

Thinking through ESG in 2024

KPMG Board Leadership Centre

The Environmental, Social, and Governance (ESG) landscape has witnessed significant momentum in recent years, driven by regulatory imperatives, investor pressures, and evolving societal expectations. With the global shift towards sustainable business practices gaining traction, companies are increasingly recognising the imperative to integrate ESG considerations into their core strategies and operations.

Key trends indicate a growing emphasis on climate change mitigation, resource efficiency, and social inclusivity. Moreover, the emergence of innovative financing mechanisms, such as green bonds and sustainability-linked loans, presents tangible opportunities for companies to align their capital allocation with ESG objectives while accessing diverse funding sources.

However, alongside these opportunities, companies also face multifaceted risks associated with ESG non-compliance. Heightened scrutiny from regulators, investors, and civil society organisations has amplified the reputational and financial repercussions of environmental lapses, labour violations, and governance deficiencies. Moreover, the evolving regulatory landscape, including stringent environmental norms and mandatory ESG disclosures, necessitates proactive adaptation by companies to mitigate compliance risks and foster long-term resilience.

In this dynamic context, companies must navigate a complex terrain of ESG opportunities and risks. By embedding robust ESG frameworks into their corporate DNA, businesses can not only enhance their competitiveness and stakeholder trust but also contribute meaningfully to sustainable development goals and societal well-being.

Clarity of purpose

Annual reports, quarterly earnings calls and investor briefings need to take not just financials into consideration, they also need to account for all the non-financial information that until now has been ignored by large parts of the financial community. ESG data can now seriously impact corporate risk, investor perceptions and corporate wellbeing. Hence, effective governance of ESG becomes essential.

Central to effective ESG integration is clarity of purpose, wherein companies align their ESG goals with their organisational core purpose.

By articulating a clear and compelling vision that meaningfully integrates sustainability principles into their mission, companies can foster a sense of purpose-driven leadership and organisational cohesion. This entails defining tangible ESG objectives that resonate with the company's values, stakeholders' expectations, and broader societal needs.

Ultimately, a well-defined purpose serves as a guiding beacon, empowering companies to navigate the complexities of the ESG landscape with conviction and integrity, while delivering enduring value to all stakeholders.

Questions for boards to consider

- How is the board making sure that the ESG objectives are clearly defined, executed, monitored, and adapted by the management as the ESG landscape is changing at such a fast pace?
- What is the difference between ESG, CSR, sustainability, and brand promise?
- What are the core issues for the company/sector and how this will change in the next ten years?
- How ready we are to tackle reputational challenges that can emerge from business practices?
- Where are the major opportunities for change and how it can be prioritised?
- How is the management understanding and developing business opportunities around the Global momentum on ESG and expectations?

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Alignment with strategy

Effective ESG integration hinges on the seamless alignment of ESG goals and metrics with core business strategy. Companies must proactively calibrate ESG risks, metrics, and goals to ensure congruence with their strategic imperatives, thereby fostering a holistic approach to value creation.

This entails integrating ESG considerations into strategy discussions at all levels of the organisation, from boardroom deliberations to operational planning sessions. By embedding ESG metrics into key performance indicators (KPIs) and decision-making frameworks, companies can systematically assess and manage ESG risks while capitalising on emerging opportunities.

Furthermore, by fostering cross-functional collaboration and stakeholder engagement, companies can enhance the robustness of their ESG strategies, driving sustainable business growth and resilience in an increasingly dynamic and interconnected world.

Questions for boards to consider

- How does our current ESG strategy align with the company's long-term strategic objectives?
- Are there any emerging ESG trends or regulatory developments that could impact our strategic direction?
- How are ESG considerations integrated into our strategic decision-making processes?
- Are there any gaps in our ESG risk management processes that need to be addressed?
- What ESG metrics or standards are most relevant to our business and how are we tracking our performance against them?
- How are we engaging with key stakeholders on ESG, including investors, customers, employees, and local communities?
- How often should ESG matters be discussed at board meetings and what information do board members need to effectively fulfil their oversight responsibilities?
- How does our ESG strategy contribute to long-term value creation for shareholders and other stakeholders?
- What mechanisms do we have in place to regularly review and improve our ESG performance?

Compliance

Ensuring robust compliance with existing and forthcoming ESG regulations and standards is imperative for companies seeking to build trust, manage risks, and unlock long-term value.

With regulatory landscapes evolving rapidly and stakeholders increasingly scrutinising companies' ESG performance, organisations must proactively monitor and comply with relevant mandates across environmental, social, and governance domains.

For instance, the EU's Corporate Sustainability Reporting Directive (CSRD) is transforming ESG reporting. Starting from 2024, almost 50,000 companies are subject to mandatory sustainability reporting, including non-EU companies which have subsidiaries operating within the EU or are listed on EU regulated markets.

To effectively oversee compliance, boards need to stay abreast of changing regulatory requirements, ensure management conduct thorough impact assessments and implement effective compliance mechanisms tailored to their specific industry and operational context. Moreover, companies should anticipate upcoming regulations and standards, engaging with policymakers, industry peers, and other stakeholders to shape future frameworks and ensure alignment with global best practices. By prioritising ESG compliance as a strategic imperative, companies can mitigate regulatory risks, enhance stakeholder trust, and position themselves for sustainable growth in an increasingly complex and interconnected business environment.

Questions for boards to consider

- Does the board have the right set of skills to understand the relevant, material, existing and new set of ESG reporting standards?
- How is the board keeping themselves up to date with the evolving material standard requirements?
- Does the management evaluate and provide the impact analysis of a new reporting standard on the business?
- How often is the management providing clarity to the board on the progress of complying with the standards?
- What are the tools and mechanisms the management is using to keep track of compliances with their respective timelines?

Talent management

Incorporating specific ESG skills and talent within organisations is crucial for effectively navigating the evolving landscape of sustainable business practices. Companies should prioritise recruiting and developing individuals with relevant expertise in environmental, social, and governance disciplines, ranging from sustainability strategy and reporting to stakeholder engagement and impact measurement.

Additionally, fostering ESG competencies within boardrooms is essential for ensuring robust oversight and strategic guidance on ESG matters. Boards should actively seek directors with diverse backgrounds and experiences, including ESG expertise, to enrich discussions and decision-making processes.

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By embedding ESG skills and talent throughout their organisational structures, companies can enhance their capacity to address complex ESG challenges, drive innovation, and create long-term value for all stakeholders.

Questions for boards to consider

- **Board composition and expertise:** Do we have board members with relevant ESG expertise and experience to provide effective oversight and guidance?
- **Talent recruitment and development:** Are we actively recruiting and developing talent with ESG skills and competencies across all levels of the organisation?
- **Training and education:** Do board members and executives receive adequate training and education on ESG topics to fulfil their governance responsibilities effectively?
- **Performance evaluation:** How do we assess and incentivise executives and employees based on their contributions to ESG goals and initiatives?
- **External engagement:** How are we leveraging external networks and partnerships to access ESG talent and expertise, including through advisory boards, consultants, industry associations, and academic institutions?
- **Succession planning:** How can we ensure a pipeline of future leaders with the necessary ESG skills and capabilities to drive sustainable growth and innovation?

Proactive stakeholder engagement

Proactive stakeholder engagement and transparent disclosures are fundamental pillars of effective ESG management. Companies should prioritise building constructive relationships with stakeholders, including investors, customers, employees, suppliers, local communities, and regulatory authorities, to understand their perspectives, expectations, and concerns regarding ESG issues.

By engaging stakeholders in meaningful dialogues, companies can identify material ESG topics, gather valuable feedback, and foster trust and credibility. Furthermore, transparent and comprehensive ESG disclosures enable stakeholders to assess the company's performance, impact, and progress towards sustainability goals. Embracing a culture of openness and accountability, companies can enhance transparency, foster stakeholder trust, and drive positive outcomes for all parties involved.

Good stakeholder engagement can help provide a view of immediate issues, long-term vision and challenges, and ensure alignment with expectations from all fronts.

Questions for boards to consider

- How are we engaging with our key stakeholders? What is the periodicity of such engagement initiatives?
- Do we have the right skilled people engaging with stakeholders?
- Do we get periodic updates from management on engagement activities?
- Are we leveraging all relevant tech-enabled collaborative platforms?
- Do we have differentiated strategies for different types of stakeholders such as our business partners, investors, customers, etc.?

Real-time data monitoring

While most of the listed companies are likely to have a robust control framework in relation to financial reporting, companies are realising that they need to identify and set up processes and technologies together with relevant controls to capture collate and report information on a variety of sustainability metrics, many of which come from operational areas, which may not necessarily have any reporting processes or technologies currently.

The responsibility frameworks of today look at post facto interventions to define social and environmental responsibility. Today's world and increasingly in the future, we are looking at real time responses to everything.

Realtime dashboards can help companies tackle problems when they occur and not wait till the sustainability data is aggregated. Optimising energy use, managing logistics to reduce emissions, increasing water use efficiency and minimising waste are all critical in ensuring high impact ESG programs that help companies in achieving their NetZero targets and managing business impacts.

To leverage sustainability data effectively for decision-making, it must be collected, transformed, and reported with greater speed, frequency, and scalability. Achieving this typically necessitates substantial technological solutions and business transformation at scale.

Questions for boards to consider

- Does the company have a digital strategy to collect the ESG data, create sustainability reports, and leverage analytical tools for analysing non-financial reporting KPIs?
- Is it aligned with ESG standards and frameworks? What consideration is given towards the quality control?
- How is the company investing in cloud-based, analytics-driven and centralised solutions?
- How real time is the data to make proactive decision making?

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Data governance

The regulatory push, better science and increased scrutiny means that ESG metrics are now growing by leaps and bounds. By some estimates, there are over 1,000 discrete measures in ESG reporting. The Environmental, Social, and Governance Reporting Standards (ESRS) alone encompass over 100 reporting requirements and nearly 700 key performance indicators (KPIs).

Consequently, internal company processes to provide the quantum of data, monitor periodically and store is also growing.

Despite the increasing quantum of data, some companies work out of excel sheets when it comes to ESG. This is because, Enterprise Resource Planning (ERP) systems were designed to measure and manage inputs, suppliers, costs, sales and receivables but don't capture ESG data. Which is why, even for calculating carbon emissions accurately, different systems need to be looked at. Hence, getting an integrated view is difficult.

The sheer scale of the ESG data problem is immense. Given that there is increased pressure on delivering higher frequency of ESG data to investors, consumers, and government, it's critical that the data be correct, verifiable, and available in real time. Turning a blind eye to proper ESG data management comes at a significant cost and could have negative consequences on organisations.

Effective ESG data governance requires a coordinated and centralised approach across multiple stakeholders. This can take place with new data architecture, data collection strategy across multiple locations and enhanced processes. For many organisations this requires significant changes to the IT infrastructure, from applications to data integration, architecture, and governance. For instance, banks require not only the management and capture of ESG data but also financed emissions models, climate risk models, ESG scorecards, climate stress tests, and climate-adjusted ratings.

Embedding ESG across value chains

A comprehensive approach to ESG integration necessitates extending the focus beyond internal operations to encompass the entire value chain, including suppliers and partners. Companies are increasingly recognising the importance of fostering sustainable practices across their supply chains to mitigate risks, enhance resilience, and drive positive social and environmental impact.

This entails collaborating closely with suppliers to ensure adherence to ESG standards, such as labour rights, ethical sourcing, and environmental stewardship. Additionally, reducing supply chain emissions will have a big role to play in reducing carbon emissions as they can be anywhere between 80-95% (on average) of an organisation's total emissions. In light of this, addressing Scope 3 emissions, which encompass indirect emissions from sources outside a company's direct control, is becoming paramount in mitigating the environmental footprint of the entire value chain. However, measuring, calculating, and disclosing Scope 3 emissions can be challenging. The more complex the supply chain, the more challenging the task.

By proactively engaging with suppliers, customers, and other stakeholders, companies can foster a culture of transparency, accountability, and continuous improvement across their value chains, thereby advancing their ESG objectives while creating shared value for all stakeholders involved.

Questions for boards to consider

- Is the board structured to engage and report 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?
- Is the company currently reporting on its value chain assessment for human rights, training, emissions, safety?
- How much contribution scope 3 emission makes to the total emissions and what are the steps taken to reduce the emissions through different types of initiatives?

Harnessing Artificial Intelligence

Both generative AI and ESG investments are seen as vehicles to enhance resilience and agility, vital attributes for CEOs leading in today's intricate and fragmented global economy. The board should be taking into consideration about: How can AI and ESG work together to give you a competitive edge and at the same time impact society and environment in a positive way? To this end:

— AI can extract insights from data and improve automation of ESG processes

— AI can use third-party ESG data to build product-level emissions profiles

— AI can be used to manage and verify supplier emissions across disparate data sets

— AI can be used to ensure compliances across boundaries

Questions for boards to consider

- **Envision:** How can ESG and AI be more accretive to the overall enterprise strategy?
- **Strategize:** How does AI fit into ESG strategy to enable business objectives?
- **Evaluate:** How are ESG KPI's aligned to business strategy and cascaded through the organisation?
- **Reskill:** What critical skills and capabilities are required to enable success moving forward
- **Commit:** What is your value case for adopting emerging technologies

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value creation

Investors are now looking to incorporate ESG factors into the investment process alongside traditional financial analysis. As part of this process, investment firms gather ESG data on companies and use it to make decisions on valuation and the risk inherent in an investment. With investors looking at ESG as a value-based dimension of their portfolio, they increasingly want to understand ESG performance the same way they would with traditional financial measures.

With over half of the world's GDP dependent on the environment, according to the World Economic Forum, business as usual is no longer an option. Companies are realising that almost all aspects of their financial stability stand endangered if they fail to act. So, it is important for boards to ensure that management is using ESG as a value driver for the business.

Questions for boards to consider

- How is your ESG strategy driving growth and performance of your business?
- What are the ways in which ESG has been embedded into the business as a means to value creation?
- How does your ESG strategy underpin your purpose?
- What are your governance systems for measuring the effectiveness of your ESG programmes?
- What are competitors measuring and reporting?

The KPMG Board Leadership Centre

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