ISSUE 114

BOARD PERSPECTIVES: Risk Oversight

SUSTAINABILITY REPORTING: WHY BOARDS SHOULD CARE

Sustainability reporting is often viewed as an expectations-meeting exercise. However, strong environmental, social and governance (ESG) performance can deliver more sustainable financial performance, lower employee turnover and reduced regulatory risk.

We often hear the assertion that corporate leadership is needed to enhance civilisation's ability to address a litany of critical societal concerns. More often, executives are called on to address environmental, economic and social challenges and enable the general welfare of present and future generations. While this may be a vague assertion to some, the reality of ESG criteria is that the concept offers powerful differentiators for screening investments and grounds the discussion in ways that can't be ignored in boardrooms and C-suites.

A recent survey of more than 500 public company directors noted that although ESG issues are currently a relatively low priority for many boards, most directors would like their boards to become more proactive and enhance ESG oversight. Specifically, 53.6 percent would like their board to improve its understanding of the company's current levels of ESG-related performance, and 49.8 percent would like to ensure ESG issues are strongly linked to the company's strategy. This growing interest is likely due to increased shareholder activism evidenced by high-profile proxy battles over ESG-related topics and institutional investors proactively assessing ESG performance of companies in their portfolios.[1]

The above research suggests that the CEO's level of interest is crucial for companies to progress from passive interest in ESG to an action-oriented perspective about sustainability issues. With that critical transition in mind, following are two important developments to watch:

[1] 2018-2019 NACD Public Company Governance Survey, National Association of Corporate Directors, December 2018, available to subscribers at www.nacdonline.org/analytics/survey.cfm?ItemNumber=63801.

Further evidence sustainable investing is on the rise — Sustainable, responsible and impact investing assets have expanded to $12 trillion in the United States, up 38 percent from $8.7 trillion in 2016. Much of this growth is driven by asset managers considering ESG criteria across $11.6 trillion in assets, up 44 percent from $8.1 trillion in 2016. The top issue for these asset managers and their institutional investor clients is climate change and carbon emissions. From 2016 through the first half of 2018, 165 institutional investors and 54 investment managers controlling $1.8 trillion in assets under management filed or co-filed shareholder resolutions on ESG issues.[2]

Evidence of responsible investing emerging as a source of outperformance — A recently released study by an asset management company noted that during the period from 2014 to 2017, responsible investing was generally a source of outperformance in both the eurozone and North America. In the eurozone, all ESG pillars and ESG score integration displayed positive returns, with the governance pillar dominating. In North America, ESG investing during this same period (2014 to 2017) also displayed positive returns, although the environmental component was the biggest winner. The study also noted that the massive mobilisation of institutional investors regarding ESG investing in Europe has impacted demand mechanisms, with a consequent effect on prices, thereby triggering a performance premium.[3]

These two developments warrant close attention. The world is changing, and investors are taking notice. That alone directs equity market focus to companies committed to sustainable performance, largely because they are demonstrating an ability to adapt to changing business realities.

In addition to the above, there are eight key factors for interested companies to monitor going forward:

Competitors issuing voluntary reports — As more companies report voluntarily, peers must consider whether to follow suit. The Sustainability Accounting Standards Board (SASB) provides useful examples of companies reporting in accordance with its standards at www.sasb.org/company-use/ to illustrate the transparency and impact of such reports on risk management, long-term performance and brand image.

Securities and Exchange Commission (SEC) mandates — The SEC has been petitioned to standardise and mandate ESG disclosures through rulemaking.[4] However, to date the Commission has been content to let market forces determine what issuers report.

Attestation of selected sustainability information is increasing — In 2017, the American Institute of Certified Public Accountants (AICPA) issued attestation standards[5] in response to increasing stakeholder expectations and more companies issuing sustainability performance in addition to financial reporting. Attestation has a long way to go in North America as it continues to lag behind the European Union in the number of externally assured reports. While attest fees may be a potential barrier (at least initially), management should consider the viability of a cost-benefit assessment that weighs the cost of attestation against the favourable impact on the company's ESG rating and the related effect on market capitalisation. Therefore, the voluntary use of attestation services is a key factor to watch.

[2] "Sustainable Investing Assets Reach $12 Trillion as Reported by the US SIF Foundation's Biennial Report on US Sustainable, Responsible and Impact Investing Trends," US|SIF: The Forum for Sustainable and Responsible Investment, October 31, 2018: www.ussif.org/files/US%20SIF%20Trends%20Report%202018%20Release.pdf.

[3] "The Alpha and Beta of ESG Investing," Amundi Asset Management, January 14, 2019: http://research-center.amundi.com/page/Article/2019/01/The-Alpha-and-Beta-of-ESG-investing?search=true.

[4] Letter to Brent J. Fields, Secretary, SEC, October 1, 2018: www.sec.gov/rules/petitions/2018/petn4-730.pdf.

[5] *Attestation Engagements on Sustainability Information Guide (Including Greenhouse Gas Emissions Information)*, AICPA, 2017, available at: www.aicpastore.com/AuditAttest/attestation-engagements-on-sustainability-informat/PRDOVR~PC-AAGSUST/PC-AAGSUST.jsp.

Pressure from activist shareholders — Pressure comes in many forms. For example, activists apply pressure on board composition and management incentives in the proxy process. They use ESG screening criteria to drive investment decisions within their portfolios. Institutional investors (e.g., BlackRock, Vanguard) are communicating pointed messages to boards and CEOs regarding the importance of ESG-related issues, and, in particular, climate change. It bears watching their actions closely to see if their bite matches their bark.

Convergence of frameworks — Because the SASB standards are tailored specifically to U.S. companies and SEC filings, it is likely that they will continue to gain traction in the United States. But there are other frameworks in use. The SASB, Global Reporting Initiative and International Integrated Reporting Council have announced a two-year project to collaborate on standardisation of sustainability reporting frameworks, as well as on frameworks that promote further integration between nonfinancial and financial reporting. Progress on this effort to harmonise frameworks and metrics can raise the level of investor interest.

Disruptive industry developments — Royal Dutch Shell's decision to tie executive pay to carbon emissions is an example of an industry-first commitment to link incentive compensation to climate change.[6] The automobile industry investing heavily in hybrid and electric cars and its attendant effects on the oil and gas and power industries is another example of pending disruption.

Egregiously misleading ESG reporting — If such instances occur, the pressure on the SEC to mandate standards and consider some form of attestation is likely to increase.

Traction on use of COSO ERM ESG supplemental guidance — This guidance incorporates ESG-specific issues into companies' enterprise risk management (ERM). As companies embrace ESG reporting, this integration effort makes sense. It is possible that internal audit functions may lead the way on this front.

Exactly how the future of sustainability reporting will unfold remains to be seen. Voluntary reporting and voluntary submission to attestation, coupled with pressure from activists and the convergence of global reporting standards, will provide an interesting and powerful mix of forces that could very well move the meter in many boardrooms and C-suites. The 10 key factors listed above bear monitoring going forward, as new developments could nudge boards and chief executives toward improving the relevancy and transparency of sustainability performance to investors.

Questions for Boards

Following are some suggested questions that boards of directors may want to consider, based on the risks inherent in the entity's operations:

- If the company does not issue sustainability reports, has the board considered whether it should? Are competitors issuing reports? Are major shareholders raising concerns that merit attention and follow-up?
- If the company issues sustainability reports, does the reporting provide sufficient insight into its nonfinancial activities related to ESG matters? Is it sufficiently focused on the ESG criteria that investors and asset managers following the industry use? Does management focus on ESG reporting as a compliance activity or is it truly integrated with the corporate strategy?

[6] "Shell Is First Energy Company to Link Executive Pay and Carbon Emissions," by Ivana Kottasová and Daniel Shane, CNN Business, December 3, 2018.

How Protiviti Can Help

Protiviti assists boards with their assessment of the enterprise's risks and evaluation of the effectiveness of its capabilities for managing those risks, including risks related to ESG performance. Protiviti can assist management with:

- **ESG Assessment —** We assist with assessing the company's processes in generating material disclosure data in accordance with the company's chosen sustainability disclosure framework and the related disclosure controls and procedures that ensure their relevancy, integrity and reliability.
- **ESG Data Management —** We help streamline the data management process by making recommendations to improve data collection system cost-effectiveness, use of technology, dashboard reporting, stakeholder engagement and internal audit deployment.
- **ESG Compliance —** For companies in countries requiring sustainability reporting, we assist with documenting and evaluating internal reporting processes, controls and procedures for ESG disclosure reporting.

Is It Time for Your Board to Evaluate Its Risk Oversight Process?

The TBI Protiviti Board Risk Oversight Meter™ provides boards with an opportunity to refresh their risk oversight process to ensure it's focused sharply on the opportunities and risks that truly matter. Protiviti's commitment to facilitating continuous process improvement to enable companies to confidently face the future is why we collaborated with The Board Institute, Inc. (TBI) to offer the director community a flexible, cost-effective tool that assists boards in their periodic self-evaluation of the board's risk oversight and mirrors the way many directors prefer to conduct self-evaluations. Boards interested in using this evaluation tool should visit the TBI website at http://theboardinstitute.com/board-risk-meter/.

Learn more at
www.protiviti.com/boardriskoversightmeter

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Protiviti partners with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on https://blog.nacdonline.org/authors/42/. Twice per year, the six most recent issues of *Board Perspectives: Risk Oversight* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.

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