they are.



Among the two-fifths of respondents who work for corporates with a one-tier board structure, several say that sustainability is integrated into reporting, with one respondent mentioning that it appears twice a year on the board's agenda with the chief sustainability officer speaking.

"A further fifth" [of respondents] discuss it through committees that cover other topics, most commonly the audit committee, with one respondent saying this because sustainability is seen primarily as a reporting requirement. ESG is also discussed on committees focused on management, innovation, remuneration, safety and culture.

Who makes decisions on ESG

The chief executive officer is responsible for sustainability in almost half of the corporates covered by this research, with a dedicated chief sustainability officer as the second most-popular option. Others have sustainability work led by people with a range of job titles (see chart on next page), with some assigning it to the head of supply chain and manufacturing, the chief risk officer or the chief investment officer.

More than two-thirds of the corporates in this research have a separate decision-making body for ESG, sometimes known as a sustainability committee or council. Where these exist, most include representation from finance, accounting and controlling as well as the group sustainability unit, and the majority also include human resources, legal and top C-level executives. One includes a representative of that corporate’s artificial intelligence ethics committee, while others involve communications, investor relations and sales. About one-quarter of these are chaired by the chief executive officer with a similar proportion chaired by the head of the group sustainability unit.

The research revealed a wide range of specific approaches to structure. One corporate structure has both an established sustainability board and a new committee focused on opportunities to accelerate business that includes the chief sustainability officer, while another has a sustainability governance committee. Some report that they no longer have separate sustainability committees as the board takes full responsibility for sustainability issues.

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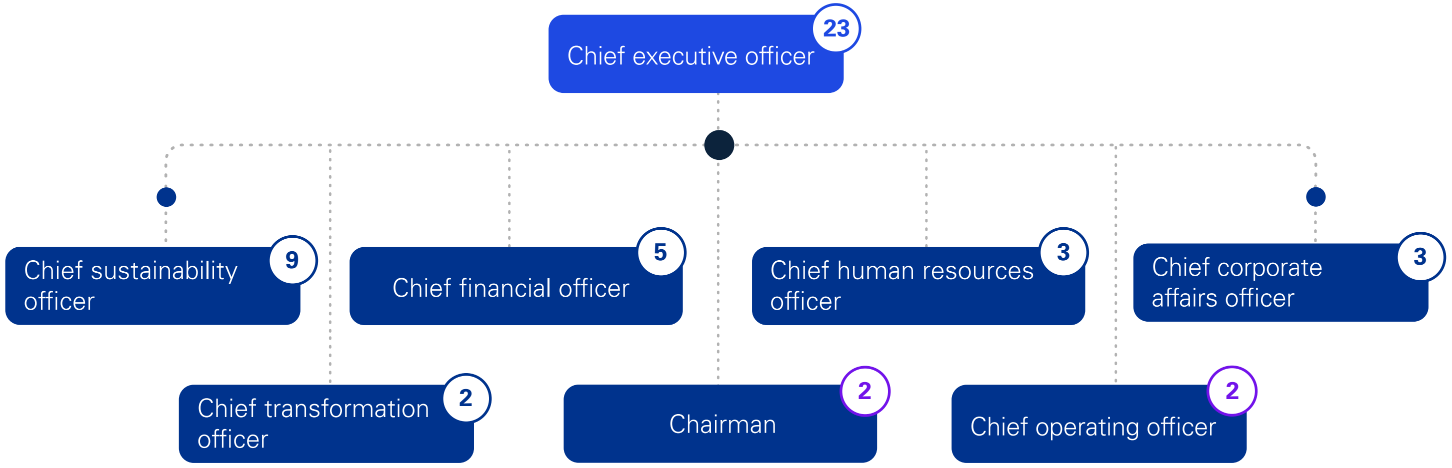
Who takes board responsibility for ESG?



Source: Anchoring ESG in governance, KPMG International, 2024

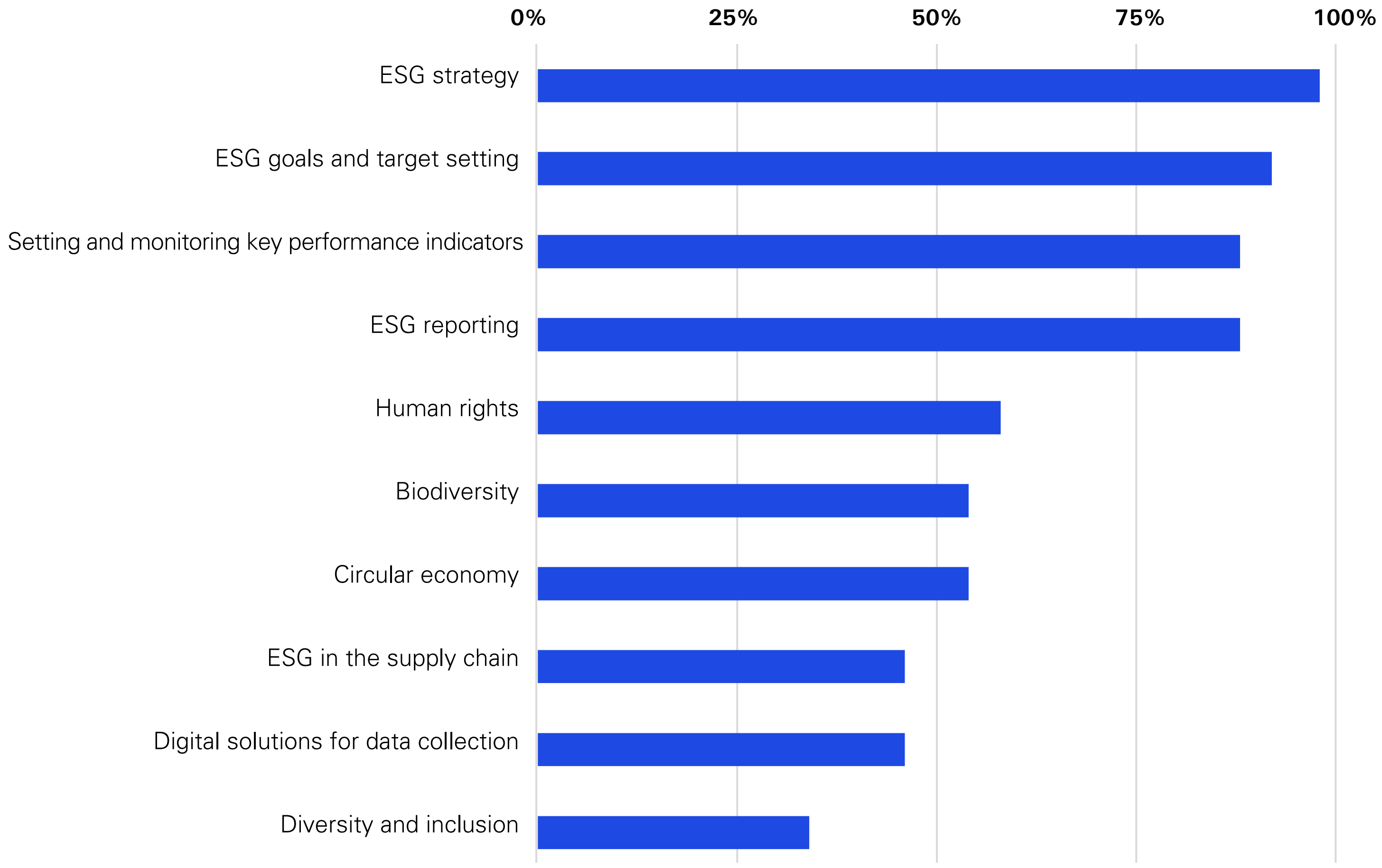
Who runs ESG

Just over one-third of the corporates covered by this research have a separate group sustainability unit. The remaining corporates place ESG within other departments, with strategy being the most popular option, while others locate ESG work in environment, health and safety, communications, legal and corporate affairs departments. One corporate runs ESG as part of its work on transformation, while others combine it with innovation or human resources.

Just under half of the heads of group sustainability units in our research have a direct reporting line to the responsible board member. The rest report to a wide range of executives, including five corporates to a senior leader focused on strategy.

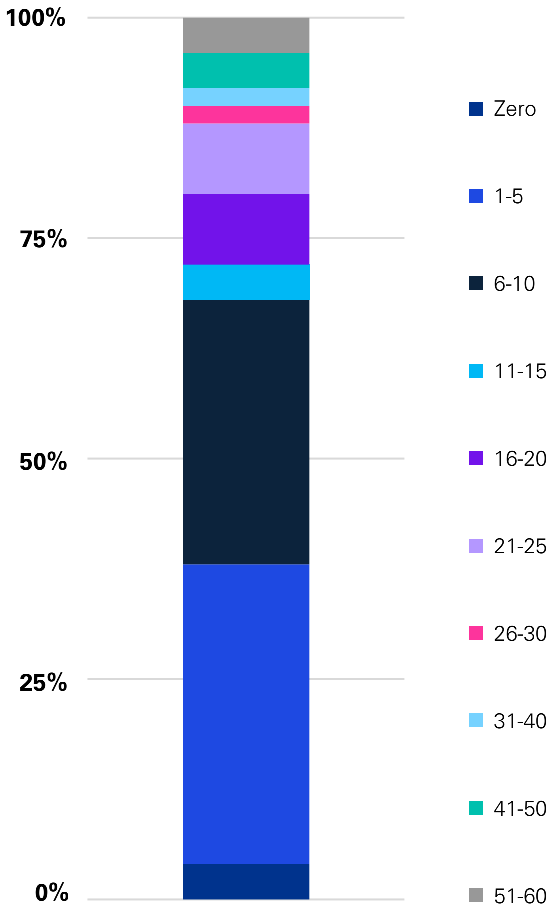
Group sustainability units tend to focus on strategic aims, with almost all dealing with ESG strategy, targets and performance indicators. “The responsibility of the sustainability department is developing the ESG strategy and related program, the actual day-to-day execution lies within business/ regions,” says one respondent. More than two-thirds of group sustainability units covered by our research have between zero and 10 full-time equivalent staff, with only a fifth employing more than 20.

Responsibilities of group sustainability units



Source: Anchoring ESG in governance, KPMG International, 2024

Full-time equivalent staff working in group sustainability units

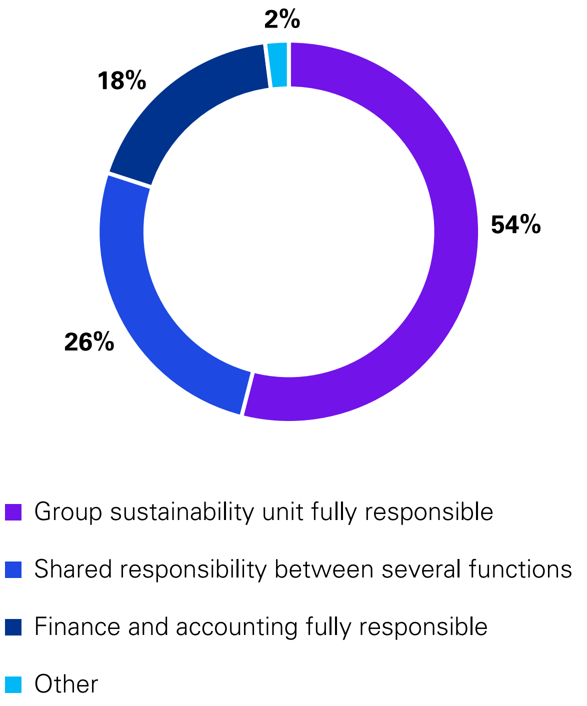


Source: Anchoring ESG in governance, KPMG International, 2024

Who takes the lead on ESG reporting

Group sustainability units take sole responsibility for ESG reporting at more than half of the corporates in this research. Another quarter of corporates share ESG reporting between several departments, with written responses suggesting that most involve both sustainability and finance, with some also including communications. The remainder of the corporates in our research make finance and accounting solely responsible for ESG reporting and a number of interviewees expect that trend to increase, except for one corporate that has a communications and government affairs department running the reporting, with an ESG unit in the finance group responsible for data quality.

Departments responsible for ESG reporting

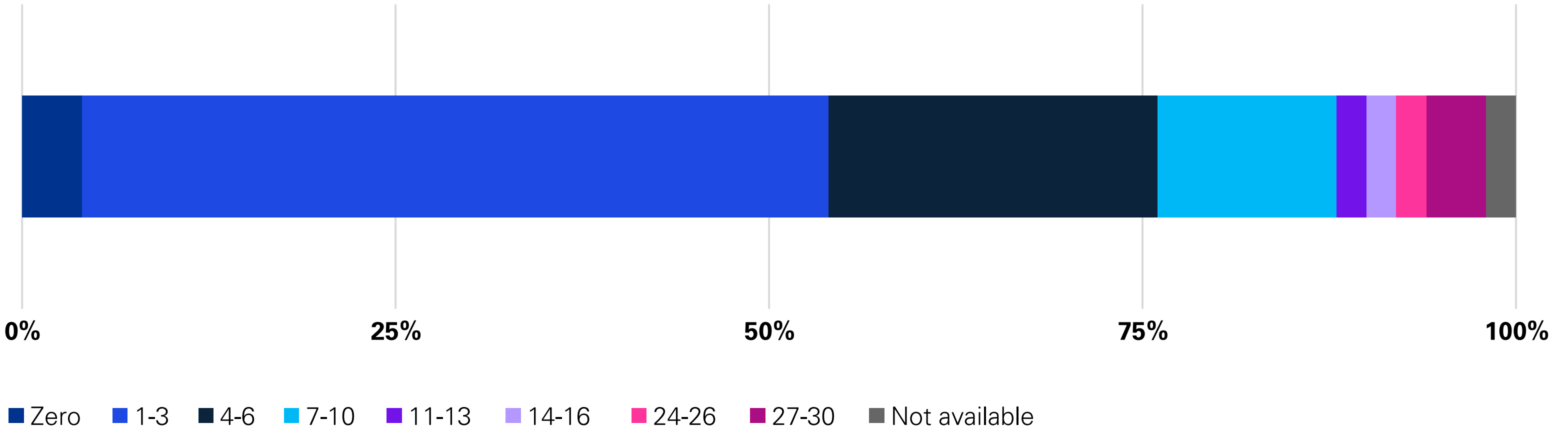


Source: Anchoring ESG in governance, KPMG International, 2024

ESG reporting has generally been a voluntary exercise, but some jurisdictions are in the process of making it compulsory, most significantly the European Union through its Corporate Sustainability Reporting Directive (CSRD). Nearly half of the respondents say their corporates plan to report in accordance with the EU's CSRD for their 2024 financial year, with nearly a fifth more planning to do so a year later.

More than half of the corporates in this research have three or fewer full-time equivalent staff working on non-financial reporting. Just over half say they expect to see an increase in this number, with most of the remaining corporates expecting numbers to stay about the same.

Full-time equivalent staff working on non-financial reporting



No respondents said that 17-20 or 21-23 full-time equivalent staff work on non-financial reporting.

Source: Anchoring ESG in governance, KPMG International, 2024

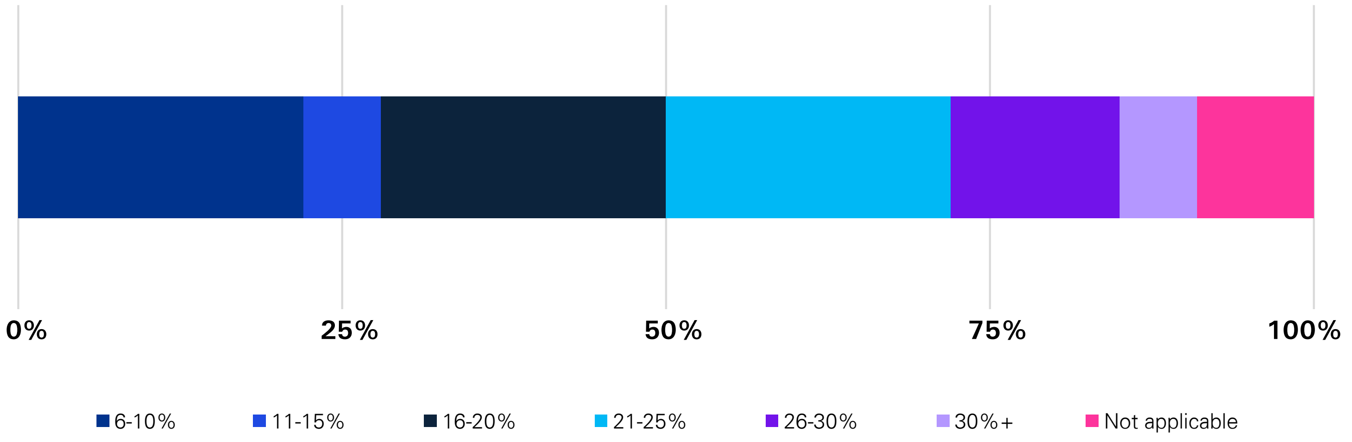
Performance and pay

Just under half of the corporates in this research have ESG topics in their core corporate key performance indicators (KPIs), with more than a quarter more including them in management-level performance reviews. Some respondents say that they plan to increase such work, with one mentioning that they currently have a single indicator on carbon dioxide emissions intensity but plan to add more.

Almost half of the corporates covered produce internal indicators on a quarterly basis and several use monthly reporting for some measures. More than three-quarters report on this externally on an annual basis, with the majority of the rest doing so quarterly.

ESG KPIs are used in calculating executive pay in a majority of the corporates covered by this research, with just over half using them for short-term incentives and two-fifths for long-term incentives. Just under half of the corporates have between 16 and 25 percent of variable executive pay linked to ESG indicators. Several respondents said they expect this proportion to increase, with others predicting that pay incentives based on sustainability indicators will be extended to mid-level managers. "The types of ESG targets are changing," says one interviewee. "We see that the targets are maturing over time and they are expected to gain even more relevance in the remuneration."

Percentage of variable executive pay linked to ESG indicators

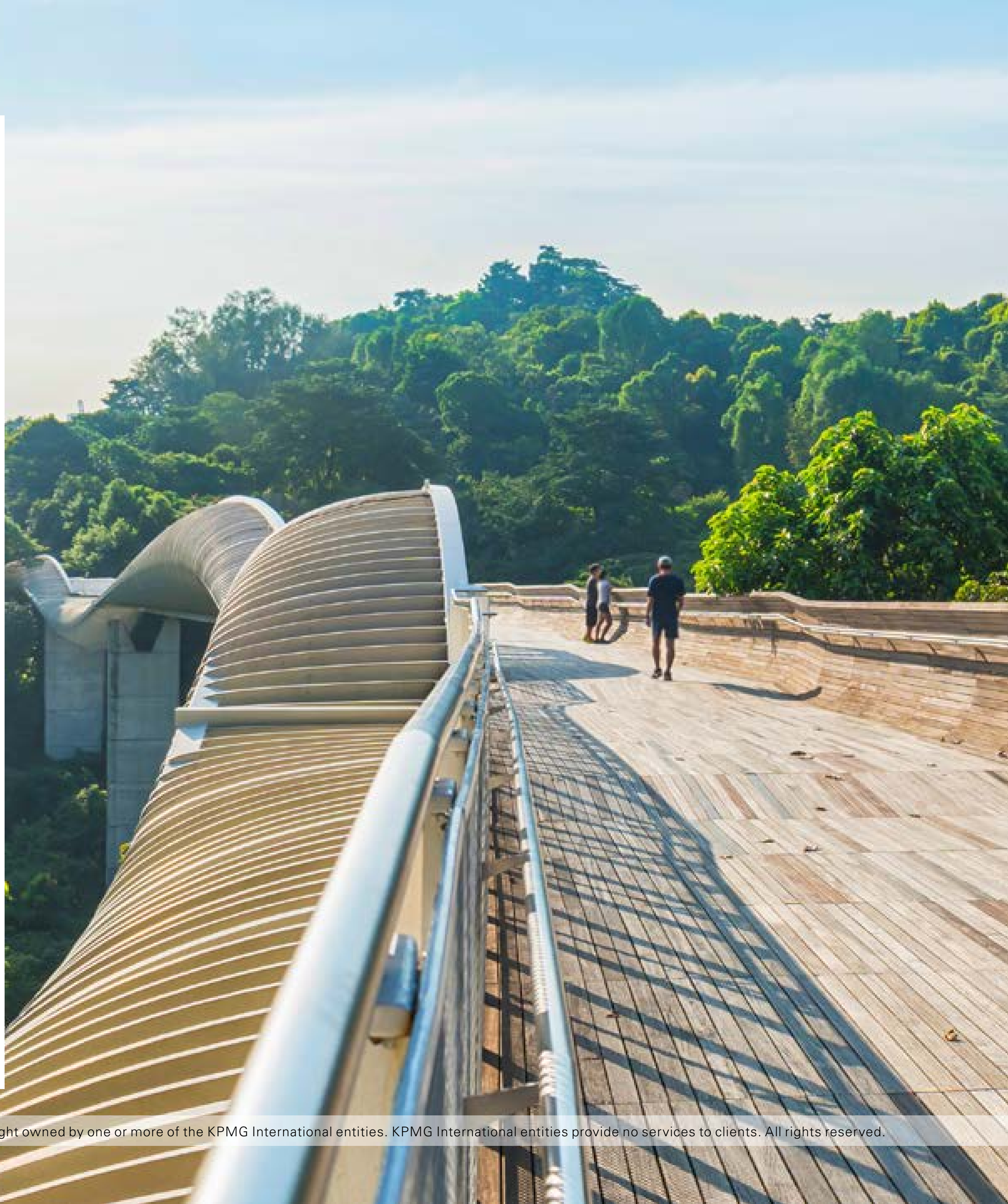


Source: Anchoring ESG in governance, KPMG International, 2024

How ESG is evolving in corporate structures

Several respondents summarize the evolution of sustainability in their corporate structures as moving from a few people in a department that has another focus (e. g. communications, environment) to a centralized unit that is embedded in and strongly connected to the business, that takes a strategic approach and has dedicated staff. One interviewee says that the last five years have seen ESG "moved from shop window to core strategic initiative" with a budget, employees and board-level reporting. Another respondent says that investor pressure has led to the work becoming part of risk management, with plans to increase the size of the ESG team and the appointment of a chief risk officer to lead it.

However, some respondents say that the trend towards the centralization of ESG work has reversed recently, such as through the establishment of sustainability networks and representatives throughout corporate structures. Sustainability "started as a top-down implementation, but meanwhile more and more ideas come from the regions," says one respondent. "It is a deliberate choice of the company to have a small sustainability function as the business model is to have sustainability fully embedded in the company's operations," adds another respondent.



ESG in corporate structures

Several interviewees report moves towards delegating accountability and ownership when asked about how ESG is anchored within the wider corporate structure. These can involve a group sustainability unit working with ‘ambassadors’ or ‘champions’ in other business units to implement measures locally. One corporate in the research has an ESG reporting manager, attached to each business unit’s chief financial officer, who looks at 30 core key performance indicators. Another interviewee says the group level acts as the central driver but with “considerable freedom” for business units. In the longer term, “we are convinced that sustainability or ESG will be part of everyone’s job with the sustainability team as an expert role,” sums up another respondent.

This federated approach can present challenges. Some respondents mention difficulties finding enough people to carry out sustainability work, particularly those with specific skills such as financial and data-handling. One respondent says they need “someone who has done decarbonization work, a consulting-type talent who can understand business and technical ramifications”. Others talk about challenges managing the interfaces between the different parts of the corporate structure and ensuring consistency of performance.

However, several interviewees stress that getting people across the corporate to consider sustainability is the right way forward. “It is a journey, we don’t want to make it a corporate thing, we want it to be part of the daily work,” says one respondent. Another adds that its use of a lean and focused ESG unit is deliberate: “Segments should from beginning have ownership to drive implementation as well as in central functions… [there is a] strong focus on enablement and decentral[ized] autonomy.”

Future of ESG

Further devolution of sustainability work to make it part of everyone’s job is mentioned by several respondents when asked about how ESG units will develop in the future. Some see the central function becoming smaller as individual business units take up work. “We expect that the responsibility for implementation of the sustainability strategies will be transferred to the respective business units as they are able to build their own knowledge and capabilities,” says one interviewee. “We as a function should be focused on the strategy and oversight while the execution should be allocated and embedded as much as possible in the regular business functions.”

Several respondents think that finance is likely to take over sustainability reporting given its increasing importance. “ESG reporting will become as important as financial reporting and will probably also fall under the finance organization,” predicts one interviewee.

The result of these two trends is that group sustainability units should become more strategic in outlook so they can provide oversight and guidance across the business and to the board. According to one respondent, group sustainability units need to become more agile, particularly when dealing with secondary topics, with another respondent predicting that ESG’s current “climate-centric view” will change. “I understand that ESG depends on all, but I want to have a C-level sustainability director to support setting the tone and changing the culture of the company,” concludes another respondent.

How to build successful and robust ESG governance

Corporates can start by developing a **clear analysis of the characteristics, strengths and weaknesses of their existing sustainability-focused organization.** This may consider how closely the unit aligns with or diverges from corporate business and sustainability strategies. It can build on the existing structure and culture by seeing what is already successful in supporting cross-functional work and enhancing it. The work can also include the development of a RACI (responsible, accountable, consulted and informed) matrix that defines roles and responsibilities and specifies cross-functional collaboration, as well as revising and enhancing the risk management framework and internal controls to embed sustainability factors.

Corporates can **involve people in sustainability work** not only based on their decision-making power, but also because of expertise, commitment and access to relevant data. This can be supported by investing time and resources in involving employees and creating ownership of the redesigned group sustainability unit and its roles through communication about ESG, education and training on its purpose, background and specific tasks.

Corporates can gradually **integrate sustainability work** into relevant functions and business units. As levels of competence and maturity grow, this can allow the decentralization of responsibility for ESG, particularly its reporting. Doing so means understanding, measuring and steering corporate culture to stimulate the implementation of a sustainability strategy.

With gradual decentralization over time, corporates can allow the **group sustainability unit to focus on its central strategic role** to drive long-term commitment to sustainability goals. This includes equipping the chief sustainability officer or head of sustainability with maximum organizational power and sufficient resources to fulfill their role as a change agent who cuts across all services.

Corporates can help ensure that their **boards can lead the transformation journey** by being equipped with the right knowledge and possessing the expertise to engage meaningfully on sustainability issues. This is likely to mean including sustainability metrics in the performance-related pay of board members and executives that align with corporate sustainability ambitions to help drive an organization's long-term commitment.

To increase alignment between sustainability initiatives and overall sustainability strategy, corporates can **use technology, tools and data governance**. It also makes sense to establish sustainability-related key performance indicators to assess and enhance an organization's performance and provide valuable insights to guide decision-making.

Corporates can involve people in sustainability work not only based on their decision-making power, but also because of expertise, commitment and access to relevant data.

How KPMG in Poland can help you?

Climate change will have a significant impact on the ways businesses operate. The risks facing companies are both physical (costs associated with increased intensity of severe weather events) and related to the transition to a low-carbon economy (new regulations, technological changes and financing). The growing interest of international institutions, regulators, investors and consumers in climate risks will shape the global business environment in the coming years and decades.

Support

In our analysis, we take a look at climate change scenarios. They help companies answer the question of the potential implications for their business strategies and the impact on the value of their assets.

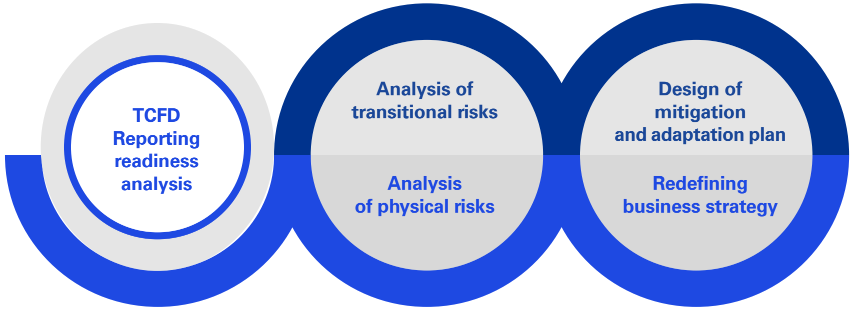
By analysing potential climate scenarios, it is possible to identify priority areas for actions that will make the company and its business model more resilient to the climate challenges it faces.

Our services

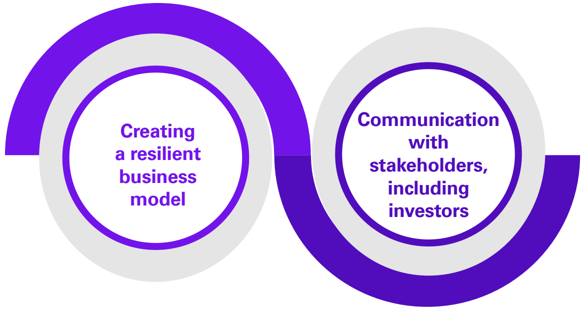
KPMG helps to better understand the risks and opportunities associated with climate change. This enables the development of mitigation and adaptation solutions relevant to the scale of challenges, and in line with the TCFD (Task Force on Climate-Related Financial Disclosures) guidelines, the EU CSRD (Corporate Sustainability Reporting Directive) directive and the ESRS (European Sustainability Reporting Standards).

- Assessment of readiness to report on climate-related risks and opportunities
- Analysis of risks and opportunities in relation to climate change scenarios, value chain and locations
- Review and recommendation of strategic actions
- Implementation of business model changes
- Progress measures and reporting – including preparation of narratives and disclosures

Stage 1: Development of the strategy



Stage 2: Implementation of the strategy



Benefits for clients

Market and regulatory trends indicate that climate issues are a permanent feature of public debate and business activities. There are a number of benefits of proactive responses to market expectations in the area of corporate sustainable development:

- **Meeting regulatory requirements** – implementing the TCFD recommendations demonstrates effective management of climate-related risks and opportunities, in line with the requirements of the EU CSRD directive and ESRS standards

- **Create a market-ready business strategy** – embracing emerging climate change opportunities and integrating climate risk analysis into broader enterprise risk management will ensure resilience to potential shocks and upcoming market changes

- **Meet stakeholder expectations** – demonstrating actions taken to customers and investors will enable organisations to gain competitive advantage and reap the benefits of the green transition

- **Access to green finance** – effective adaptation to new market, regulatory and policy requirements will lead to continued access to a growing green finance market and lower cost of capital

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Growing interest in the issue of climate risks from international institutions, regulators, investors and consumers will shape the global business environment in the years and decades to come.

Methodology

This report draws on in-depth interviews carried out by KPMG professionals with 50 sustainability executives, some with more than two decades of experience working in ESG.

Interviewees: Chief sustainability officers, heads of sustainability or professionals with a management function in sustainability.

Selection: Companies across a range of sectors from the following countries:

Belgium

Brazil

Canada

France

Germany

Ireland

Sri Lanka

Switzerland

The Netherlands

United Kingdom

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Publication name: Anchoring ESG in governance | Publication number: 139206-G | Publication date: February 2024 | Document Classification: KPMG Public