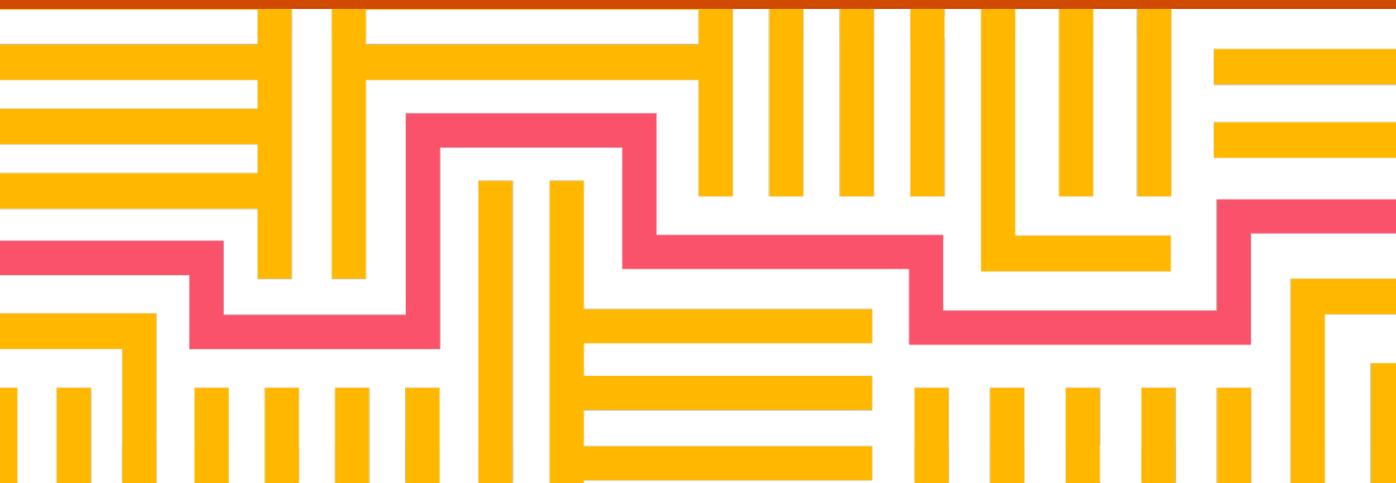


ESG in the boardroom: What directors need to know

February 2019



Investors and corporates continue to be divided on the importance of ESG strategies and disclosures. Investors want to understand companies' long-term value creation plans using credible, standardized information. Many corporates, even those with a good ESG story to tell, are not giving investors the right information in the right format. What do directors need to know about the issue, and what can they do to help bring the two sides together?

Environmental, social and governance (ESG) issues continue to be a priority for shareholders. Investors are urging companies to build ESG considerations into their long-term strategy, bringing it up during engagements and using shareholder proposals to force companies to take action. But what is ESG, why does it matter and what role should you play as a director?

Parsing ESG

For many, the term “ESG” brings to mind environmental issues like climate change and resource scarcity. These are an element of ESG—and an important one—but the term means much more. It covers social issues like a company’s labor practices, talent management, product safety and data security. It covers governance matters like board diversity, executive pay and business ethics.

Some directors think of ESG as window dressing. But when it comes down to it, ESG is about risk, and it’s about opportunity. It’s about the ways in which value could be destroyed or created. Larry Fink, CEO of BlackRock—the largest asset manager in the country—made this point in his annual letter to CEOs in 2018. Fink emphasized that companies must serve a social purpose. “To prosper over time,” he writes, “every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”

ESG: what does it really mean?

Examples of questions that investors might ask



Many enterprises have sensitive data stored all over the globe and with third parties. How well can they defend against cyber threats?



Many utilities and industrial companies need plentiful water at adequate temperatures to operate. How robust are their plans to confront possible water scarcity?



Many consumer-facing organizations have vendors in countries with weak labor laws. Can they prevent human rights violations and maintain a stable workforce that meets consumer demands?

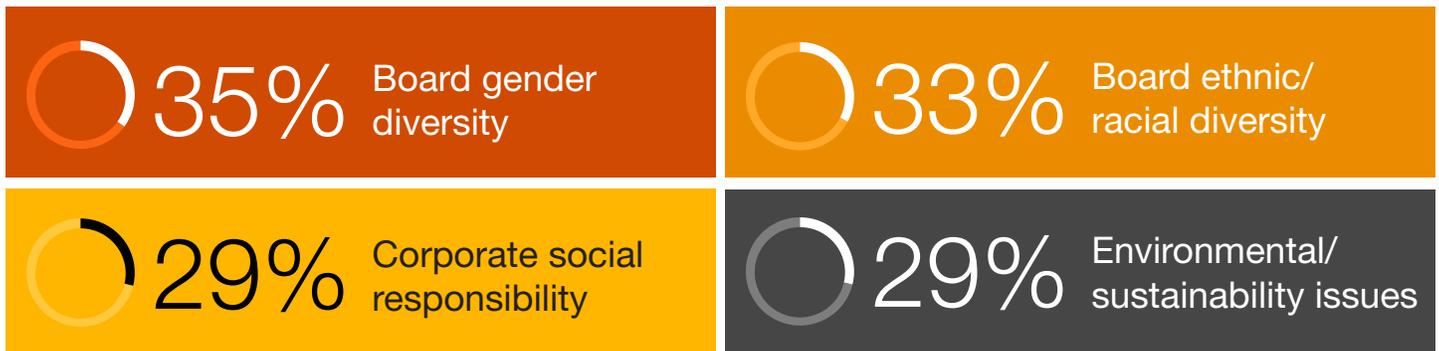


Most large enterprises serve diverse markets. Does senior leadership and the board have the diverse backgrounds and skills to understand and meet these customers’ needs?

According to our *2018 Annual Corporate Directors Survey*, about one-third of directors say that shareholders pay too much attention to ESG issues like board diversity, corporate social responsibility, and environmental or sustainability issues.

Directors think shareholder focus is misplaced

% of directors saying that institutional investors devote too much attention to:



Base: 696-701

Source: PwC, *2018 Annual Corporate Directors Survey*, October 2018.

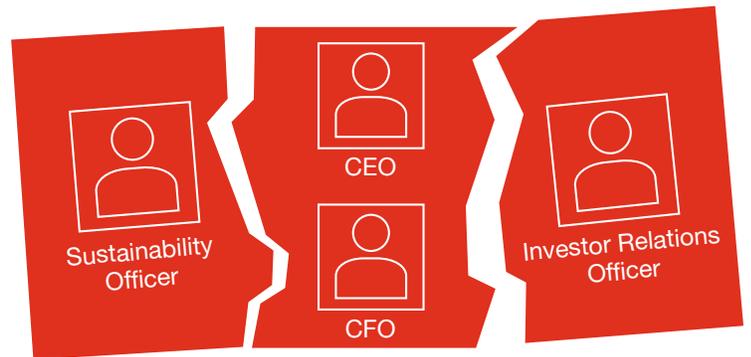
But there's good reason for investors to raise ESG questions. Companies with risk management practices that take into consideration broader industry, regulatory and societal risks may be better prepared to drive long-term sustainable performance—and shareholder value.

The ESG disconnect

A major struggle facing companies in the ESG area is the communications gap between companies and investors on the topic. Many investors are looking for standardized data on ESG that they can use to compare companies. But the types of data that are important to one shareholder may not matter to the next. Even within one investment firm, there may be competing priorities. While the portfolio manager may emphasize the company's ability to make annual earnings targets, the stewardship officer may focus on ESG elements with an eye toward long-term sustainable value creation.

Companies, for their part, also struggle with the topic. When investors ask about ESG, a company might point to the sustainability group or officer who issues an annual corporate responsibility report. Those reports often take a broad look at the issue. They might describe employee volunteer opportunities at local soup kitchens during the holidays, recycling programs in offices, or recruitment efforts at local colleges.

But these initiatives are not what investors are interested in when they think about the company's efforts around ESG risks. Even if the annual corporate responsibility report includes sustainability data that is aligned with long-



term risk management—things like carbon use in energy-intensive industries, employee turnover rates and engagement, or material use efficiency, the owner of that reporting is typically not integrated with core decision making at the company. They are usually not a part of the company's strategy development, asset allocation, risk assessment, financial reporting or investor relations teams. As a result, the company may not have a united message on ESG. And they may not be fully including ESG risks and risk mitigation strategies into their overall company strategy.

To learn more about this disconnect between companies and investors on ESG, and our recommendations for closing the gap, please read *Mind the gap: the continued divide between investors and corporates on ESG*.

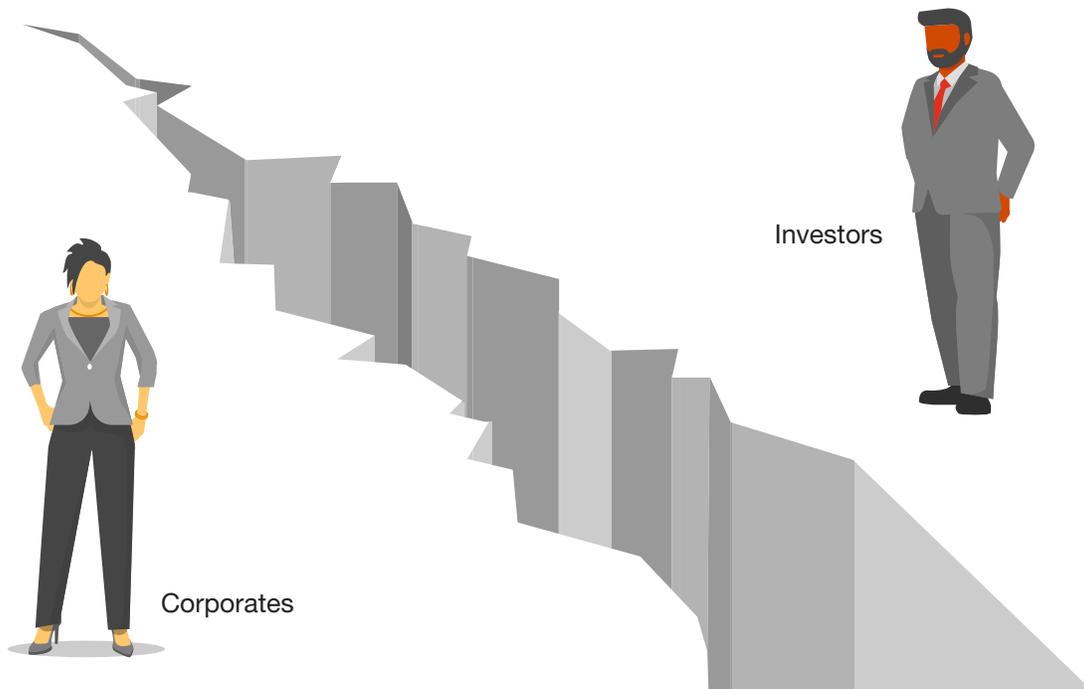
Capitalizing on ESG reporting

In recent years, a number of groups have proposed ESG-related reporting standards. One of the leaders in this area is the [Sustainability Accounting Standards Board \(SASB\)](#) which has developed industry-based standards intended to “help public corporations disclose financially material information to investors in a cost-effective and decision-useful format.” In November 2018, they released standards for 77 specific industries, following a six year process of obtaining stakeholder feedback.

Many investors like these standards, but corporates are often wary. Some are concerned about presenting ESG-related risks as “financially material.” Others may not have completed a robust and rigorous assessment of these risks.

But these reporting standards aren't all or nothing. Companies don't have to disclose all of the recommended metrics for their specific industry designation. They can use their own judgment as to what is financially material and select relevant metrics from across the standards suggested by SASB (or others).

When it comes to ESG, the important thing is start by considering ESG-related risks within the organization's overall risk assessment. Many enterprises will then find that applying the standards offered by SASB or others is an opportunity: to help identify those risks, and to shape the narrative in a format that investors will appreciate.



Where the board comes in

Companies that are getting it right on ESG have identified material ESG-related risks and opportunities, and embedded them into their long-term value creation story. Since ESG issues may impact their present and future business model, these forward-thinking organizations are integrating values, goals and metrics into business strategies to mitigate ESG risks. Their enterprise risk management (ERM) programs fully consider ESG risks. They are seizing related opportunities to innovate and reduce costs. Their corporate responsibility efforts are aligned with the company's strategy and purpose statement and are presented as a cohesive front, rather than being housed in separate functions and in separate reports.

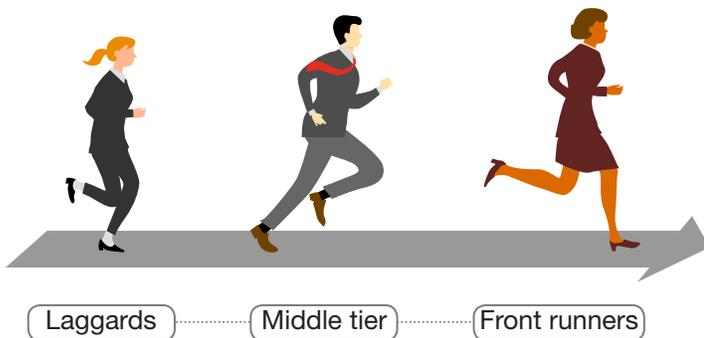
Seeing the risks and opportunities in ESG

What does an ESG front runner look like? Take, for example, a logistics company. Shipping and delivering goods is carbon intensive, and labor intensive. By relying solely on traditional forms of energy, the company risks losing business due to inefficiencies, or facing rising costs when oil prices rise. The company could be targeted as a carbon polluter and face negative attention from consumers.

These are ESG risks, but really, they are business risks. So the company invests heavily in electric vehicles to reduce their carbon footprint—and as renewable energy sources continue to become more readily available and cost efficient, the company can capitalize on alternative sources of fuel, rather than being overly dependent on oil products.

The business is also labor intensive. The company is exposed to risks of labor shortages or disruptions, and its employees face additional risks, like injuries from driver collisions. So the company is investing in the development of driverless technology, in new technology available in delivery drones, and in collision mitigation systems in vehicles. These investments then pay off as deliveries become faster and more efficient.

The ESG evolution has three stages



The board can identify where the company is on the spectrum of ESG-related communications with shareholders. Are they front runners with a cohesive identification, integration and communication of ESG strategy, with ESG fully baked into the ERM program? Are they in the middle tier—strong on identification, but weak on communication? Or are they laggards, lacking in even the most basic identification of ESG issues?

For companies in the third tier, a strong focus from the board can help spur action and attention on the question of how ESG factors might impact the business. Some directors may have a blind spot for the role ESG issues play in the business. For example, while nearly every company will be impacted by environmental changes in the future, 39% of directors don't think climate change should play any role in strategy, according to our *2018 Annual Corporate Directors Survey*. And while any company with a labor force is aware of increasing problems of income inequality, our survey also shows that 38% of directors say that

the issue should not affect company strategy at all. Allocating board time to these issues forces directors, and management, to take the topic seriously. Directors should expect management teams to have a systematic process for identifying the environmental and social trends that are likely to impact their strategy over the short, medium and long term and receive regular updates on how those trends are being managed.

For companies that are already strong on identifying ESG risks and opportunities, the board can play a critical role in helping to tell their ESG story. A company can be doing all the right things, but if they aren't communicating with shareholders about that work, your investors are left in the dark.

Shareholder communication is in part about the company's published reports. Companies can use their publicly-filed documents as well as other reports made available on the website to talk about their work in the ESG area. Just posting a sustainability or corporate responsibility report to their website is not enough. Those standalone reports offer useful information, but may go unnoticed on the company's website. By integrating information from those reports into publicly-filed documents, and in particular the ways that ESG risks and opportunities are baked into company strategy as a whole, companies can really tell their story.

Investors are increasingly looking to ESG disclosures to understand companies' strategies, and to support decisions ranging from portfolio construction to voting. Boards should seek to understand the disclosure controls and procedures supporting this ESG information. ESG disclosures have historically focused on other stakeholder audiences (e.g., civil society organizations) and companies may not have systems and processes in place for such disclosures.

Direct shareholder engagement often plays a big part as well. Engagement directly between investors and companies has become mainstream in recent years. Strategy, executive compensation and board governance matters have been the primary topics, but investors are becoming more focused on risk oversight. That often includes a discussion about ESG. Investors want to know how ESG is embedded within the risk oversight program, and how it supports the company's long term sustainable value creation plan.

In some cases, investors do not want to hear from just management or an investment relations team on the company's strategy. They also want to hear from board members about their oversight

role. According to our *2018 Annual Corporate Directors Survey*, nearly half of directors say that a member of their board, other than the CEO, has engaged directly with shareholders in the past year. As part of that engagement, directors may get an opportunity to tell the company's long-term sustainable value creation story—with an emphasis on ESG matters.

So directors need to be up to speed on what the company is doing, and be able to articulate the “how” and the “why.” They need to understand how ESG informs the risks the company faces. Which risks relate directly to ESG, and which have an ESG element? What steps are being taken to mitigate those risks? Just as important, they need to know how the company identifies the related opportunities. How is the company seeing possibilities in change, and how are those opportunities being maximized? By becoming invested in the topic, directors can push their companies to take advantage of ESG opportunities, identify and embed ESG risks into the overall ERM program and take credit with shareholders for the work they have done.



Questions you can ask management to understand where your company stands on ESG and how to chart a path forward:



1. **Are ESG risks included in our ERM program?** What are our key ESG risks that the business faces? How are we addressing them? How do they evolve under different time horizons?



2. **Is ESG being baked into our long-term strategy?** How are we looking at ESG to innovate and effectively add value or cost savings to our business? Are ESG risks dealt with separately, or are they fully included in our overall strategy? Are we keeping an eye on what our competitors are doing?



3. **When investors want to talk about our long-term sustainable value, should we ask the sustainability or corporate responsibility team to step in?** If our corporate responsibility leader or sustainability officer has oversight of our ESG efforts, is that team working closely with finance, investor relations and risk management? Are members of those other teams fully versed on our ESG efforts? Or is it a siloed effort?



4. **Do we have the information we need to oversee our ESG strategies and risks?** Is the board getting the right metrics to monitor these risks effectively?



5. **Have we considered using a framework to assess/report ESG metrics at our company?** Have we taken a look at the SASB framework, or other available models?



6. **Can we improve the transparency of our ESG disclosures considering investors' expectations?** How can we improve our ESG disclosures and increase trust in this area? How do we benchmark against others?



7. **Are we effectively telling our ESG story to investors?** Have we included the key ESG-related risks and opportunities in our broader shareholder disclosures—rather than simply including them in a separate report? Have we clearly conveyed to investors how ESG is part of our company's strategy? Are directors who are meeting with shareholders prepared to answer those questions?

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

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