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# Modernizing governance:

## ESG challenges and recommendations for corporate directors

# Contents

1

# Foreword

In 2015, the world finally woke up to the need for fundamental change to address existential environmental threats and corrosive social problems.

Firstly, United Nations Member States adopted the Sustainable Development Goals (SDGs) a framework for structuring the decoupling of economic development from the abuse of nature and the exploitation of social inequalities. That same year, after a full year of efforts and negotiations, 195 parties signed the Paris Agreement and set a clear goal to reach zero net emissions as the only way to secure our future as a species on this planet.

2015 will be recognized as a turning point. For the first time, business moved from being partly responsible for the problem to being an essential part of the solution. To be successful, business models now need to drastically change. The way companies recognize the services that nature provides and consider their responsibility towards nature and human development must change radically.

Over the past 50 years, business has developed on two misleading assumptions. The first is that the purpose of a company is solely to please shareholders and the second is that responsibility for the business model and strategy resides wholly in the hands of management, which should be focused primarily on generating returns for shareholders.

In most countries, there has been a common acceptance that shareholder primacy is the cornerstone of governance systems. The shareholder value maximization model positions shareholder interests as clearly superior to those of other stakeholders. It has been accomplished in companies through the appointment of obedient board members that consider that their duties is mainly or even solely toward achieving maximum short-term financial returns for the shareholders. This assumption comes from the belief that shareholders do not just own shares in a company, but that they own the company itself.

This practice disregards the fact that the corporation is the legal owner of its business enterprise, not the shareholders. The shareholder primacy theory implies that not only the company's assets but also its relationships with its stakeholders - its employees, suppliers, communities and others - are owned by the shareholders and, as such, can be used at will to serve the shareholders' sole interests, all under the board oversight.

It has become increasingly apparent to me that, if we are to effectively handle the existential challenges of climate change and other sustainability problems we face, then we must reclaim with the upmost urgency the role of the board of directors as the lead body with the responsibility of guiding the company to success and this must be built with respect for the rights and expectations of all stakeholders.

I believe the board is the ultimate legitimate forum for arbitrating the tensions that naturally exist among parties and for defining the weighting used to pursue value maximization - not only for shareholders, who are often most visible and vocal, but for all stakeholders.

This is why at Earth on Board we propose to guide boards towards becoming "Earth Competent": solidly grounded by the purpose the company's founders initially had in mind and legitimately revisiting this purpose to adapt it to new circumstances.

To do this boards must have the right skills, organization and decision-making process, the right agenda and enough time dedicated to the relationship with stakeholders to place sustainability issues at the heart of the company strategy.

I was pleased and honored to be invited to guide the work of WBCSD and its partners Deloitte and Baker McKenzie on this important project. This report represents the first phase of a journey to propose a set of instruments that will help boards manage their fundamental tasks and to fulfill their duties. Built on interviews with board members, it highlights practical changes needed in all areas of board responsibility and showcases useful best practices. The initial recommendations give food for thought that all boards can tailor to their own specific context.

It is time to recognize the fundamental role of the board in guiding, challenging and supporting the management team. This means reconsidering the duties of the board and their duty of care to the company and to wider society. The wide recognition of the Paris Agreement and the SDGs means boards can no longer ignore the environmental and social issues they are asked to grasp by their stakeholders in making decisions. Boards must rehabilitate their sense of purpose, understand the emergence of new categories of risks and opportunities, and strengthen relationships with stakeholders. The content of communications and reporting must be adapted to this new context.

The strengthened recognition of the need for change is evidenced by the recent Business Roundtable's Statement of the Purpose of a Company, which focuses on commitment to all stakeholders and not primarily shareholders. This is a long overdue move in the right direction and businesses need to go further to protect and renew their company's social license to operate. It is time for the board to lead the way towards true value creation - dismissing "fake profit" which takes nature and people for granted, remunerating services rendered and repairing damage caused. Sending the bill for our misconduct to the weakest or to the next generation is not acceptable and boards have a duty to change their actions and behavior accordingly.

**Philippe Joubert**
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Senior Advisor and Special Envoy, Energy and Climate for WBCSD

2

# Executive summary

In today's complex and uncertain world, focusing on near-term shareholder value alone is no longer enough to ensure long-term business success. Sustained value creation requires companies to manage business performance to ensure that sustainability matters that affect business value are addressed. At present substantial value is being destroyed by governance systems that fail to address wider sustainability matters affecting the company.

The board has ultimate responsibility for navigating emerging issues and changing societal demands that could influence its long-term prospects. In this context, ensuring business resilience requires boards to consider the relevant factors, including ESG factors that could affect the long-term value and viability of the business model. Yet many boards remain ill-equipped to oversee and assure the company's capacity to appreciate, and act on, the changing landscape.

By addressing emerging and increasingly relevant impacts and dependencies, boards are better equipped to make informed decisions about strategy and to provide robust oversight while delivering on their fiduciary duties.

## Project aims and methodology

To better understand the current state of play and potential solutions, we proceeded on two fronts:

- examining the current governance approach relating to sustainability in 12 jurisdictions; and[a]
- interviewing board members representing more than 40 companies to understand their perspectives on sustainability governance.

There can be no doubt over the growing scrutiny of the impact of business on the environment and society. For the purposes of this report we refer to these broader considerations as "sustainability matters".

To better understand board performance and challenges, we explored varying dimensions of governance ranging from regulatory requirements to operating realities and good practice. This report outlines what we learnt and offers some preliminary recommendations.

## Who is this report for?

At its heart, the project is about facilitating better decision-making at the board level. It seeks to assist boards by putting them in a position to make informed decisions that are aligned with the priorities and perspectives of the stakeholders on whom the business relies.

Unfolding developments and global considerations underscore that now is the time to make changes to ensure for more effective boardroom discussion. Boards which standstill, or which resist the expanded role, will soon see their companies overtaken by competitors who have better understood and responded to evolving market trends.

This report builds on the earlier WBCSD report The state of corporate governance in the era of sustainability, which reviews the international corporate governance landscape from a business, regulatory and academic perspective.

[a] Brazil, China, France, Germany, Hong Kong, Japan, the Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States of America.

## Key findings

Not surprisingly, perspectives on sustainability governance and the role of the board varies between jurisdictions, but some consistent patterns emerged.

Almost all interviewees anticipate a growing need for boards to assess and address sustainability matters. They agreed such issues increasingly relate to and impact on business strategy, risks, opportunities and long-term value creation. Consistently, directors highlighted the need for sustainability considerations and priorities to relate directly and be integral to the purpose of the company. But many expressed concerns about the current governance approach and time devoted to sustainability. While viewing sustainability as increasingly important, many directors are unsure about the efficacy and effectiveness of the current board governance approach for addressing sustainability.

From a structural governance perspective, some differences emerged between jurisdictions. European board members were more likely to suggest there should be a sustainability committee on the board to oversee sustainability and assure alignment of sustainability matters with purpose and strategy. In contrast, US board members were less convinced of the merits of a separate sustainability committee and thought responsibility for sustainability should reside within the enumerated responsibilities of an existing board committee (such as audit, strategy or risk). While interviewees diverged as to which committee should house sustainability oversight, they agreed that the importance of sustainability matters merits the express inclusion of sustainability in the responsibilities of a board committee accompanied by specific enumerated responsibilities.

Interviewees were also divided along geographic lines as to whether boards should include a member with specific sustainability expertise. Regardless of the feasibility and desirability of a dedicated "sustainability" board position, most interviewees expressed concern about a lack of sustainability experience and expertise on the board, impacting members' collective ability to identify, evaluate and oversee sustainability matters. In this context, resources and training to enhance individual and collective understanding of sustainability matters was an area that was widely suggested for development.

Finally, while companies and boards varied materially in their engagement and awareness of sustainability matters, there was general concern over the adequacy and sophistication of current processes for engagement with, and oversight of, sustainability in risk assessments and strategy, sustainability management; and reporting and disclosure.

Additional processes are needed to facilitate effective and efficient understanding and oversight of sustainability in operational activities to enable boards to meaningfully carry out their responsibilities.

In the following sections of the report, we review existing statutory and regulatory governance regimes across twelve jurisdictions and highlight examples of good and innovative practice. Attention is drawn to the current challenges boards face in integrating sustainability matters.

## CHALLENGES TO MODERNIZING GOVERNANCE[b]

The interviews identified a number of impediments to modernizing governance, including:

- Challenges associated with articulating a clear purpose and vision for the organization to focus and direct decision-making.
- Clear responsibility and ownership for sustainability matters within the board.
- The need for board members to have appropriate diversity of skills and experience to provide effective leadership, as well as incentivize required behaviors of their colleagues.
- Training on sustainability matters tailored to a company's business model.
- Sufficient attention paid to issues that are material to corporate performance – getting the context right for consideration of sustainability matters and not isolating such consideration from the core business.
- Lack of board-level awareness of, and involvement in, stakeholder engagement.
- Ensuring governance systems and sustainability performance considerations align with the company's overall strategy.

## RECOMMENDATIONS FOR MODERNIZING GOVERNANCE[c]

The following recommendations aim to assist in adopting approaches which embed consideration of sustainability matters into the board's mandate:

- Ensure that the company's purpose is clearly established and aligned with material sustainable development impacts and opportunities.
- Develop a strategy and assess risks and opportunities in light of environmental, social and governance (ESG) concerns, so that sustainability matters become a core consideration of the board.
- Equip the board with sustainability capacity-building opportunities through a multi-faceted approach, including expert presentations on sector-specific insights, engagement with sustainability management, and training on material sustainability issues.
- Establish a performance review process which considers ESG-related matters and is supported by clear key performance metrics and outcomes. Ensure that board responsibility and remuneration policies are aligned and integrated.
- Create a dialogue and partnership with stakeholders to encourage their input and assist and challenge the board in developing policy.
- Critically review reporting on sustainability matters through robust processes that are consistent with mainstream company activities.

## NEXT STEPS

The recommendations in this report will inform the development of a toolkit of resources for boards to use in facilitating more effective consideration and oversight of sustainability matters. This will be available on WBCSD's website.

[b] See section 6 for further detail
[c] See section 7 for further detail

3

# Why do we need to modernize governance?

**In this age of global communication and 24-hour media coverage, the scrutiny of business is intensifying and boards must increasingly justify and defend their decisions.**

## INCREASING SCRUTINY

As the law continues to enlarge the fiduciary duties of directors, attending only to the needs of shareholders is insufficient to discharge their responsibilities. The creation of shareholder value alone may not be enough to justify a company's long-term existence. If its financial objectives are advanced at the expense of wider stakeholder interests, then a company's license to operate may be at risk and its directors viewed as having failed in their fiduciary duties. Such consequences are becoming more common and severe in an increasingly resource-constrained world. Externalities that have been ignored in the past are now bringing businesses to a standstill – from constrained natural resources to social inequalities. Operating and planning with a "business as usual" mindset may present significant risks for future value creation.

In response to rising public and investor concern, regulatory pressure to enhance board oversight on ESG-related matters is increasing. This is happening through soft law mechanisms – such as reporting obligations, voluntary codes, guidelines and toolkits – and an increasing trend towards obligations and mandates that compel companies to take sustainability impacts into account.

For example, corporate governance requirements in France, Germany, South Africa and the UK now define the board's responsibility to consider the contribution of the organization to wider society. But despite these changes in some jurisdictions, implementation of enlarged responsibilities varies noticeably across countries suggesting that more work needs to be done to improve board performance.

Litigation is also on the rise with directors being challenged for not properly discharging their duty of care. For example, recent Delaware judgments have made it clear that directors simply deferring to perceived effective compliance systems may be at personal risk. The Court reaffirmed that directors must make a "good faith effort to put in place a reasonable system of monitoring and reporting".[1]

In short, growing judicial and regulatory developments underscore the shifting and increasing expectations surrounding board performance.

## ESTABLISHING A CLEAR PURPOSE

An entity's purpose, strategy, values and business model are interrelated but distinct concepts. Strong governance is essential to good decision-making in all these areas, providing the framework within which concepts should function and interconnect. Governance is the way in which companies are directed and controlled and includes the systems they have in place to ensure proper accountability and conduct.

While businesses may use different terms for the concepts and approaches, the disclosure of an entity's purpose, strategy, values and business model should, together, explain the relationship between an entity's ambition for external impact (purpose), the choices for achieving that impact sustainably through commercial success (strategy) and the means of activating those choices (business model). While purpose, if defined appropriately, should be consistent over time, strategy should be reviewed constantly to accommodate the needs of an ever-changing world.

Clarity of company purpose can provide a direct communication about the future of the organization and deliver long-lasting and broad benefit to the business. Articulation of a company's purpose is an important signal of the direction of the organization and help its business model to remain relevant. A clear statement of purpose can help to overcome stakeholder suspicion that business is prioritizing a narrow agenda of pure profit over purpose.

## STRATEGIC THINKING

Consideration of strategy, risks and opportunities have always been core elements of the board's activities and they should remain so. However the lens through which directors develop strategy and think about risk and opportunity needs to be broadened to incorporate a wider perspective than in the past.

Consideration of sustainability matters needs to operate as automatically as, for example, financial considerations. Too often, sustainability matters are addressed in isolation from board discussions about core business strategy and risk management. This disconnect might deliver positive short-term results for the company, but it may overlook fundamental material sustainability risks and opportunities for the company's strategy and business model.

As evidenced in a study undertaken by Bank of America Merrill Lynch,[2] firms with a record of effective management and integration of sustainability matters consistently outperform their peers. Moreover, very targeted and isolated short-term sustainability activities can, in some cases, work against the long-term strategy and vision of the company; such as when a company follows consumer sustainability-related trends that are not aligned with the company's purpose and values.

## ENGAGING WITH STAKEHOLDERS

Companies can deliver strong performance while creating value for shareholders, employees, customers, and society. For example, when a company invests in training for the most in-demand skills, it improves productivity and benefits employees, whether they stay with the company or not. Society also benefits from a more highly skilled workforce.

When a business is able to make a strong case that they are creating long-term value for society, trust with stakeholders is strengthened. Defining purpose, designing effective stakeholder engagement mechanisms and tracking success with verifiable data, measured over time, presents an opportunity to transform behaviors and create long-term value.

For organizations that have mechanisms in place to engage with stakeholders, their links into the boardroom and core strategic processes, risk identification and assessment can be missing.

To be resilient, boards need greater awareness of and engagement with the business context, as informed by its broad stakeholders, so that business models can be adapted in a considered and timely manner. Unfortunately, this approach is not being employed in many companies. Instead, they remain focused on the short-term needs of shareholders at the expense of the longer-term viability of the company.

4

# Board responsibility

**Board directors have a duty and a responsibility to ensure the long-term success of the corporation, this should include the integration of sustainability matters into key decision-making processes.**

## GETTING SUSTAINABILITY MATTERS ONTO THE BOARD AGENDA

Our research showed that, with two exceptions (Singapore and Thailand), local laws, regulations or codes place some form of mandate on boards to consider sustainability matters. The nature of this requirement varies, as illustrated by the following examples from South Africa, the United Kingdom and Brazil:

In countries where there is a growing focus on sustainability within laws, regulations and/or codes, directors report that it is easier to have conversations and facilitate discussions about sustainability.

The Social and Ethics Committee should monitor the company's activities, having regard to any relevant legislation, other legal requirements or prevailing codes of best practice, with regard to matters relating to social and economic development.

**Source:** South African Companies Act 2008

The board should understand the views of the company's other key stakeholders and describe in the annual report how their interests and the matters set out in section 172[3] of the Companies Act 2006 have been considered in board discussions and decision-making.

**Source:** UK Corporate Governance Code 2018

Note that the requirement to report on compliance with section 172 goes beyond listed companies and applies to all UK incorporated companies that qualify as "large". Generally, this includes all UK companies meeting 2 or more of:

(i) turnover of > £36 million;

(ii) balance sheet total of > £18 million; or

(iii) > 250 employees, wherever located.

Companies have to implement and maintain effective mechanisms, processes and programs for the monitoring and financial performance and the impact of the Company's activities on the society and the environment.

**Source:** Brazilian Corporate Governance Code 2016

For countries like Singapore and Thailand where there are no specific laws, it can be more challenging to ensure sustainability matters receive the board attention they need. However, there are exceptions - a Thai company interviewed as part of this project stated that sustainability is a priority, that it is on the agenda at every board meeting, and that sustainability is incorporated into business strategy and mid- and long-term plans.

Some board members observed that regulatory requirements make it easier to include sustainability matters on the board agenda. As commented by one of the board members interviewed:

*"Codes and regulations draw attention to sustainability issues and create accountability."*[4]

Another board member felt that regulation in this area was not necessarily a good thing as it can become more of a compliance exercise rather than getting under the skin of the relevant sustainability matters. The board member explained:

*"Laws and regulations can be a two-edged sword. On the one hand, they raise awareness and cause a company to look into trends and best practices. On the other, they may serve to frustrate and/or dilute a company's efforts because they create complexity and also create a baseline that may be an easy "out" on an issue, rather than affirmatively taking a stand."*

Regardless of differing views about the efficacy of mandatory rules, all agreed that sustainability considerations merit greater board attention.

## INTEGRATING SUSTAINABILITY FACTORS INTO RISK MANAGEMENT AND STRATEGIC DEVELOPMENT

Just over half of the countries considered in this project have some form of requirement or recommendation for boards to consider sustainability matters within either risk management and/or strategic activities.

It is relatively easy to find examples of companies that have established sustainability programs accompanied by annual reports referencing that they are doing the "right thing". However, unless these programs are embedded in, and relevant to, the strategy and business model of the organization, such programs run the risk of failing to address the issues that really matter to the long-term viability of the business. This risk was reinforced in the interviews:

*"Just being "less bad" is no longer sufficient."*

*"We have to start operating in a fundamentally different way to demonstrate our sustainability."*

Consumer sentiment presents huge market risks and is a major factor in the growing distrust of companies.[5] There is a significant generational shift in what consumers expect. In the past, core customer groups were pleased to see companies behaving well, but they did not question or challenge those behaviors, or the products and services offered. Current generations of consumers are already showing that they are going to be much more challenging. They have higher expectations of how companies manage their social and environmental impacts and are increasingly questioning ways of working, product development and other fundamental elements of a company's business model for example, company commitments to reduce or remove single-use plastic from its operations.

Boards need to get ahead of this trend; consumers are a stakeholder group they cannot afford to ignore. If consumer concerns are left unattended to, companies can face reputational damage that erodes consumer trust and confidence. These are the sorts of considerations boards should be including in their assessment of the risks to their strategy and business model. One interviewee said:

*"The single most important thing that impacts the sustainability of business today is how we manage and mitigate reputational risk. The boards that do a good job at that are the ones that will emerge sustainable enterprises."*

The following extract from the Principal Risks section of the 2018 Annual Report & Accounts of Unilever[6] demonstrates that some boards have concluded that sustainability is one of their principal risks. They are therefore committed to addressing sustainability risk, including describing the risk and its management in the annual report.

**SUSTAINABILITY**

**The success of our business depends on finding sustainable solutions to support long-term growth.**

Unilever's Vision to double the size of our business while reducing our environmental footprint and increasing our positive social impact will require more sustainable ways of doing business. This means reducing our environmental footprint while increasing the positive social benefits of Unilever's activities. We are dependent on the efforts of partners and various certification bodies to achieve our sustainability goals. There can be no assurance that sustainable business solutions will be developed and failure to do so could limit Unilever's growth and profit potential and damage our corporate reputation.

The Unilever Sustainable Living Plan sets clear long-term commitments to improve health and well-being, reduce environmental impact and enhance livelihoods. Underpinning these are targets in areas such as hygiene, nutrition, sustainable sourcing, fairness in the workplace, opportunities for women and inclusive business as well as greenhouse gas emissions, water and waste. These targets and more sustainable ways of operating are being integrated into Unilever's day-to-day business.

Progress towards the Unilever Sustainable Living Plan is monitored by the Unilever Leadership Executive and the Boards. The Unilever Sustainable Living Plan Council, comprising six external specialists in sustainability, guides and critiques the development of our strategy.

Source: Unilever, (2018), Annual Report and Accounts

## USING SUSTAINABILITY METRICS TO DETERMINE EXECUTIVE PAY

The corporate governance codes of two countries (South Africa and the UK) require the inclusion of metrics associated with ESG-related matters in the determination of executive pay. Germany includes a similar mandate within company law.

The South African King IV Code recommends the use of performance measures that support positive outcomes across the triple context (economic, social and environmental) in which the organization operates, and/or the capitals that the organization uses or affects.

The UK Corporate Governance Code focuses on consideration of executive pay in the context of the pay policies and practices used across the wider workforce.

Code Provision 33 - the Remuneration Committee should review workforce remuneration and related policies and the alignment of incentives and rewards with culture, taking these into account when setting the policy for executive director remuneration.

Code Provision 41 - the annual report should describe what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy.

Source: UK Corporate Governance Code 2018

Some companies have embraced the use of sustainability performance in compensation. The example below shows how Danone has integrated sustainability metrics into the determination of executive pay.

Annual variable compensation of Danone's top executives has a social and societal component, which refers to Danone's social, societal and environmental targets.

For example, 35% of Danone's CEO compensation in 2019 is linked to the fulfillment of sustainability-related objectives: "One Person, One Voice, One Share" program (13%), climate commitments (12%), 2030 objectives and progress towards global B Corp certification (10%).[7]

Danone has also integrated societal performance into its variable compensation system for 1,500 senior executives.[8]

### Key messages on board responsibilities

1. Being purpose-driven and underpinning that with a well-articulated and aligned statement of values can help to embed sustainability within the core business.
2. Regulation can help to get sustainability matters on the board agenda, but that in itself will not ensure consideration of sustainability matters is truly embedded and delivered as a core part of the operating model of the organization.
3. Consumer sentiment is a key driver of changing behaviors and an increasing focus on sustainability matters. This needs to be well understood by boards or they risk threats to their reputation, strategy and business model.
4. Integration of sustainability matters into key performance indicators and compensation metrics can change behaviors and facilitate increased consideration of these matters as appropriate for the business.

5

# Sustainability oversight practices

The board has an oversight responsibility for key decisions made within the organization. This should include oversight of sustainability information. Failing to integrate sustainability into all elements of the board agenda may impact the achievement of the company strategy and business objectives.

## IS IT NECESSARY TO ESTABLISH A SUSTAINABILITY COMMITTEE?

Just one of the countries examined for this project had any form of requirement for a Sustainability Committee or similar committee. Under South African Company Law since 2011, all state-owned companies, listed public companies and companies with a significant public interest must establish a Social and Ethics Committee.

It was clear from some of our interviews with directors that there is still a need for boards to appreciate that failing to properly integrate sustainability into all elements of the board agenda is likely to impact the business model and achievement of strategic objectives. Some of the suggestions offered include:

*"The board of directors must dedicate time to sustainability, and for this, sustainability must be included in the agenda."*

*"Sustainability could be a formalized topic within e.g. the audit committee/examination board, because sustainable business practices are considered a compliance issue."*

*"Sustainability is a brand reputation risk and should therefore be discussed by the full board."*

Ideally, the whole board should take an active role in management and oversight of sustainability matters. However, in the absence of that good practice, establishing a formal sub-committee of the board that is dedicated to oversight of sustainability matters (including how those are integrated across the company), or its clear inclusion in an existing related committee (e.g., audit, risk, compliance or strategy), can help the board to fulfill its responsibilities. Interviewees supported explicit inclusion of sustainability within a board committee. Many interviewees advocated the benefits of having a dedicated committee for sustainability matters:

*"Higher results are achieved with an established sustainability committee."*

*"It really helps board discussions when there is a formality and structure built around consideration of these matters. Establishing a Sustainability Committee with formal terms of reference and with equal standing to the other board sub-committees, is extremely important to meet our responsibilities."*

*"The responsible board committee members need to interact directly with company sustainability management to take a deep dive, outside the confines of the board meeting, to really probe and understand the issues, strategy and adequacy of performance."*

Danone has established a Social Responsibility Committee, charged with overseeing social, environmental and ethical issues related to its activities. This specialized Committee reviews the company's materiality matrix, ESG-related risk assessment, non-financial ratings and on-going social projects and assesses impacts of Danone's social investments.[9] Sustainability topics are discussed at board meetings. In 2017, the Committee's agenda included sustainability topics such as the review of Danone's non-financial reporting and rating, social risk materiality matrix, social funds, work and pay equality matters.[10]

L'Oréal has established a Strategy and Sustainable Development Committee composed of five board members and chaired by the company's CEO and Chairman. The Committee verifies the integration of the Company's commitments with regards to sustainable development and in light of challenges specific to the Group's business activities and its objectives.[11]

Mobile operator MTN has also established a Social and Ethics Committee with a mandate to hold the Group's president and CEO accountable for MTN's ethics performance, monitor its sustainability activities and ensure good corporate citizenship. In 2017, the Committee oversaw the implementation of the ethics management program, took responsibility for the sustainability framework and reporting and reviewed activities of the MTN foundations and other initiatives.

## GETTING THE RIGHT LEVEL OF SUSTAINABILITY KNOWLEDGE INTO THE BOARDROOM

South Africa's company law requires members of a company's Social and Ethics Committee to have relevant experience. No other country surveyed includes such a specific requirement, although the French Corporate Governance Code does suggest that each director should be provided, if he or she considers it to be necessary, with supplementary training relating to aspects of their social and environmental responsibilities.[12]

Most of the directors we interviewed were not in favor of appointing a sustainability expert to the board or having a designated sustainability position. One interviewee said:

*"Sustainability needs to be integrated into the [responsibilities] of the entire board, not residing solely in a specific board "sustainability" designee."*

Having board members with a strong range of experiences is likely to offer substantial collective perspectives as individuals will have been exposed to varying discussions on sustainability and can share their experiences. Boards would be well served to undertake a regular assessment of the ongoing training needs of board members and to provide appropriately tailored educational sessions to facilitate understanding of key issues. In terms of training on sustainability matters, our interviewees made it clear that the quality and impact of training can vary. The interviewees shared comments such as:

*"Engaging and educating board members on sustainability topics is very much required. We are planning a half day group level board members' retreat, including ESG scenario planning."*

*"Having outside sustainability experts present on particular case studies can be informative."*

Boards will be challenged to effectively handle their oversight responsibilities without the appropriate skills and knowledge to be able ask sustainability-related questions of management and to evaluate their responses. Educating the board and providing an appropriate external perspective is hugely important. A number of companies organize "knowledge sessions" for their boards to raise awareness of relevant sustainability issues, e.g. plastics. Boards can choose to bring appropriate experts into the boardroom, either from within the company or from outside. These additional perspectives provide important insights for board members.

This need for awareness, expertise and understanding of sustainability extends beyond the boardroom and down the chain of command - everyone in the company needs to understand how their role relates to the company's sustainability efforts and strategy.

## ESTABLISHING AND MAINTAINING ENGAGEMENT WITH STAKEHOLDERS

The board needs to be aware of what matters to a company's stakeholders if they are going to protect the long-term sustainability of the business. Several directors we interviewed highlighted the importance of effective engagement with stakeholders and their changing expectations, for example:

*"The critical factor is the generational change: younger colleagues bring more focus on other topics."*

In addition, helpful external perspectives can be provided by independent experts. Some companies have set up what they refer to as "Critical Friend Committees". The following case studies describe some of the practices adopted to bring in the wider external view:

In 2014, L'Oréal set up an external governance body called the Panel of "Critical Friends". It meets once a year, together with Jean-Paul Agon, the Group's Chairman and CEO. The panel's role is to examine the progress made on the Group's "Sharing Beauty With All" program, cast a critical eye over the actions conducted and suggest improvements. Composed of major international personalities and experts on environmental and social issues, the panel met for the fourth time in March 2018 in Paris.[13]

Besides continuous dialogue with external stakeholders, engagement also takes the form of panels and consultations, such as one on biodiversity held in Brazil in June 2016.[14]

DSM has established an External Sustainability Advisory Panel, comprised of a diverse international group of thought leaders. This acts as a "sparring partner for the Managing Board and senior executives to help sharpen their focus on strategic issues, deepen their understanding of external stakeholder needs, conduct advocacy and handle dilemmas." The board met twice in 2018 together with the Managing Board and a number of senior executives. Subjects included DSM's corporate strategy update and purpose, innovation project and business updates, science-based targets, digitization and the future of transport.[15]

## ENSURING EFFECTIVE COMMUNICATION

In many cases, companies use a number of communication channels to explain how material sustainability matters impact their business. The nature of those impacts needs to be clearly communicated to stakeholders include how revenue and operations will be affected. This also need to be taken into account in setting and executing on the company's strategy. Rarely does this communication provide insights about the role of the board in evaluating these assessments, leading to the inference that it has been done without board oversight or engagement. More generally, governance disclosures and other statements about sustainability management continue to be limited, providing little insight regarding the role or involvement of the board.[16]

The recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), issued in June 2017, have strong support as a framework for disclosing clear, comparable and consistent information about the risks and opportunities for a company presented by climate change. Their widespread adoption could ensure the effects of climate change become routinely considered in business and investment decisions. It is expected that the European Commission's new guidelines for companies reporting on climate-related information will further reinforce the use of the TCFD recommendations.

The following case study highlights activities which the board of Veolia undertakes to identify the material issues which could impact their operations, future revenues and reputation.

In 2017, Veolia carried out a formal materiality analysis of ESG issues, determined from an operational (representing 81% of company revenue) and functional department point of view. During this exercise, issues were prioritized based on business impact (financial, regulatory, investor confidence, customer loyalty, employee satisfaction and the company's reputation) and perceived external stakeholder expectations (clients, consumers, suppliers, investors, rating agencies, regulators and local authorities, the media and opinion leaders, local communities and civil society).[17]

Five external members of Veolia's Critical Friends Committee also provided their opinion. Veolia's Critical Friends Committee gathers 12 external experts from diverse backgrounds (NGO/civil society, academia, social business) and is chaired by former CEO of the French Development Agency, Michel Severino.

The final result of the materiality analysis was validated by the company's Chairman and CEO.

Identification of company-specific material issues is also undertaken using Veolia's risk management system. Once a year, global risk mapping is presented to the Executive Committee, meeting as a Risk Management Committee, and to the Accounts and Audit Committee of the Board of Directors in order to validate and monitor the effectiveness of the company's action plans.

Risk assessment contributes to the company's adjustment of its exposure to environmental, labor-related, corporate social and economic factors. It also helps to identify business opportunities in the management of risks linked to sustainable development that Veolia's clients (municipal authorities and industries) delegate to it.

Many countries now require greater transparency around company sustainability activities. For example, the EU Non-Financial Reporting Directive has delivered enhanced disclosure and focus across the European Union.[18]

Additionally, social media has also become a force for increased transparency and more and more consumers want to understand what is behind the products they are buying. As noted in this quote from one of our interviewees:

*"Another dislocation I am finding in the sustainability space is the advent of social media. If someone picks up on an issue and we do not respond in an appropriate way it can become a potential problem. We have to have a response strategy that allows you to manage the risks."*

With this increasing focus, it is in the organization's interest to ensure relevant and robust sustainability reporting. Doing so allows boards to demonstrate action and progress and provides the opportunity for benchmarking by the organization and by its stakeholders.

Unfortunately, some organizations continue to report information that lacks relevance, transparency and comparability. Often, the aggregation of information across business units is too great for the reader to appreciate the subtle differences that arise between geographies and industries. In addition, reporting may not always make clear whether the board has considered and identified the most material sustainability issues for their business.

The following case studies provide examples of sustainability reporting activities where the board is involved through its role in approving the overall reporting document.

In 2010, Unilever shaped its Unilever Sustainable Living Plan around three sustainability goals and nine pillars. For each goal, Unilever has defined specific targets and metrics.

Unilever has two main channels to report on its sustainability actions: its yearly integrated annual report and a specific online sustainable living report. Some country-level offices also publish their own sustainability reports.[19] As part of its reporting process, Unilever receives feedback from the Board's Corporate Responsibility Committee and the USLP Council of external sustainability advisers.[20]

The Group's sustainability management and reporting performance was recognized in 2017 by leading agencies including Dow Jones Sustainability Index (DJSI) and CDP.[21]

Carrefour's ESG strategy is built around four topics, each with associated action plans and targets: waste reduction; biodiversity; partners; and social dynamics and diversity.

To assess its ESG performance, Carrefour has established an ESG Index which provides an overview of commitments and progress made by action plans across the four main topics over a three-year period. For each objective that is not reached, a remediation program is put in place. No information is provided on the board's involvement in this process.

ESG performance results are disclosed in the Group's annual registration documents. This includes a specific section on how non-financial performance is reviewed by the Board's ESG Committee.[22]

In 2017, Carrefour joined its most successful peers from an ESG perspective on the DJSI World. This distinction puts the Group in the top five global retailers in terms of ESG.[23]

### Key messages on sustainability oversight practices

1. Board discussions on sustainability are more productive where there is a formalized structure for accountability and oversight of relevant issues. For some, this is done through a dedicated Sustainability Committee with formal terms of reference. For others, it is achieved through discussions at the entire board level.
2. Training on sustainability matters needs to be in the context of relevant business decisions. Without this framework, board members will not have a clear point of reference to apply sustainability issues to core activities.
3. Interaction and dialogue with stakeholders should form an integral part of the board's oversight activities as a mechanism for engagement, insight and feedback.
4. Reporting should be relevant, transparent and comparable. It should be appropriately disaggregated so that the reader can appreciate the differences between geographies and industries.

6

# The challenges to modernizing governance

The interviews carried out with board directors identified significant challenges boards can experience in their oversight of ESG-related matters.

The challenges identified by directors as part of this project involve five areas of board responsibility: structure of governance; people; processes; internal and external stakeholders; and reporting.

## GOVERNANCE STRUCTURE

**Purpose:** Some companies inadequately define their purpose and vision. This can impede board focus and decision-making. It may also be difficult for boards to easily link global sustainability issues (climate change, biodiversity loss, supply chain issues, for example) with the company's purpose, activities and risk profile. Some boards will draw guidance from legal requirements on specific sustainability matters, such as greenhouse gas emissions. This can be a helpful start but addressing these limited issues may distract the board from recognizing equally important but less well-understood sustainability matters that impact the company.

*"Having a purpose-driven statement fundamentally sets the course for sustainability and that is underpinned by that is the values and the behaviors that you expect."*

*"The extent to which ESG is linked to the long term depends on how crucial it is felt to be to the purpose of the company."*

**Culture:** Culture impacts the ability of companies to understand, integrate and manage emerging issues like sustainability. In particular, companies which are siloed with independent business lines can find it challenging to develop effective, consistent and coordinated sustainability policies and actions.

An appreciation of the cultural benefits and barriers within an organization can be helpful in considering how best to introduce, manage and implement sustainability strategies.

*"Regulation is key but how you use that regulation is key. What drives a sustainable culture is whether those regulations are embedded and executed as part of your operating model."*

**Mandate on sustainability:** Directors widely appreciated the growing importance of sustainability and expressed a need for, and expectation, of greater attention to be devoted to it. However, boards continue to struggle with how to best institutionalize and manage sustainability and concern was expressed about the time and efficacy of board engagement with the issue. Boards also struggle to understand their role and responsibility in shaping and embedding sustainability concerns into their long-term strategy and performance evaluation methods.

*"If not linked to strategy, regulation can become a check-the-box exercise that is not particularly important or helpful to the company. The company needs to "control the narrative" about sustainability by having a strategy that it can clearly articulate to employees, investors and markets. There has to be a clear articulation of what is being done and why."*

**Responsibility:** Boards highlighted difficulties in addressing sustainability matters effectively in the absence of clearly identified responsibilities for key material issues. There is also often a lack of clear accountability for sustainability risks.

*"Directors must determine their own agendas, or it becomes hard for investors to hold them accountable for their performance. An analogy is goal-setting for executive management, where it is difficult to hold an executive accountable for performance if the executive has been micro-managed."*

## PEOPLE

**Board composition:** Boards recognize the importance of skills and expertise on material sustainability issues in order for the full board to understand and effectively respond to sustainability challenges. However, they have found it challenging to recruit members who fit this profile. Finding the right board members works best when there is a comprehensive approach to defining the board's responsibilities and roles, including sustainability. For many boards, that critical foundational element remains underdeveloped.

*"A board needs to be well-rounded and directors should not be experts in one area only – if that is the case, they cannot then be effective board members."*

**Training:** Many board members would welcome and benefit from enhanced training on emerging issues, including sustainability. However, it remains difficult to find effective board training that is sufficiently tailored to the company's business model. It is important to find a common business language which can help to ensure directors clearly understand the environmental and social impacts and dependencies specific to the risks, opportunities and strategic objectives of the organization.

*"A key challenge for training is relevance. If the training is tailored to the sustainability issues that are most relevant to the organization's industry, this will be most impactful."*

*"Training needs to be provided in the context of relevant business decisions or the board members."*

## PROCESS

**Materiality:** Effectively answering the question of materiality as it pertains to sustainability issues has been a challenge for organizations and especially so for boards. Some companies fail to define the most material risks and opportunities of the organization due to a lack of awareness and information on sustainability issues. If a company lacks an effective process for obtaining appropriate and timely information in a business-relevant language, it prevents the board from effectively analyzing and prioritizing key sustainability-related issues affecting the company.

**Integration into risk management and strategy processes:** Boards may inadequately evaluate sustainability as part of their risk management, strategy and financial reviews. A board that does not have a formal process to consider sustainability opportunity and risk is not well positioned to assess a company's overall performance.

*"Sustainability reports provide insights on key sustainability issues; however, these tend to be operational and not strategic. We are looking to integrate sustainability matters into business key performance indicators (KPIs) and to increase ownership."*

**Board agenda:** Boards find it challenging to plan and provide sufficient agenda time for all relevant matters. Sustainability matters are seen as not commanding enough board attention when compared to nearer-term crises and challenges. When it is discussed, the sustainability agenda is often presented less effectively than other business matters.

*"Board members in general do not give the sustainability agenda the right level of attention that it should be given – we tend to leave this as nice to have."*

*"Sustainability activity at board level is not yet at the same of level of rigor that we see for financial matters".*

**Board impact and evaluation:** Assessing the impact and outcomes of the board's sustainability-related activities is difficult. In light of emerging sustainability trends and competing standards in the marketplace, it can be challenging for boards to determine whether the company's and the board's sustainability efforts are achieving the desired objectives. Given the potential impact of failing to address sustainability matters on the business model, it is worth considering making sustainability performance a factor in the evaluation of board performance. Sustainability is not yet a common feature of board performance evaluations.

## STAKEHOLDERS

**Engagement with stakeholders:** While many companies have a stakeholder engagement plan, rarely does the process of developing and implementing the plan involve the board. This forecloses the opportunity for the board to participate in and support this important undertaking.

*"It is essential for stakeholders and independent non-executives to increase their interaction and engagement as this improves decision-making and thought processes and achieves mutual goals."*

*"Boards need to consider the extent to which their company interacts with their stakeholders or investors. It requires both sides to be willing to come together and interact."*

**Shareholders:** Boards can struggle to obtain complete and regular information about shareholder and investor views on sustainability-related matters, including those of significant investors.

**Employees and customers:** Boards may give inadequate attention to the perspectives and interests of employees and customers. Often, boards request and receive only limited information on these views. Considering the increasing role and purchasing power of millennials and their growing focus on sustainability, boards would be well-advised to engage more effectively with their customer and employee communities, particularly to attract and retain talent.

## REPORTING

**Alignment with board processes:** The approach to sustainability reporting often appears to be inconsistent with board processes and position on sustainability-related risks and opportunities. This lack of alignment results partly from lack of board involvement and understanding of the reporting process, data gathering, scope, purpose and balance of resource allocation on sustainability reporting.

**Frameworks and consistency:** Boards have found it challenging to navigate the complexities of sustainability reporting-related resources and frameworks which can varying in quality and approach with differing rules and requirements across jurisdictions. Whilst the sustainability debate has matured in recent years, reporting has, to a certain extent, not kept pace. However, approaches such as Integrated Reporting and the Reporting Exchange aim to equip companies and boards on their sustainability reporting journey.[24] The priority for the board must be to ensure reporting provides an accurate representation of the company's activities in a way that is readily digestible for stakeholders. WBCSD's ESG Disclosure Handbook and Library of Indicators provide companies with a systematic way to approach reporting on material issues, using a three-step evaluation process and six core questions companies can determine how best to report information that is material to their business model.[25]

**Measuring progress:** There is no single reporting standard for measuring progress with regards to efforts to integrate sustainability into decision making. The most commonly used measures - such as GRI, SASB, TCFD, UN SDGs, and CDP - all overlap and conflict in some respects. There has also been an explosion of competing reporting standards and models for individual issues and topics.

Moreover, rating agencies can deploy complex permutations of these standards, in effect creating their own measurements. This confused marketplace confuses and impedes clear and consistent progress reporting.

Though boards have worked to resolve challenges and differences, comprehensive solutions are difficult to identify and implement. In the next chapter, we provide an initial set of recommendations to offer some preliminary guidance to boards in addressing the gaps as they continue their journey of modernizing governance.

7

# Initial recommendations for modernizing governance

**To assist boards on their journey towards modernizing governance, a series of recommendations have been developed based on the challenges identified.**

These recommendations are intended to help the board institutionalize the consideration of sustainability matters into their responsibilities.

1. The board must ensure that sustainability considerations are clear and aligned with the company's purpose. Once purpose and sustainability are aligned, the board role can shift its focus to implementation, oversight and reassessment.

2. Sustainability should be a core consideration of the board. Strategy discussions should include and integrate ESG-concerns. It is essential for the board to be specific about the impacts that define the company's sustainability strategy. The board should be involved in developing the stakeholder matrix, identifying environmental and social impacts and dependencies, and determining how risks and opportunities are addressed. While it may be management's responsibility to develop these strategies, the board's fiduciary duties require a meaningful understanding, assessment and oversight of these areas.

3. The board should adopt a comprehensive approach to developing relevant sustainability skills by:

   - Seeking management insight around sustainability priorities and activities and their potential impact on the firm's existing strategy, and/or engaging external experts to provide sector-specific insights on current and emerging environmental and social issues;

   - Enhancing the board's sustainability capacity by recruiting directors who have relevant sustainability competencies and creating stronger liaison between sustainability management and the board; and

   - Undertaking board training to improve knowledge and understanding of material sustainability topics, while also undertaking deep dives on the material sustainability issues that have the potential to significantly impact the business.

4. The company performance review should include consideration of environmental and social capital and be subject to oversight by the board. For this to take place, the board must prioritize the most important environmental and social concerns for the company. Based on these priorities, clear responsibilities can be assigned to business leaders and integrated into their performance dashboard and remuneration structure. Key performance metrics around material sustainability concerns should be established.

5. The board should participate directly in and ensure effective company engagement with stakeholders. The company's engagement strategy should encourage the input of stakeholders and assist the board in developing a policy which best allows stakeholder needs to be considered in an effective and beneficial manner for the company.

6. In reviewing and signing the external reports of the company, the board must ensure alignment with real company activities and robust metrics and narrative. This should account for the company's material environmental and social impacts, including how the company is addressing these challenges. The board should encourage integration of sustainability and financial reporting. Resources such as the Reporting Exchange can help to identify the appropriate reporting framework for the business. The framework of the TCFD presents a strong example of integrating reporting on climate-related concerns.

These recommendations will contribute to the development of a set of training resources for the board directors, which we will publish during Phase 2 of this project. These materials will aim to facilitate more effective board consideration and oversight of sustainability matters.

8

# Appendix

## PROJECT OVERVIEW AND METHODOLOGY

The project is made up two phases:

1. a. Research to understand the governance landscape around sustainability by reviewing statutory and/or listing requirements, governance code provisions and other expectations across twelve jurisdictions.

   b. Interviews with board members of a selected set of more than 40 global companies to understand how they consider and undertake oversight of sustainability matters in the governance of the organization and what they see as the benefits of and/or challenges in doing this well.

2. Developing training resources for boards to better integrate sustainability into the way they approach governance and boardroom decision-making.

This report represents the output from phase 1b. The training resources to be in phase 2 will be published in 2020.

## APPROACH

**Value** - The increasing prevalence and significance of sustainability matters is putting pressure on companies and increasing the complexity of board decision-making. To stay ahead, boards need to adapt their business models and strategies to ensure companies' resilience over the long-term.

**Impact** - Governance is evolving fast and investors and other stakeholders are demanding greater transparency. Sustainability can no longer be considered in isolation; it must be integrated into board governance and decision-making. This project helps boards consider sustainability-related risks and opportunities.

**Voice** - This project helps board directors improve their decision-making processes to protect and preserve long-term value.

## WHO IS INVOLVED?

The materials are the sole responsibility of WBCSD. WBCSD has worked with Deloitte and Baker McKenzie who have brought their respective sustainability and governance expertise. We have also worked with multiple subject-matter experts to make sure our work is useful and effective for boards.

## METHODOLOGY

The project has focused on the following twelve jurisdictions: Brazil, China, France, Germany, Hong Kong, Japan, the Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States of America.

For each jurisdiction, we have considered a set of questions around existing sustainability governance requirements to build a picture of the current sustainability environment. We have conducted interviews with board directors in each jurisdiction to gain their perspectives of how these requirements are translating into practical activities undertaken by boards. Interviews mainly focused on board members of companies within the food and agricultural sector due to the sector's critical role in many of today's most pressing environmental and social issues (for example deforestation, water scarcity and access, climate change and food security). A handful of companies were also interviewed that operate in sectors facing significant sustainability challenges.

## RELEVANT WBCSD TOOLS AND MATERIALS

In collaboration with other international organizations, WBCSD has developed a range of tools and materials to support companies in understanding and integrating sustainability impacts and dependencies within the overall governance structure and internal decision-making processes, including at board level.

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WBCSD, (2018), Materiality in corporate reporting – a white paper focusing on the food and agricultural sector, available at: https://www.wbcsd.org/Programs/Redefining-Value/Resources/A-White-Paper-focusing-on-the-food-and-agriculture-sector

The Reporting Exchange, available at: http://www.reportingexchange.com

WBCSD, (2019), ESG Disclosure Handbook, available at: https://www.wbcsd.org/Programs/Redefining-Value/External-Disclosure/Purpose-driven-disclosure/Resources/ESG-Disclosure-Handbook

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WBCSD, (2019), A buyer's guide to assurance on non-financial information, available at: https://www.wbcsd.org/Programs/Redefining-Value/External-Disclosure/Assurance-Internal-Controls/Resources/A-buyer-s-guide-to-assurance-on-non-financial-information

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## RELEVANT EXTERNAL PUBLICATIONS


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IFC (2017), Headaches, Concerns and Regrets: What Does the Experience of 102 Brazilian Directors Tell Us? Available at: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/private+sector+opinion/headaches%2C+concerns%2C+and+regrets+-+what+does+the+experience+of+102+brazilian+directors+tell+us

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3. Companies Act (2006), Section 172 - All directors have a duty to promote the success of the company for the benefit of the shareholders but in doing so, to have regard to the following:

   (a) the likely consequences of any decision in the long term,

   (b) the interests of the company's employees,

   (c) the need to foster the company's business relationships with suppliers, customers and others,

   (d) the impact of the company's operations on the community and the environment,

   (e) the desirability of the company maintaining a reputation for high standards of business conduct.

   Available at: http://www.legislation.gov.uk/ukpga/2006/46/section/172

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## DISCLAIMER



## ABOUT THE WORLD BUSINESS COUNCIL FOR SUSTAINABLE DEVELOPMENT (WBCSD)

WBCSD is a global, CEO-led organization of over 200 leading businesses working together to accelerate the transition to a sustainable world. We help make our member companies more successful and sustainable by focusing on the maximum positive impact for shareholders, the environment and societies.

Our member companies come from all business sectors and all major economies, representing a combined revenue of more than USD $8.5 trillion and 19 million employees. Our global network of almost 70 national business councils gives our members unparalleled reach across the globe. WBCSD is uniquely positioned to work with member companies along and across value chains to deliver impactful business solutions to the most challenging sustainability issues.

Together, we are the leading voice of business for sustainability: united by our vision of a world where more than 9 billion people are all living well and within the boundaries of our planet, by 2050.

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