On the 2023 ESG committee agenda

KPMG Board Leadership Center

How companies address climate change, diversity 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.

Research shows that ESG committees are becoming an increasingly common presence on boards of listed companies, with many of them 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.

Eight foucs topics

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 eight issues for ESG committees to keep in mind as they consider and carry out their 2023 agendas.

1. 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 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 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.

2. 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 may also 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 potentially as diverse as human rights, energy efficiency and renewable energy transition, scope three emissions and other supply chain issues, and reporting?
- 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 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.

3. 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.

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 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"?

4. Embed ESG, including climate risk and diversity 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 diversity 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 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.

- 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?

5. 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 the desired culture embedded into decision-making processes (e.g. taking into account costs that are associated with the changes)?
- 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.

6. 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 "three 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).

7. 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?
- 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 International Sustainability Standards Board (ISSB) developments as they finalise new IFRS Sustainability Disclosure Standards, as well as developments in the EU to finalise European Sustainability Reporting Standards. Both are aligned with the TCFD framework, whilst the ISSB also incorporates SASB.

8. The Swiss Angle – By SWIPRA Services

So far, most Swiss companies have decided to keep ESG an overall board topic. Of the largest 100 SPI® companies, only 17 have formed a dedicated sustainability board committee. On the other hand, 84% of companies participating in the SWIPRA Governance Survey 2022 indicated that sustainability is a regular topic on the board agenda and for 90% of the respondents, the ESG discussion takes place in the full board. 76% of corporate participants also indicated that sustainability experience and competency is a selection criterion in their recruitment process for new board members. The majority of companies (58%) also perceives that their ESG ambitions are reflected in their corporate culture fairly comprehensively. For the first time since 2018, shareholders and companies indicated that environmental and social topics were the most discussed items in their ESG engagements with their institutional shareholders. Yet less than a third of the shareholders understand the strategically material ESG factors of their portfolio companies and how these factors link to strategy. Also, despite the prominence of the topic, less than 50% of companies and fewer than 22% of institutional investors participating in the survey understand well, what the financial impact of these ESG ambitions are.

About the KPMG Board Leadership Center

The KPMG Board Leadership Center offers support and guidance to board members. We equip you with the tools and insights you need to be highly effective in your role, enabling you to focus on the issues that really matter to you and your business. In addition, we help you to connect with peers and exchange experiences.
Learn more at www.kpmg.ch/blc

Contact us

KPMG AG
Badenerstrasse 172
PO Box
8036 Zurich
Switzerland

kpmg.ch

Rolf Hauenstein
Partner, Head of the
Board Leadership Center
KPMG Switzerland

+41 58 249 42 57
rhauenstein@kpmg.com

Prof. Dr. Reto Eberle
Partner, Member of the
Board Leadership Center
KPMG Switzerland

+41 58 249 42 43
reberle@kpmg.com