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Sustainability and the board: What do directors need to know in 2018?

Introduction

Sustainability, which encompasses environmental, social, and governance (ESG) concerns, is increasingly positioned at the top of board agendas. Although it might not be the first boardroom topic you think of, sustainability is now central to corporate competitiveness and a company's continued ability to operate. Traditionally encompassing topics as varied as environmental disasters, labor relations, safety incidents, or scandals, sustainability affects all sectors and challenges even the most progressive companies and the most thoughtful directors.

With growing investor attention to sustainability, there is often greater emphasis on the governance element (the "G") of ESG and the board's fiduciary duty to oversee a company's strategy, risk, and capital allocation. Enterprise risk management (ERM) is a central avenue for expanding the company's consideration of those risks posed by environmental and societal trends as well as changing stakeholder expectations that can, and increasingly do, impact a company's ability to achieve its strategic objectives. Expanding ERM to include ESG risks can help connect risk, strategy, and decision making and can make companies more resilient and competitive. A more robust integration of ESG risks into broader ERM practices can promote measurement and disclosure of meaningful ESG information and enable management and the board to assess overall resource needs and allocate capital more effectively.

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Deloitte sees sustainability securing more time at and in between board meetings, in part because there is no single, standardized approach to incorporating ESG into boardroom discussions on business strategy and risk. The stakes are high, and directors need to act now to recognize sustainability as a fundamental element of their stewardship and fiduciary role.

Why now?

Companies that neglect the physical and economic impact of sustainability do so at their own peril. There is a growing body of evidence indicating that sustainability factors influence financial returns and present an opportunity to drive long-term value.

Risk	Opportunity
Poor environmental performance in the areas of energy, waste, water, and emissions can expose a company to fines, lawsuits, regulatory exposure, reputational impact, and increased operating costs.	Investment in sound environmental practices reduces costs by improving resource and waste management while providing greater insight into the physical and financial exposure to climate risk, as well as expanding access to capital.
Poor labor practices and talent management can result in lost work, fines and penalties, and higher turnover.	Investment in talent and supply chain performance can yield lower costs, a rise in productivity, and greater ability to attract talent.
Lack of attention to changing consumer and commercial expectations can threaten a company's ability to operate.	Investment in positive environmental and social attributes of products and services can drive market penetration and competitiveness.

The World Economic Forum's *Global Risks Report*,[1] released in January 2018, notes that environmental concerns top the global risk list again. All five risks in the environmental category are ranked higher than average in terms of both likelihood and impact over a 10-year horizon. A survey conducted by Deloitte and Forbes in 2017[2] indicates that sustainability has emerged as the top risk for senior leaders.

Consistent with their fiduciary duty to their beneficiaries, large investors are seeking greater transparency into how companies are addressing environmental and social trends, including changes in stakeholder expectations, in their business strategy, governance, risk assessment, and measurement and disclosure practices. Investors want companies to report on how sustainability drives and protects value through credible communication of performance and ongoing engagement. They also want to see that the board is actively engaged in integrating ESG into long-term strategy.

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Influential voices like Blackrock's CEO Larry Fink[3] continue to promote the expectation that companies take a long-term approach to communicating business strategy and performance, including sustainability. The board should consider the needs of a broader universe of stakeholders and establish a clear social purpose if they are to continue to operate and grow.

According to the 2017 Edelman Trust Barometer[4], 66 percent of investors say they must trust a company's board of directors before making or recommending an investment. Transparency into the board's consideration and management of ESG impacts can help promote that trust.

Why is sustainability a board-level risk?

On a global scale, the directors of public companies are facing challenges from investors and other stakeholders to be proactive in evaluating competitive threats and understanding disruptive market trends, which include environmental and societal concerns. Board oversight is central to investor trust and confidence in an organization's future performance. Directors have an important role to play in defining the organization's critical stakeholders and overseeing how the strategy and risk management practices meet the needs of broader stakeholders as a means to driving shareholder value. Directors can enable more effective engagement with investors by fostering more proactive identification, measurement, and disclosure of ESG risks that provide insight into how the organization is integrating sustainability and changing stakeholder expectations into risk and strategy.

Expectations of investors around ESG continue to increase, but investors are not a monolith, and their interest in sustainability spans a spectrum of strategies and approaches. Investors continue to reinforce their belief that ESG factors provide critical insight into how the company is driving and protecting value, but in the absence of effective disclosure, they cannot price that risk effectively. Without transparent and consistent sustainability disclosure, investors cannot execute their investment strategies effectively. This need has intensified the push by investors to engage with companies and use any and all levers to encourage more meaningful disclosure.

Deloitte's work with investors suggests that they do not have easy access to comparable and consistent sustainability information, including industry-specific information. A number of sustainability data providers and raters have stepped in to fill this void. Given that much of this information does not come directly from company disclosures, data providers often rely on proxies or other sources to provide a clearer picture for investors. Companies are increasingly challenged to understand the universe of sustainability data used to evaluate corporate performance, and this information gap represents a clear call to action for companies to increase the level of sustainability disclosure in a more standardized and consistent format. If a company doesn't tell its sustainability story, someone else will. This is an opportunity for boards and management to better communicate, through improved disclosure, how sustainability is integrated with strategy, risk management, and operations to drive long-term value. Investors expect the board to be fully engaged in this process and demonstrate a solid understanding of ESG.

Ongoing evolution of sustainability standards and policies

Near-term US regulation of sustainability is unlikely, and we don't anticipate the SEC to take any immediate action promoting enhanced sustainability disclosure. Outside the United States, the policy landscape is quite different. The European Union Directive on Non-Financial Reporting[6] went into effect in 2017, with the 2018 reporting season representing the first period for disclosures. Companies that operate in EU member states and meet certain criteria are required to disclose information on the way they operate and manage social and environmental challenges. Regulatory bodies and stock exchanges around the world are also taking measures to respond to growing investor demands for more uniform sustainability information linked to financial performance of global companies. We note that Nasdaq's Nordic and Baltic exchanges issued ESG guidance in March 2017.[7]

There is no single sustainability standard in the market today, but a number of initiatives are under way to advance greater standardization and transparency of sustainability disclosures. These standard-setting and reporting initiatives are important market mechanisms driving improved sustainability disclosure, and they also can enable increased reliability of sustainability reporting and facilitate external assurance of reporting to promote trust and confidence with stakeholders, increasingly through external assurance. There, however, remains a certain level of market confusion as to the purpose and use of these standards, including questions on how to determine materiality and how disclosures should be presented (e.g., standalone report, survey response, annual report, or financial filing).

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A few of the leading initiatives include:

- The Global Reporting Initiative (GRI)[8]: Based in the Netherlands, the GRI is an independent international standards organization that helps companies communicate their efforts on sustainability issues such as climate change, human rights, governance, and social well-being.
- The Sustainability Accounting Standards Board (SASB)[8]: Based in the United States, the SASB is an independent organization whose mission is to develop and disseminate sustainability accounting standards that help public corporations disclose material information useful to investors.
- The Financial Stability Board Task Force on Climate-Related Financial Disclosures[10]: Established by the G20, the Financial Stability Board is an international organization that monitors and makes recommendations for the global financial system; the Task Force on Climate-Related Financial Disclosures is an industry-led body that has developed recommendations for voluntary climate-related disclosures that are consistent, comparable, and provide useful information to investors, lenders, insurers, and other stakeholders.
- The International Integrated Reporting Council (IIRC)[11]: Based in the United Kingdom, the IIRC is a global coalition of regulators, investors, companies, standard setters, accounting organizations, and NGOs committed to establishing an international framework for producing an integrated report on how a company's strategy, governance, performance, and prospects lead to the creation of value.

In a world where stakeholder expectations and reporting standards continue to evolve, some argue for a "wait and see" approach to sustainability reporting. However, sitting on the sidelines is itself risky. The company will fail to get "credit" for existing ESG practices and, as stated earlier, someone else will tell the company's ESG story. The board can, and should, play a crucial role in moving the company's ESG practices and disclosure forward.

What can boards do to stay ahead?

Directors are in a unique position to connect sustainability with corporate purpose and strategy. Once the value of sustainability is established, the business case for the critical importance of its disclosure will naturally follow. Careful consideration of the needs of a broader universe of stakeholders ultimately drives value for shareholders, and directors have an opportunity to use transparency to promote more effective engagement with investors.

Beyond disclosure strategy, many boards do not feel they have access to the sustainability information they need, nor do they necessarily understand how sustainability is tied to business value. This gap is an opportunity for the board to work with management to define the broader universe of risks and the critical stakeholders and determine what warrants measurement and disclosure.

There are a number of steps boards can consider and questions they can ask to gain a better command of emerging sustainability risks and changing stakeholder expectations.

Questions to ask	Steps to take
Do we have regular access to the information needed to evaluate risks emerging from environmental and social trends?	Establish, or increase the frequency of, management reporting of sustainability risks to the board.
How frequently do we discuss sustainability risks?	Establish a standing board agenda item on sustainability.
Do we have a board committee focused on sustainability risk?	Establish, or clarify the responsibility of, a board committee with a sustainability mandate.
Who on the board has sustainability competence?	Consider giving the nominating committee responsibility for evaluating sustainability competence on the board.
Do we have an understanding and list of critical stakeholders and how we're meeting their needs as a means of driving shareholder value?	Ensure management has established clear sustainability responsibilities for functions such as finance, investor relations, legal, risk, strategy, talent, and operations.
Do we have a clear message on how our long-term strategy considers sustainability risks and opportunities?	Establish a disclosure strategy that prioritizes the needs of stakeholders, aligns sustainability to business value, and uses leading sustainability standards to guide meaningful disclosure.
What external sustainability disclosures do we provide and how confident are we that they are complete, accurate, and reliable?	Ensure management has taken steps to establish sustainability data management systems (i.e., energy management systems), document sustainability reporting processes and controls, engage internal audit in sustainability reporting, and obtain external assurance to increase confidence in disclosures and improve the quality of the data used in decision making and risk management.
Are sustainability risks specifically included in the company's ERM program and processes?	Ensure management sustainability risks are incorporated in the ERM processes of the company.

Q&A with Gregory Aliff

Q: What do you see as the biggest challenge to boards embracing ESG?

Directors are charged with overseeing strategy, risk, and capital allocation for an organization. Given that ESG risks are highly uncertain, unpredictable, and largely outside the entity's control, directors don't know what they don't know. Directors need to engage with management to translate ESG risks, trends, and stakeholder expectations into the business context, define material ESG topics, and establish measurement and reporting practices to inform disclosure.

Q: How can the board's role in enterprise risk management improve identification and oversight of ESG risk and opportunity?

ESG risks are business risks that can threaten a company's competitiveness and license to operate. ERM helps apply a systematic approach to identification and assessment of a broad universe of risks, including ESG risks, for potential impact on the company's strategy. The board has a role to play in challenging an appropriate level of rigor and attention to the needs of a broader universe of stakeholders, critical to driving shareholder value, that enable prioritization of and allocation of resources to ESG matters that are material to the business.

Q: How can ESG prioritization, measurement, and disclosure position the board and management to be more effective in anticipating and responding to ESG risks that can threaten the company's ability to achieve its strategic objectives?

The board can play a critical role in mapping and prioritizing critical stakeholders and identifying material ESG topics that can impact long-term business value. Armed with a better command of critical stakeholders and a more proactive and comprehensive approach to risk identification, the board and management can promote greater adaptability to changing market conditions.

Q: What is the one thing you would tell other directors about the importance of ESG in driving value for an organization?

ESG is likely to be more evolutionary than revolutionary. That said, those companies that take a leadership role should realize tangible competitive advantage in a variety of ways – capital markets, customers and talent. Fast followers will likely realize little more than the added costs associated with eventual compliance.

Gregory Aliff
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Gregory Aliff is a director and audit committee member of SCANA Corporation and California Water Service Group. He also serves on the board of GRID Alternatives, a non-profit organization. Before retiring from Deloitte US, he was vice chairman and senior partner for for Deloitte US's energy and resources industry, and led the practice from 2002 to 2012. He is co-author of the annually updated industry treatise Accounting for Public Utilities, and the author of the Math Series, three papers on innovation in the electric utilities industry.

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