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ESG, strategy, and the long view

A framework for board oversight

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The role of the corporation in society is an abstract, politically polarizing question that is not high on the priority list of most boards. Yet, embedded in this question are strategic and operational issues critical to long-term value creation. And these issues are attracting heightened attention from investors, consumers, and other stakeholders.

56% cite stakeholder expectations as a primary driver of their company's ESG focus.

Source: KPMG Board Leadership Center survey, 2017

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From our perspective, many of these issues fall under the broad rubric of environmental, social, and governance (ESG), from climate change impacts and worker safety to workplace diversity, executive compensation, and board composition. Given the significant opportunities and risks associated with ESG, companies that excel at identifying and incorporating these issues into their strategy enjoy a competitive advantage in the marketplace and among institutional investors. It is increasingly clear that ESG and ROI are connected.[1]

So why isn't ESG top of mind in every boardroom? Too often, the pressures of short-termism—from quarterly earnings reports to investment vehicles valued daily or monthly, to management compensation incentives—cause companies to neglect ESG issues, which, by their nature, tend to be more long term oriented in the context of strategy and performance. Language can also present barriers, and the subject is often difficult to define. Is it corporate social responsibility (CSR)? Shared value? Conscious capitalism? Triple bottom line? Responsible business? Corporate citizenship? Sustainability?

And context matters. How ESG issues are framed for discussion in the boardroom—and across the company—will influence whether they are viewed as business issues that are essential to long-term value creation or soft topics that are more marketing and brand/reputation driven. For example, a company's approach to the topic of "climate change" might be considered politically fraught and relevant primarily to the company's reputation. But a discussion of how long-term risks to manufacturing operations and the supply chain created by severe weather patterns is likely to be more meaningful and productive.

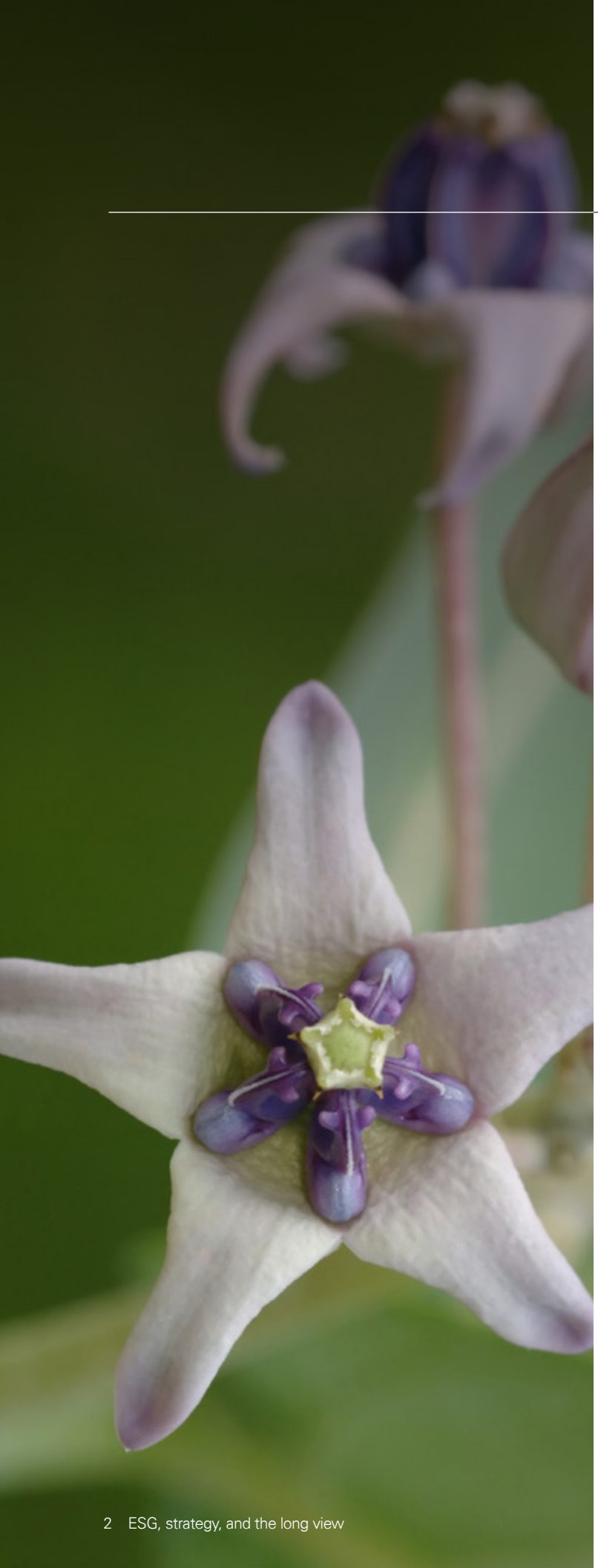
In addition to the challenges of short-term pressures and finding a common language, there is no cookie cutter approach to ESG. The strategic importance of specific ESG issues can vary widely by company and by industry. A company's ESG profile may change as the company's business changes, and a company's philanthropic activities captured in a glossy report can create the perception (and complacency) that ESG is being addressed—that the company is "doing its part." In fact, addressing ESG as the long-term strategic issue that it has become and embedding it into the company's core business activities (strategy, operations, risk management, and corporate culture) is a formidable challenge—requiring an understanding of why ESG matters to the company's long-term performance, a clear commitment and strong leadership from the top, and enterprise-wide buy-in.

Companies—and boardroom discussions—are moving at different speeds in addressing ESG issues today. But wherever a company is on this journey, the board can help lead the organization forward by focusing on the big picture. Which ESG issues are of strategic significance to the company? How is the company managing ESG-related risks and opportunities and embedding ESG into the strategy and culture to drive long-term performance? How is the company telling its "ESG story" to investors and other stakeholders?

ESG

Each company will have its own mix of ESG issues, but for purposes of this paper, "ESG" encompasses those that are prominent on investors' and other stakeholders' agendas today and commonly cited in corporate responsibility and sustainability reporting:

- Climate change impacts
- Water and waste management
- Natural resource scarcity
- Product and worker safety
- Supply chain management
- Workplace diversity and inclusion
- Talent management
- Employee relations
- Human rights
- Health
- Labor practices
- Executive compensation
- Political contributions
- Board independence, composition, and renewal



To help boards understand and shape the total impact of the company's strategy and operations externally—on the environment, the company's consumers and employees, the communities in which it operates, and other stakeholders—and internally, on the company's performance, this paper presents a five-part framework:

- **Level setting:** Agree on definition of ESG and its importance to the company.
- **Assessment:** Determine which ESG risks and opportunities are of strategic significance to the company.
- **Integration:** Encourage integration of strategically significant ESG issues into the business strategy.
- **Stakeholder communications:** Shape the company's key ESG messages to investors and other stakeholders in the context of strategy and long-term value creation.
- **Board oversight:** Ensure that the board has the right composition, structure, and processes to oversee ESG in the context of strategy and long-term value creation.

This framework, developed by the KPMG Board Leadership Center in collaboration with Professor George Serafeim of Harvard Business School, will form the basis for deeper dives and case studies in future white papers.

Board oversight framework

Total impact strategy

Our framework for board oversight of ESG as a strategic issue recognizes that creating long-term value increasingly requires companies to understand the impact of their strategies on key stakeholders—investors, employees, customers, communities—as well as on the natural resources and supply chains that the company relies on. Total Impact Strategy encourages companies and boards to widen their aperture for a fuller view of ESG, strategy, and long-term performance.

Level setting

Agree on definition of ESG and its importance to the company.

While we use the term "ESG" to cover the broad range of environmental, social, and governance issues that are meaningful to investors, employees, customers, and other stakeholders, others may use terms like CSR, sustainability, or corporate citizenship. These terms often mean different things to different people, even those who believe they are speaking a common language. An important first step is for the board to reach an understanding with management not only on language but what that language means as a practical matter. A case in point: Companies often conflate ESG and charitable giving, but giving is just a narrow aspect of the much larger, strategic ESG equation.

How ESG issues are framed and discussed has a big impact on understanding why they matter to the business and how to address them. Given the pitfalls and barriers that ESG language can create, it is important to (re)frame the discussion in business terms—particularly risk, opportunity, efficiency, and financial performance. As in our earlier example, "climate change" can be framed as a discussion about the risks water shortages and droughts pose to a beverage company's manufacturing operations, the potential financial impact these risks pose, and how the company might mitigate these risks in a way that improves bottom-line performance. This strategic approach can help short-circuit preconceptions, politics, and personal views while setting the discussion on the right course at the outset.

"Given the pitfalls and barriers that ESG language can create, it is important to (re)frame the discussion in business terms—particularly risk, opportunity, efficiency, and financial performance."

Importance of ESG to corporate performance

ESG issues continue to rise on investor agendas for good reason. Poor ESG practices or ignoring ESG issues pose environmental, legal, and reputation risks that can damage the company and have a lasting impact on the bottom line. By contrast, firms with strong ESG performance tend to have a more stable and loyal investor base, lower cost of capital, and better access to financing, as numerous research papers have now documented.[2] For example:

— Calvert Research and Management's 2017 paper, "The Financial and Societal Benefits of ESG Integration: Focus on Materiality," found that material ESG issues impact a company's financials in terms of revenues, costs, and the cost of capital.[3] Because ESG data is slow to be incorporated into stock prices, investors who accurately understand ESG implications typically have time to take advantage of opportunities and generate alpha.

— Bank of America Merrill Lynch's June 2017 paper, "ESG Part II: A Deeper Dive," found that ESG investing would have offered long-term equity investors benefits in mitigating price and earnings risks and avoiding 90 percent of bankruptcies in the period studied (2002–2015).[4] The paper found that ESG attributes "have been a better signal of future earnings volatility more than any other measure we have observed at a market level."

— A 2012 Deutsche Bank review of more than 100 academic studies of sustainable investing around the world found that ESG factors are correlated with superior risk-adjusted returns at a securities level.[5]

And the benefits that accrue to these companies are not limited to favorable capital markets. Studies also show benefits in terms of employee engagement and customer purchasing behavior—both of which are vital to competitive advantage and long-term performance.[6]

For many years, investors have focused on the "G" in ESG—governance issues, such as executive compensation, board leadership and composition, and the ability of shareholders to include their director candidates on management's proxy card. But institutional investors are increasingly turning their attention to a range of environmental and social issues that they view as critical to the long-term financial health of the company.

According to Gibson Dunn,[7] over 40 percent of the 827 shareholder proposals submitted in 2017 dealt with environmental and social issues, making it the largest category of shareholder proposals during the 2017 proxy season. (This included 201 social proposals—up from 160 in 2016—related primarily to diversity, discrimination, and gender pay gap issues; and 144 environmental proposals—up from 139 in 2016). The level of shareholder support for environmental issues was notable, with climate change proposals receiving majority support at large-cap companies ExxonMobil, Occidental Petroleum, and PPL, and climate change proposals generally garnering one-third of votes cast.

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What are the greatest challenges to addressing ESG as a strategic issue at your company?

ESG is viewed as a "soft" brand/marketing issue 35%

Pressure to deliver short-term/quarterly results 29%

ESG issues are disconnected from core business processes 27%

Source: KPMG Board Leadership Center survey, 2017

Level setting (continued)

The 2017 proxy results are perhaps not surprising, given that a number of the largest institutional investors—including BlackRock and State Street—have been so outspoken in emphasizing the importance of environmental and social issues (along with governance issues) in corporate strategy and generating long-term value:

In his recent letters to CEOs of FORTUNE 500 companies, Larry Fink, chairman of BlackRock,[8] asked them to lay out for shareholders a strategic framework for long-term value creation and emphasized that over the long term, ESG issues—ranging from climate change to diversity to board effectiveness—have real and quantifiable financial impacts and can provide essential insights into management's effectiveness and thus a company's long-term prospects. In its engagement priorities for 2017–2018, BlackRock identified "climate risk disclosures" as one of its five engagement priorities and emphasized the importance of a "climate competent board" for companies that are significantly exposed to climate risk. BlackRock also stated that "we will engage companies to better understand their progress on improving gender balance…If there is no progress within a reasonable time frame, we will hold nominating and/or governance committees accountable for an apparent lack of commitment to board effectiveness."[9]

In its January letter to directors, State Street Global Advisors emphasized the importance of sustainability in long-term corporate strategy and stated, "in 2017 we will be increasingly focused on board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent management, some or all of which may impact long-term value." State Street attached a framework to its letter to help boards focus on ESG issues, including a list of questions that boards can use as a starting point to begin work with management to incorporate a sustainability lens into long-term strategy.[10]

In 2017, Vanguard updated its proxy voting guidelines, stating that it will evaluate each environmental and social proposal on its merits and may support those with a demonstrable link to long-term shareholder value. Subsequently, in connection with negotiating the withdrawal of a climate change shareholder proposal submitted to certain of Vanguard's own funds, Vanguard announced that it had prioritized climate risk on its engagement agenda, noting: "It is crucial to our fund investors that market participants have access to consistently comparable information to incorporate these risks and opportunities into market prices."[11] And Fidelity Investments revised its proxy voting guidelines to say it may support shareholder proposals calling for reports on sustainability, renewable energy, and environmental impact issues and may also "support proposals on issues such as equal employment, and board and workforce diversity."[12]

Activists, too, are sharpening their focus on ESG factors. While activist investors have largely focused on board/governance issues in recent years (board composition, executive pay, proxy access), social and environmental issues are featuring more prominently in the investment process. For example, in its recently revised policy statement, Trian Partners notes that environmental and social issues "can have an impact on a company's culture and long-term performance and that companies can implement appropriate ESG initiatives that increase their sales and earnings." Trian also indicates that it "will report periodically on the progress on ESG matters at our portfolio companies in communications with our investors."[13]

"Because sustainability issues affect so many aspects of a company's business, from financial performance to risk management, incorporating sustainability into the business in a meaningful way is integral to a company's long-term viability."

Taken together, 2017 ESG proxy season results and recent pronouncements from major institutional investors and activists send a clear message to directors that ESG issues are a priority for investors and should be a priority for companies.

As we look to 2018 and beyond, we expect these issues will remain a priority and perhaps even grow in importance as the Trump administration's pullback on environmental and social issues may cause investors to step in to fill a perceived void.

Corporate America appears to be listening. Some of the largest U.S. corporations are publicly emphasizing the strategic importance of ESG to their businesses, and the Business Roundtable (an association of CEOs of leading companies[14]) addressed the importance of ESG in its *Principles of Corporate Governance 2016*:[15]

— "Companies should strive to be…responsible stewards of the environment and to consider other relevant sustainability issues in operating their businesses. Failure to meet these obligations can result in damage to the company, both in immediate economic terms and in its longer-term reputation. Because sustainability issues affect so many aspects of a company's business, from financial performance to risk management, incorporating sustainability into the business in a meaningful way is integral to a company's long-term viability."

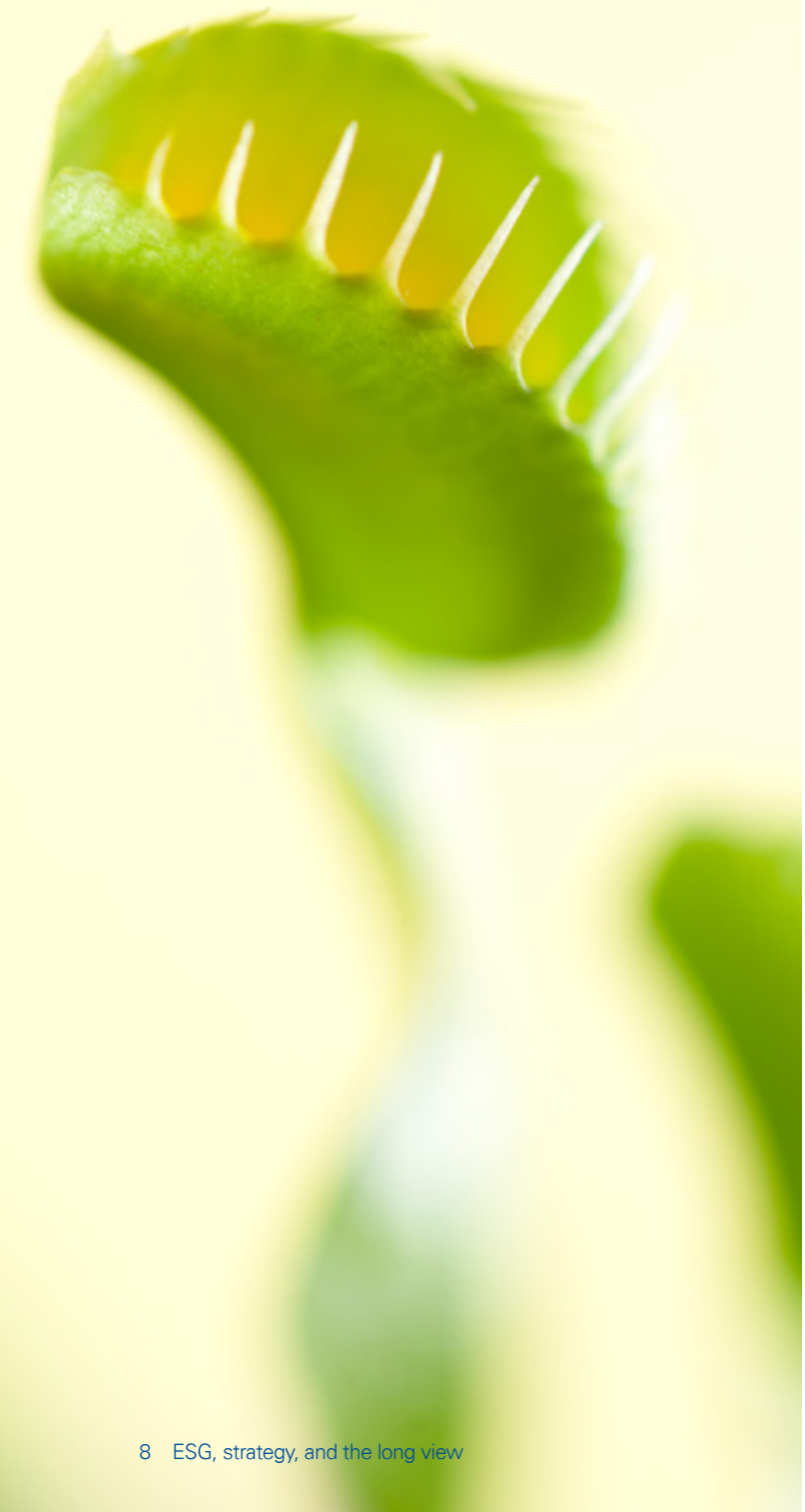
— "A company should conduct its business with meaningful regard for environmental, health, safety and other sustainability issues relevant to its operations. The board should be cognizant of developments relating to economic, social and environmental sustainability issues and should understand which issues are most important to the company's business and to its shareholders."

Other leading organizations—including CECP (the "CEO Force for Good") and its Strategic Investor Initiative, the Committee on Economic Development, and the Organisation for Economic Co-operation and Development—are also sharpening their focus on, and advocacy for, ESG as a critical factor in long-term corporate performance and the long-term health and sustainability of capitalism.

"2017 ESG proxy season results and recent pronouncements from major institutional investors and activists send a clear message to directors that ESG issues are a priority for investors and should be a priority for companies."

Assessment

Determine which ESG risks and opportunities are of strategic significance to the company.



Identifying the strategically significant ESG risks and opportunities for a company is complex, as they vary by industry and sector, and even within industries. Generally, however, a two-step process is helpful:

1 **Identify and assess all the ESG issues that are material to the business,** such as environmental degradation, product and worker safety, waste generation, etc.—issues that could materially affect the business or its stakeholders. Part of the identification and assessment process should involve analyzing the likelihood and magnitude of ESG risks and opportunities, knowing that these variables may shift and thus need to be revisited.

2 **From the broad inventory of material ESG issues, identify the two or three ESG issues that are strategically significant.** Which ESG issues are truly core to the business strategy and key to the long-term health and viability of the company? In addition to internal assessment and dialogue, which ESG issues do customers, suppliers, and other external stakeholders view as key to the company's long-term strategy? While it is common to coalesce around six to eight issues that could affect the operating efficiency of the company, in most cases, only two or three issues will affect the company's strategic advantage. The board should concentrate on these topics as they fundamentally affect a company's ability to remain competitive. For example, companies that compete on the basis of differentiation and strong brands should focus on issues that would affect the brand value of the firm. For companies competing on the basis of price, the emphasis should be on factors that have the potential to further decrease the cost structure or to prevent any unexpected cost increases. Other companies identify one overarching ESG initiative—e.g., to generate X percent of new product revenues from environmentally friendly product materials—which serves as the basis for various business units and functional groups to develop supporting ESG goals and initiatives. In short, when deciding which ESG issues to focus on in the boardroom, less is more.

Indeed, making the distinction between *strategically significant* ESG issues and other material ESG issues is important to bring discipline and structure to how these ESG issues should be governed. While management needs to focus on all ESG issues, the board should focus its limited time on the most strategically important ESG issues.

> “Regardless of whether ESG issues are categorized as material or strategically significant, they all should be appropriately addressed in the company’s risk management processes.”

Once the strategically significant issues are identified, the board should work with management to establish metrics and key performance indicators (KPIs) that enable the board to monitor management’s performance against goals. At the same time, the board should monitor stakeholder communications that address these strategically significant issues in the context of strategy and long-term value creation. Other material ESG issues that may well be ancillary to strategy must still be managed by the company and its ESG team, as these issues will also be the subject of stakeholder communications—both mandatory Securities and Exchange Commission (SEC) filings as well as voluntary disclosure that may be of interest to investors, employees, customers, and other stakeholders. (See more on this in Stakeholder communications). And regardless of whether ESG issues are categorized as material or strategically significant, they all should be appropriately addressed in the company’s risk management processes—about which the board should receive regular briefings.

Oversight of management’s assessment process

Boards need to understand and oversee management’s identification and assessment process. A broad and inclusive process that includes key stakeholder perspectives is valuable in several respects, including:

— Ensuring that management of the ESG issues is embedded in wider business processes

— Identifying issues and trends on the horizon—such as technological disruption, scarcity of water and other natural resources, or changing weather patterns—that could significantly impact the company’s ability to create long-term value

— Enabling different functions of the business to be ready to take advantage of opportunities to develop new products or services and stay ahead of competitors

— Prioritizing resources for the ESG issues most important to the company

— Helping to identify where the company is creating, or reducing, value to society.

There is no standard approach for inventorying and assessing material ESG risks and opportunities—or for condensing this broad assessment to a shortlist of strategically significant ESG issues. However, the Sustainability Accounting Standards Board’s (SASB) provisional sustainability accounting standards may be a helpful reference. SASB currently maintains provisional standards for 79 industries in 11 sectors. The standards focus on industry-specific sustainability factors that are reasonably likely to have material impacts. The SASB Materiality Map, an interactive tool that identifies and compares likely material sustainability issues across different industries and sectors, may also be helpful.[16]

An important caveat: Many ESG efforts inside companies start with a process focused on ESG issues as risks. In fact, many of the leading companies embed the ESG inventory and assessment process into enterprise risk management or other existing processes. While this can be an efficient process and a good starting point, it is important to avoid focusing only on risk, as this may cause the organization to miss the “opportunity train.” The board should also encourage management to focus on the potential for innovation, disruption, and value creation posed by ESG activities and demands in the marketplace, such as:

— Solutions for a low carbon world including energy storage, energy efficiency, and renewable energy generation

— Access to education, affordable housing, and financial services to decrease inequality

— Health and well-being, including healthy food consumption, activity services, and healthy lifestyle choices

— Infrastructure in cities to support increasing levels of urbanization

— Technologies that accelerate the sharing economy. ●

Integration

Encourage integration of strategically significant ESG issues into the business strategy.

While many companies have developed ESG initiatives, they are often disconnected from the core business strategy and remain peripheral corporate activities that don't directly contribute to the company's competitive advantage.

Companies that recognize the strategic importance of ESG are embedding these issues—particularly those aligned with the company's business interests and long-term viability—into their strategy and how they think about long-term performance.

Indeed, by integrating strategically significant ESG issues into the strategy, management and the board will bring the same focus and discipline to the management and oversight of these ESG initiatives as they do to other strategic initiatives aimed at creating long-term value. How best to achieve such integration, however, is complex and will likely vary by company based on business models and strategy processes. From our perspective, integration efforts should include two broad areas—employee selection and behavior, and organizational processes and routines.

Employee selection and behavior

— Are we hiring the right talent and is our selection process compatible with building an inclusive and talented workforce that reflects our business needs?

— Do we tie compensation and promotion decisions to the metrics that advance performance on the critical ESG issues that we face?

— Are we empowering people and giving decision rights to teams that can make decisions by taking into account ESG information reflecting local knowledge?

— Is our culture promoting employee behaviors that are consistent with our priorities rather than providing perverse incentives that could actually *deter* employees from exhibiting the behavior management and the board hope to see?

Organizational processes and routines

— Do we have the right ESG metrics to monitor performance, set targets, and incentivize action?

— Are the metrics reliable, comparable over time, and credible for decision making? What are the mechanisms to help ensure these qualities?

— Have we integrated these metrics into capital allocation decisions to help determine which projects to invest in?

— Are corporate functions considering ESG issues when making marketing, procurement, hiring, financing, and investment decisions? Are business unit leaders aligned with the corporate vision?

— How are we achieving harmonization of ESG practices across a diverse set of geographies while at the same time adapting to local culture and laws?

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> "ESG is an enterprise-wide issue, and enterprise-wide buy-in is essential."

Integration (continued)

Effective integration of ESG into strategy and operations will also hinge on ensuring that the entire C-suite—not only the chief diversity/sustainability officer, head of marketing, and chief risk officer, but the CEO, CFO, COO, head of human resources, investor relations, and other key players—understands the importance of ESG to the company's strategy and long-term performance, and how ESG issues impact their respective functions and areas of responsibility. ESG is an enterprise-wide issue, and enterprise-wide buy-in is essential.

Of course, the board has a pivotal role to play in the integration process. For example, Nike's board provides guidance to management on ESG impacts and "the integration of these impacts into Nike's business including innovation, product design, manufacturing and sourcing, and operations."[17] Moreover, recognizing the strategic importance of brand and human capital, the board "provides guidance regarding the involvement of significant corporate responsibility issues in major business decisions, to protect Nike's valuable goodwill and human and intellectual capital."[18]

Similarly, Coca-Cola's Public Issues and Diversity Review Committee provides guidance on the three issues the company has identified as critical competitive drivers: women, the vast majority of buyers of the company's products; water, a key ingredient of the products; and well-being, an important competitive attribute given the shift towards healthier lifestyles.[19] (Also see *Incorporating ESG into the board's oversight of strategy*, p. 19).

A note on "purpose"

The board's oversight of ESG would be incomplete without considering the importance of purpose, which adds an important dimension to the ESG/strategy discussion.

Many business leaders—Richard Branson (Virgin Group), Indra Nooyi (PepsiCo), Paul Polman (Unilever), and others—have emphasized the role of purpose in business. Beyond defining and giving a company direction, the intangibles of a clear corporate purpose—motivation and commitment, quality and integrity, values and culture—are all essential to long-term performance. In our own initiative to articulate KPMG's purpose, nearly 95 percent of KPMG employees who told us their leaders discuss the firm's "higher purpose" said KPMG "is a great place to work" and are "proud to work for KPMG," compared to about 65 percent among those whose leaders *do not* discuss purpose. Not surprisingly, we also found actual turnover among these two groups to be dramatically different—5.6 percent vs 9.1.[20]

Yet research has shown that most organizations today are struggling to create a sense of purpose throughout the organization—and to connect purpose with better future financial performance.[21] Creating a purposeful organization where employees feel that they contribute to the mission of the organization and its positive impact on customers, communities, and other stakeholders is a challenging and often long-term undertaking.

We consider purpose to be a significant lever for fully and effectively using the five-part framework we've outlined in this paper. In organizations where employees feel a strong sense of purpose, developing a common language to talk about the company's major ESG challenges and opportunities—and to focus squarely on those that are most strategically important—will be an easier task. Integrating these issues into the organizational processes of the company will also face fewer hurdles when employees share a common purpose.

Finally, clarity of purpose helps to drive consistent and compelling messaging from senior leadership and the boardroom about the strategic importance of ESG to the company's long-term success.

Thinking long-term: ESG and strategy

Unilever

Global consumer products company Unilever, under CEO Paul Polman, has made "sustainable living" central to how the company operates, and the company says that its brands under that aegis grew 50 percent faster than the rest of the business and accounted for 60 percent of growth. Some examples of ESG-related strategic goals include cutting water use associated with its product use by 50 percent from 2010 to 2020; a goal of 100 percent sustainable sourcing of agricultural raw materials; and a 50 percent reduction in waste associated with consumer product disposal and an even greater cut in manufacturing waste.[22]

Pfizer Inc.

In an industry that garners more than its fair share of critical press, pharmaceutical company Pfizer Inc. counts earning greater respect from society as a strategic imperative. The company views a commitment to corporate responsibility as central to earning that respect. Like many organizations that provide goods or services that are fundamental to human life, Pfizer sees an intrinsic connection between its core business activities and doing good for society—and it does not take that link for granted. As Caroline Roan, the company's vice president of corporate responsibility and president of the Pfizer Foundation noted, "Our license to operate very much depends on our ability to build that trust and that respect with society."[23]

Starbucks Corp.

For years, coffee retailer Starbucks Corp. has pursued corporate responsibility programs aimed at, among other things, helping coffee farmers sustain their businesses while simultaneously improving the resilience of Starbucks' supply chain and ensuring the company a long-term supply of high-quality coffee beans. Starbucks has invested more than $70 million in such efforts. In 2008, amid the financial crisis—and despite sales slowing for the first time in its history and its net income and stock price each falling by more than half—the company stayed the course on its corporate responsibility programs, which it views as core to its long-term business strategy.[24] From the end of 2008 through November 30, 2016, Starbucks' stock significantly outperformed the S&P 500 stock index. Notably, in May 2016, the company issued a $500 million sustainability bond to enhance coffee supply chain management programs around the world. The company's announcement stated that the move "demonstrates that sustainability is not just an add-on, but an integral part of Starbucks, including our strategy and finances."[25]

Stakeholder communications

Shape the company's key ESG messages to investors and other stakeholders in the context of strategy and long-term value creation.

"Progress, results, linkage to strategy, and an explanation of how ESG factors benefit the long-term interests of the company and its stakeholders should be part of the company's communications—and reinforced in tone and communications by senior management and the board."

Addressing the information needs of different stakeholders

The first step in crafting ESG messages that resonate is understanding the varying information needs of the company's stakeholders. Employees, consumers, communities, regulators, and investors frequently seek different ESG information. For example, the information in an annual "corporate citizenship" report covering issues such as employee engagement and diversity, corporate philanthropy, and reducing energy consumption may appropriately address the concerns of employees, consumers, and communities, but it will not fully address the information demands of regulators, such as the SEC, or the needs of investors focusing on the impact of ESG on the company's long-term performance—and the basic question of whether to invest.

The board's role

Investors expect directors to be competent in ESG matters and to help ensure that the company provides disclosure that translates ESG into the language of the portfolio manager—finance, efficiency, risk, strategy, and long-term performance. Since an increasingly large number of investors view strong ESG performance as an indicator of a well-managed company, a board should ensure that the company's disclosures proactively tell its ESG story.

In addition to disclosing strategically significant ESG matters (as discussed on p. 8), companies should disclose other material ESG issues and any additional information necessary to put material information in context. Progress, results, linkage to strategy, and an explanation of how ESG factors benefit the long-term interests of the company and its stakeholders should be part of the company's communications—and reinforced in tone and communications by senior management and the board. GE, Goldman Sachs, Intel, and Unilever are among the companies that have been in the forefront in effectively communicating ESG messages.

The need to put information into context means that providing only the information required in public securities filings may not be enough. The board should work with management to determine whether additional disclosures are appropriate and whether such information should be in securities filings, annual sustainability reports, integrated reports that include both financial and nonfinancial information, the ESG section of the company's website, or elsewhere. For example, if ESG metrics are included in SEC filings, they may be easier for investors to "scrape" and put into their models, but publicly-filed information carries a greater litigation risk than information posted on a website.

As part of its oversight, the board should also understand the process management uses to determine the ESG information to be disclosed and how it verifies the accuracy of that information. In that regard, independent review or verification adds another level of rigor, accountability, and reliability to ESG reporting. Clorox, for example, obtains assurance from its auditor on certain nonfinancial ESG metrics included in its integrated reporting. Bristol-Myers Squibb uses third-party reviewers to assess its ESG program and the systems for collecting and reporting data from its worldwide facilities.[26]

Materiality and ESG standards

"Materiality" is central to understanding the ESG information investors want, and there are clear reasons why. As we noted earlier, companies with good ratings on material ESG issues demonstrate less volatility, a lower cost of capital, and, according to some studies, significantly outperform firms with poor ratings on these issues.[27] Moreover, immaterial ESG information is not correlated with superior performance,[28] and may be dismissed by investors as "greenwashing." That said, it is important to recognize that materiality can change over time; therefore, the assessment and determination of material versus nonmaterial issues should be an ongoing process.

Under U.S. securities laws, information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision, or, put another way, if a reasonable investor would view the information as significantly altering the total mix of information made available. Climate change is one of the ESG issues that has attracted the most attention from the SEC. Guidance provided by the SEC in 2010[29] indicates that unless a company's management can determine that known ESG uncertainties (such as changes in the severity of weather due to climate change) are not reasonably likely to have a material impact on its financial condition or operating performance, disclosure is required.

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Stakeholder communications (continued)

But providing material ESG information in a manner that allows comparisons among companies in the same industry and across industries has been elusive and the quality of ESG disclosure to date has been weak. Approximately 82 percent of the S&P 500 published corporate sustainability or responsibility reports in 2016, according to a 2016 Governance and Accountability Institute report. However, the most common form of disclosure was generic boilerplate that is inadequate for investment decision-making. Also, in the less than 24 percent of cases where metrics were disclosed, they were non-standardized.[30]

To date, over 100 ESG standard-setting initiatives have been developed, creating a confusing, alphabet soup. Among the most prominent standard setters that employ some type of materiality filter:

— **SASB** is an independent nonprofit that, as noted on p. 9, currently maintains provisional sustainability accounting standards for 79 industries in 11 sectors. The standards focus on the industry-specific sustainability factors reasonably likely to have material impacts, identifying an average of 5 topics and 13 metrics per industry. Materiality is based upon the materiality framework of existing U.S. securities laws. Companies can use the standards to disclose information to investors in SEC filings, such as annual reports on Forms 10-K and 20-F. Some U.S. public companies, such as Jet Blue[31] and Kilroy Realty,[32] are already issuing SASB reports or implementing SASB provisional standards; and Bloomberg LP, a private company, reports on its sustainability initiatives using SASB standards (the first company to do so).[33]

— **The Global Reporting Initiative (GRI)** is an independent, international organization that seeks to help businesses, governments, and other organizations understand and communicate the impact of business on ESG issues such as climate change, human rights, and corruption. The GRI factors are not limited to investment-related issues. Of the world's largest 250 corporations, 93 percent report on their sustainability performance and 82 percent of these use GRI's Standards to do so.[34] SASB and GRI have developed a partnership in an effort to foster harmonization.[35]

— **The Financial Stability Board's Task Force on Climate-Related Financial Disclosure (TCFD)** employs a disclosure regime, based upon other existing climate disclosure frameworks, that is intended to support the reporting of consistent, forward-looking climate-related risks and opportunities to investors, lenders, insurers, and other stakeholders.[36]

Demand for data

We believe that investors will increasingly seek standardized disclosures and metrics so they can analyze comparable data, particularly within industries. As a result, we anticipate there will be a consolidation among raters as winners are selected and comparability prevails. In the interim, public companies will continue to receive numerous questionnaires, surveys, and requests for information from standard-setting organizations and the many organizations that gather ESG data. Some companies will choose to ignore some or all of these requests, since they can be time-consuming and expensive to answer. The problem, however, is that data providers and analysts/raters may nonetheless gather data or supply a rating—and without information directly from the company, the data or rating on which it is based may be inaccurate.

Low ESG scores can have real-world consequences that a board must understand. For example:

— Company-issued requests for proposals (RFPs) may include minimum ESG "score" requirements.

— Some funds are restricted from investing in companies with low scores.

— ESG scores can prompt stockholder proposals and affect investor loyalty in activist situations.

— Some clients will not use asset managers with low ESG scores.

— ESG scores are now being used in the worlds of fixed income, lending, and insurance.[37]

As a result, companies and their boards should focus on effectively telling their ESG story and understand issues that could result in negative ratings from data or ratings providers used by their investors.

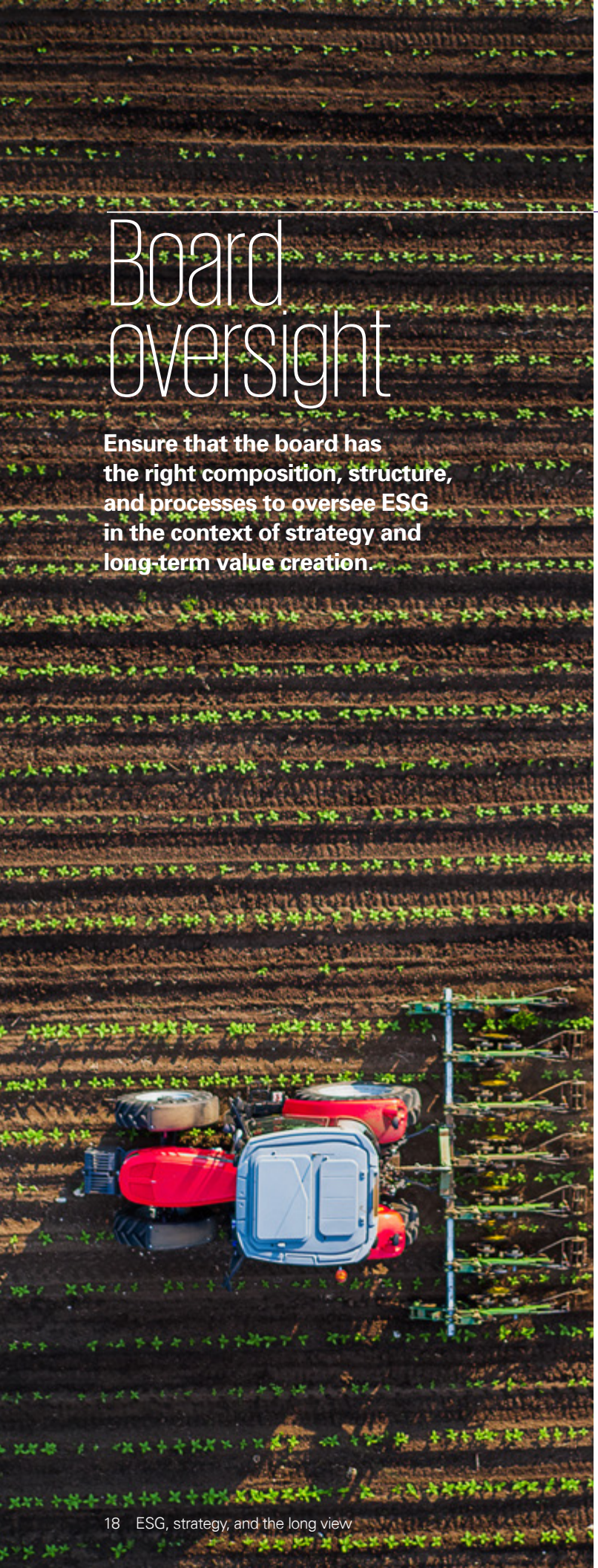
Since comparable metrics-based data is prized by investors, what should the board do to help facilitate such disclosure? One option is to use metrics proposed by SASB (or another widely recognized standard setter); another is for companies in the same industry that are not inclined to use existing frameworks to work together to craft meaningful industry metrics. The latter creates the opportunity for a direct dialogue with investors on the usefulness of the chosen measures and then refinements to those metrics based on feedback.

In addition to standard-setting bodies and regulators focused on disclosure, several investor initiatives are defining how ESG matters align with investment returns. Established in 2005 and supported by the United Nations, Principles for Responsible Investment (PRI) counts nearly 2,000 investment managers, asset owners, and service providers as signatories who strive to include PRI's six principles in their investment processes. In 2015, Ceres, a nonprofit focused on leadership and sustainability, worked with BlackRock to create a guide for institutional investors on how to engage with corporations on ESG issues.

While mandating ESG disclosure may not currently be a priority for the SEC, the reality is that investors will continue to push for useful information. ESG is no longer just a negative screen for socially responsible investors; it is increasingly a component of mainstream portfolio managers' investment analysis. In that regard, Bank of America Merrill Lynch's June 2017 report found that 50 percent of the institutional investors with investment horizons of more than five years that responded to its annual survey employed ESG factors, compared to 11 percent with "months" as their time horizon.[38]

As a practical matter, a stockholder base that includes long-term investors should be attractive to boards and management—and aligns with the underlying concept of long-term value creation.

"ESG is no longer just a negative screen for socially responsible investors; it is increasingly a component of mainstream portfolio managers' investment analysis."



Board oversight

Ensure that the board has the right composition, structure, and processes to oversee ESG in the context of strategy and long-term value creation.

The structure and processes a board creates to oversee ESG issues will vary based on a number of factors, such as the size and complexity of the company's operations (including its supply chain and whether operations are international), its industry, the magnitude of the company's ESG risks and opportunities, the degree to which ESG issues are central to the company's strategy, and the level of director expertise regarding relevant ESG issues.

In analyzing appropriate ESG oversight, we recommend directors consider the following factors:

Board composition

An important question for boards of all companies with exposure to material ESG risks and opportunities is whether they have the composition—including directors with the relevant experience and expertise—to understand ESG risks and opportunities and to oversee management's handling of these issues. In some instances, a specific issue may be so critical to the company that subject matter expertise will be important, such as in the example noted on p. 6 of investors calling for certain companies to have "climate competent" boards. Some high-profile boards, such as ConocoPhillips and GM, have recently added directors with strong ESG expertise, and by doing so, have sent a message to the market about their priorities.

To the extent the board lacks the necessary experience and expertise, directors should consider including it as a criterion for future candidates. As is the case with cyber expertise, a board should not look for a candidate who just possesses this one skill set. Rather, the goal is to find a well-rounded candidate who also has relevant ESG background. Whether or not the board includes a director with relevant ESG expertise, the full board will benefit from continuing education on the issues and may consider looking to third-party specialists for help.

Structure and processes

In considering how to provide strong oversight in this area, the board's considerations should include:

— **Allocating oversight responsibilities.** Which activities should involve the full board and which are best handled by an appropriate committee? Given the importance of having everyone on the same page, level setting is best done at the full board level. In contrast, oversight of the assessment and the various types of stakeholder communications may require a significant amount of time and expertise that might more effectively be delegated

to an appropriate committee. The determination of whether this set of responsibilities should be added to the agenda of an existing committee or housed in a more focused, newly created committee will depend on factors including the type and magnitude of the issues, the available bandwidth (if any) of the existing committees, and the culture of the board. For example, the board of Nike formed a Corporate Responsibility and Sustainability Committee, which includes in its charter the following responsibility: "Review and provide guidance to management on sustainability issues and impacts, and the integration of sustainability into Nike's business, including innovation, product design, manufacturing and sourcing, and operations."[39] According to Bloomberg LP's latest data, in 2015, 123 S&P 500 companies had assigned responsibility for oversight of ESG/CSR to a board committee, up from 116 in the prior year.[40]

— **Information flow.** What information should management provide to the board? The board must work with management to determine what information the board will receive—e.g., the KPIs and metrics to be used—and how frequently. In that regard, the board or appropriate committee should consider whether an ESG dashboard would help facilitate understanding and discussion of important ESG issues.

— **Incorporating ESG into the board's oversight of strategy.** For many companies, this is a *change management* effort. Adding an ESG lens to strategy, incorporating ESG risks into the overall ERM process, and establishing and tracking metrics that include the strategically significant ESG initiatives as part of assessing progress against overall company strategy, implications for compensation, talent and culture, etc., may require significant organizational change—not only for management, but also for the board. Whether it rests with the chairman, lead director, governance committee, ESG committee or somewhere else in the board structure, there should be a "home" for oversight of ESG integration.

As a bottom-line matter, finding the right mechanisms for board oversight is likely to be an iterative process, subject to change as the company and its ESG risks and opportunities change. Oversight of these issues, like oversight of any issue that significantly impacts long-term value creation, requires the right people in the boardroom, information to keep the board sufficiently informed and allow directors to track progress, processes that enable the board and its committees to exercise appropriate levels of oversight, and a commitment to continuous improvement. ●

What would most improve your board's oversight of ESG-related risks and opportunities?

Board as a whole needs to view ESG as a strategic issue/ business priority 29%

Improving tracking of ESG issues and related communications to the board 29%

Clarifying board/ committee responsibilities for oversight of ESG issues 29%

Source: KPMG Board Leadership Center survey, 2017

The drum beat of "meet or beat the quarter" is increasingly being challenged by a chorus of investors, employees, customers, and other stakeholders calling for greater focus on the long term. As ESG continues to move from the periphery to the center of corporate thinking—on strategy, risk and reputation, operations and efficiency, and long-term performance—the board has a pivotal role to play in helping to set the context and the drive the company's focus on these issues:

- articulating what "ESG" means to the business and agreeing on common language;
- identifying key ESG-related risks and opportunities—particularly those that are strategically significant to the company;
- integrating ESG issues into the company's strategy, and helping to ensure alignment and buy-in across the enterprise through the right culture and incentives;
- effectively communicating the company's "ESG story" to investors and other stakeholders; and
- ensuring that the board itself has the skills, processes, and information necessary to help guide the company forward.

Wherever the company is on the ESG journey, the five-part oversight framework outlined in this paper can help to drive a robust conversation about what ESG risks and opportunities may impact the company's key stakeholders, corporate strategy, and long-term performance and how they will be addressed. (Future papers will offer deeper dives into various components of the framework and will explore the lessons learned and impacts that companies are seeing from their efforts.)

Companies that identify and incorporate these issues into their strategy will clearly stand apart—to investors, customers, employees, and the communities in which they operate—as forward-thinking organizations, focused on long-term performance and value creation. ●

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Note: Survey data reported is based on 120 responses (from board directors and senior management) to an online survey conducted by the KPMG Board Leadership Center August–September 2017.

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