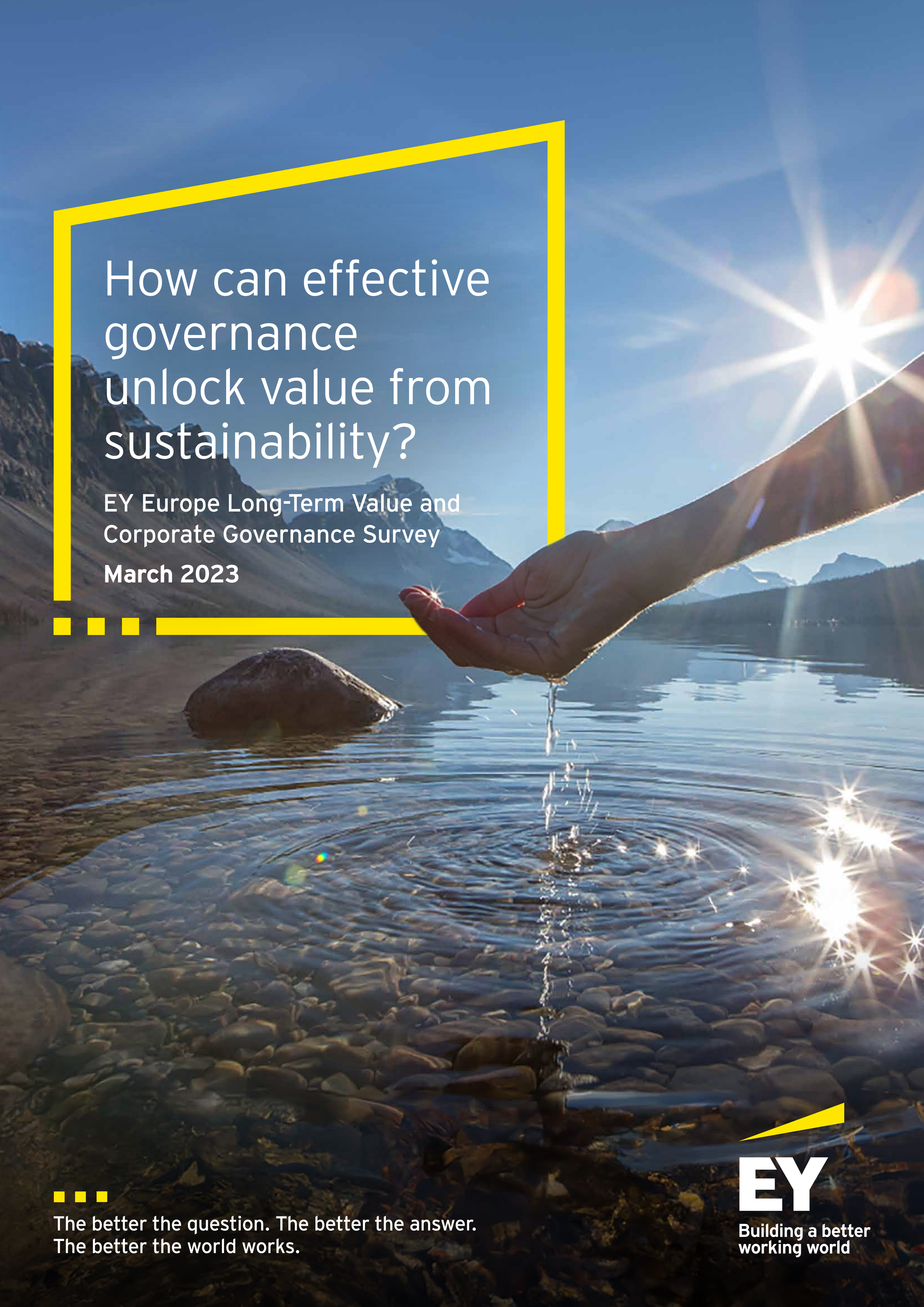


How can effective governance unlock value from sustainability?

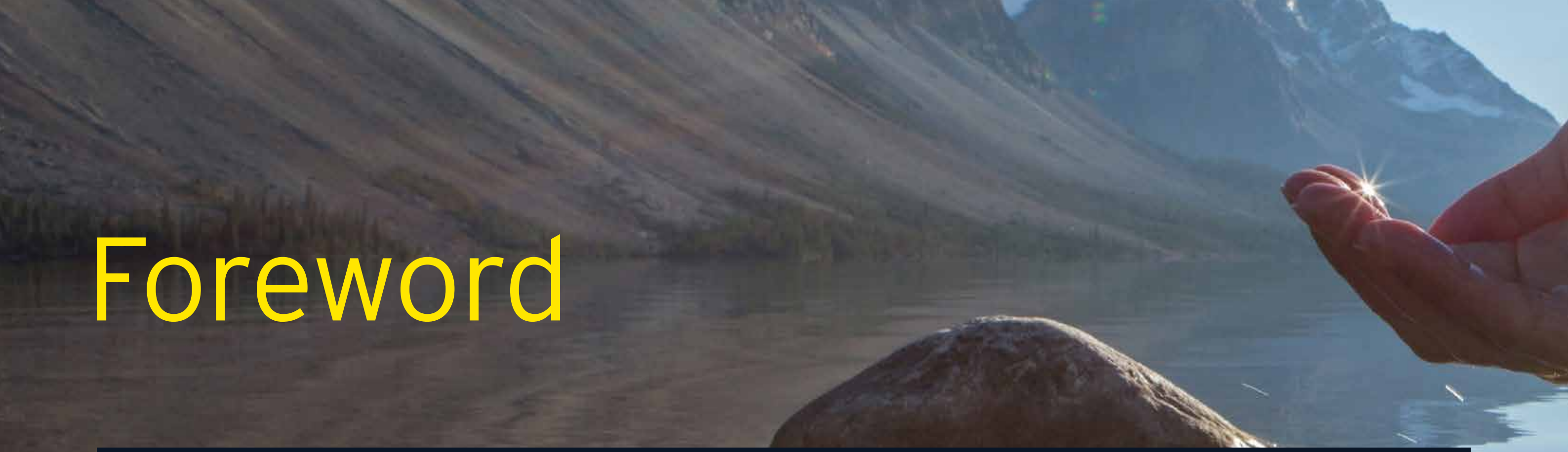
EY Europe Long-Term Value and Corporate Governance Survey

March 2023

The better the question. The better the answer.
The better the world works.

Building a better working world

Contents



Foreword

While the corporate world has never expressed more willingness to rise to the sustainability challenge, the clock is ticking, and we are running out of time to deliver. Corporate sustainability had its conceptual origins in the late 1980s, but more than 30 years have passed, and we are still struggling to deliver real-world outcomes in areas such as global warming or modern slavery. Society is leaning on businesses to take the lead, but corporate sustainability needs to dramatically change if it is to deliver.

This third edition of our annual research draws on the views of 200 senior leaders to examine how corporate governance is evolving to embed sustainability into a company's strategy and approach to long-term value. It shows that one factor is critical when it comes to driving sustainability from targets to concrete outcomes: **effective governance and board oversight**. In analyzing the results of our survey, we found that a small group of high-performing sustainability governance "experts" are driving both financial value and progress, compared with a long-tail of "beginners" who still have much more to do:

- Seventy-six percent of experts are optimistic about their company's revenue growth prospects over the next 12 months, compared with less than half (45%) of beginners.
- Over half of experts (52%) are "very satisfied" with the progress they have made to date in achieving the climate targets that are part of their approach to environmental sustainability. But this drops to 13% for beginners.

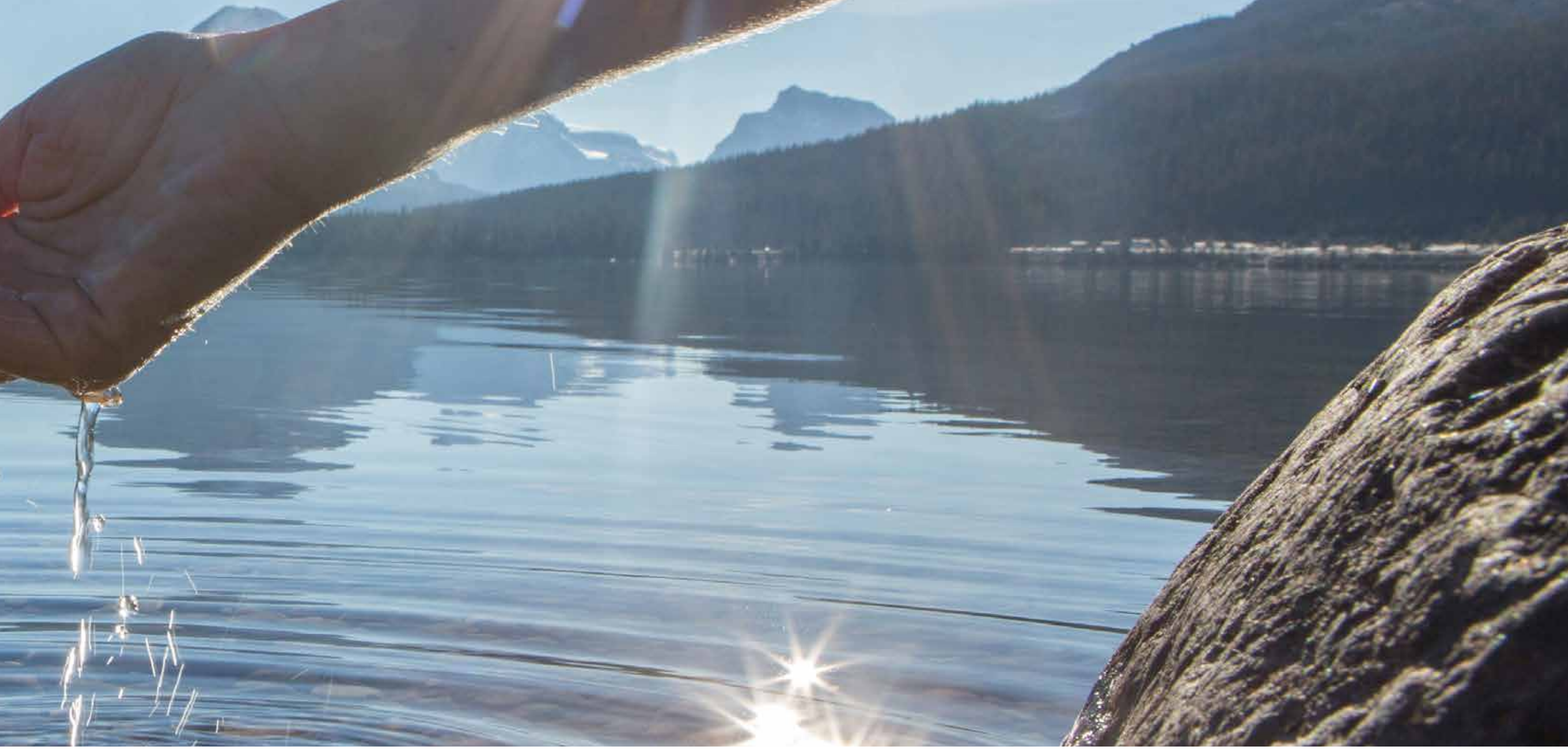
To unpick what separates the experts from the rest, and help organizations plot a path to more effective sustainability governance, this report examines three themes:

- How effective governance is instrumental in driving value-led sustainability, but short- versus long-term tensions persist
- How leading companies drive better outcomes, but recognize that the sustainability governance journey has further to go
- How to create systematic, accountable and authentic governance that unlocks value from sustainability

We hope this report plays a role in galvanizing new ideas and best practices for integrating sustainability into governance, and our thanks go to the corporate leaders and experts who contributed their thinking to this discussion paper.

Julie Linn Teigland
EY EMEIA Area Managing Partner; EY Global Leader, Women. Fast forward

Andrew Hobbs
EY EMEIA Public Policy Leader



Our thanks to the following business leaders, academics and other experts who gave their insights as part of a wide-ranging interview program:

- **Rachel Davis,** Vice President and Co-Founder at Shift, the leading center of expertise on the UN Guiding Principles On Business And Human Rights
- **Catherine Guillouard,** Director at a range of companies, holding roles as chairwoman and chair of the audit committee
- **Arne Karlsson,** Chairman and board member at a range of companies, including Maersk, where he is Chair of the audit committee
- **Maria Pierdicchi,** Director at UniCredit, Autogrill and Chairwoman and Board Member of NED COMMUNITY
- **Sebastian Steinhäuser,** Chief Strategy Officer, SAP
- **Sonia Tatar,** Executive Director, INSEAD Corporate Governance Centre and INSEAD Wendel International Centre for Family Enterprise

Our thanks also go to the EY subject matter experts who contributed their insights — Matt Bell, Martha Cook, Alexis Gazzo, Jan Niewold, Katherine Savage, and Charlotte Söderlund — as well as other EY contributors: Jeanne Boillet, Patrick Dawson, Monica Dimitracopoulos, Gregory Gruz, Martijn de Jong, Maria Kepa, Maria Kowalski, Brandon Perlberg, Hanne Christine Thornam, Elsa Venturini, Katharina Weghmann and Mike Wheelock.

Note on methodology: To identify the experts and beginners, we created a sustainability governance score based on respondents' assessment of how effective their governance was in six key areas ranging from harder issues (such as "incentivizing ESG performance through executive compensation mechanisms") to softer issues (such as "encouraging open and honest debate to ensure all board members are aligned on the company's ESG priorities and approach"). Using these scores, we split respondents into those with more effective (experts) or less effective (beginners) sustainability governance and evaluated the approaches, benefits and challenges each group reported.

Executive summary

How can effective governance unlock value from sustainability?

Effective governance key to long-term, value-led sustainability

Experts

76%

of experts are optimistic about their company's revenue growth prospects over the next 12 months, compared with less than half (45%) of beginners.

Sustainability governance journey has further to go

55%

Over half of all respondents say "Our employees do not feel we are moving quickly enough on climate issues."

Three priorities for systematic, accountable and authentic governance

Systematic

7%

Only 7% of all respondents feel that sustainability is fully integrated into their board's structures and decision-making processes, and more than a quarter (27%) believe that significant change is still needed for it to be fully integrated.

Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

Experts

52%

Most experts are "very satisfied" with the progress they have made to date in achieving their climate targets.

Beginners

13%

In comparison, only a small minority of beginners are "very satisfied" with progress.

Experts

90%

The vast majority of experts plan to increase investment in executing their sustainability agenda, including close to a third (29%) who plan to "increase a lot."

Beginners

54%

In comparison, only just over half of beginners plan to increase investment, with only 9% planning a significant increase.

Accountable

61% vs. 29%

61% of experts include sustainability metrics as a significant element when setting the compensation of senior executives, but this drops to 29% for beginners.

Authentic

83% vs. 55%

83% of experts say they have the technology and data analytics skills needed to respond to the EU's impending regulation on corporate sustainability reporting and due diligence, but this drops to 55% for beginners.

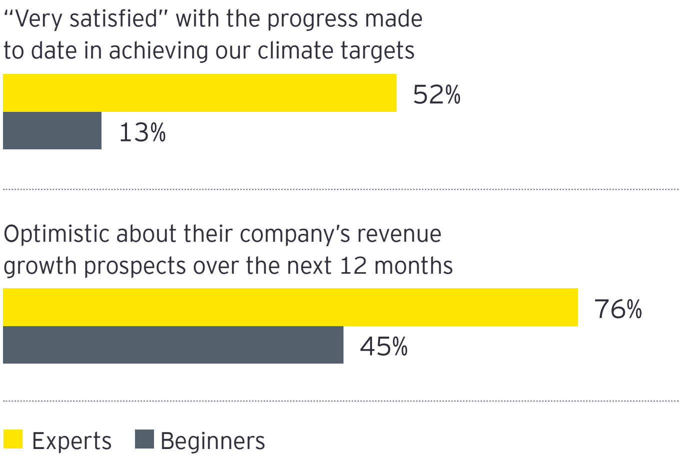
Effective governance key to long-term, value-led sustainability

1

While the world has a collective responsibility to address sustainability, businesses play a central role in driving the urgent change needed. Companies that take decisive sustainability action do not just create more value for the planet and society, they also capture more financial value for themselves – an approach EY calls "value-led sustainability." In an earlier study by EY, **How can slowing climate change accelerate your financial performance?**, 69% of companies said they captured higher financial value than expected from their climate initiatives.[1]

This latest research shows that effective sustainability governance is instrumental in driving those outcomes. As Figure 1 shows, experts are not only more optimistic about revenue growth prospects, they are also more satisfied with progress against climate targets.

Figure 1: Experts drive better outcomes and are also more optimistic about future financial performance



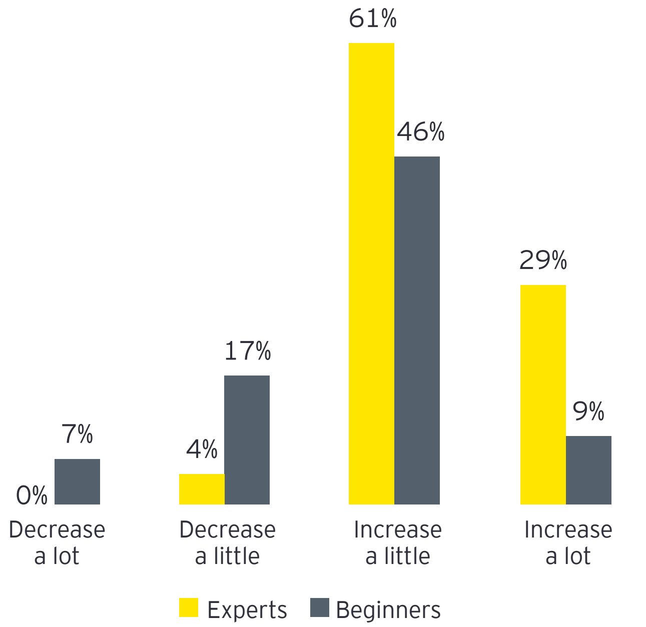
Note: Chart is based on responses to two questions:
(1) How satisfied are you with the following elements of your climate action strategy?
- Our level of climate action ambition
- The progress we have made to date in achieving our climate targets

(2) Compared to six months ago, how do you feel today about your company's revenue growth prospects over the next 12 months?

Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

Reflecting this positive impact, 90% of experts plan to increase investment into sustainability priorities, including close to a third (29%) who plan to "increase a lot" (see Figure 2).

Figure 2: How do you expect the level of capital investment in executing your company's ESG strategy to change over the next 12 months?



Note: Excludes those who responded "Neither decrease nor increase."

Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

[1] "How can slowing climate change accelerate your financial performance?", EY, 2 November 2022.

The continued tension between short-term priorities and long-term value

CEOs and boards have always faced the tension between delivering the robust short-term financial performance that markets expect while also investing in the long term. It is a perennial leadership test that requires the agility to optimize short-term performance (such as portfolio changes or margin improvement) with investments in long-term plays. Today, however, the need to drive the sustainability agenda has added a new layer of complexity when it comes to balancing short- and long-term business pressures. This is particularly apparent when it comes to the critical dynamic between companies and shareholders:

- Both leaders and investors are aligned on the need to avoid short-termism, where strategic decision-making is shaped only by immediate performance and longer-term sustainability risks and opportunities are neglected. In this research, 74% say that their "company should address ESG issues relevant to their business, even if doing so reduces short-term financial performance and profitability." This aligns with the views of investors – 78% of the investors surveyed in the *EY Global Corporate Reporting and Institutional Investor Survey* believe the companies they invest in should make investments that address sustainability issues relevant to their business, even if it reduces profits in the short term.[2] In other words, both "camps" are aligned on the need to make the difficult decisions and trade-offs needed to protect and grow long-term value.
- At the same time, however, 64% of the respondents to this survey say, "We face short-term earnings pressure from investors, which impedes our longer-term investments in sustainability."

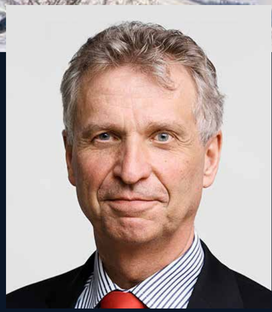
The quality of engagement between boards, management and investors is a critical factor in addressing this tension, particularly in terms of reporting. In the *EY Global Corporate Reporting and Institutional Investor Survey*, 80% of investors said, "Too many companies fail to properly articulate the rationale for long-term investments in sustainability."[3] This indicates a pressing governance need to improve corporate narratives and how leaders make the case for a company's strategy for long-term value. Part of this is framing a long-term journey (such as the path to net zero by 2030) in terms of the "stepping stones" to get there. For some companies, this could even be quarter-by-quarter updates on the path to a long-term destination in 2030 or 2040.

Of course, an effective external narrative depends on the organization itself being aligned on the balance between necessary short-term optimization and long-term value. However, as Figure 3 shows, there has been a significant uptick in the number of company leaders who feel that there are differences of opinion within the leadership team on balancing short-term performance with longer-term sustainability plays.

> "Companies that execute on their sustainability strategy – whether in operating model, products, support functions, or talent – do not just create more value for our planet and society, they are also likely to capture more financial value for the company and its shareholders.
>
> **Julie Linn Teigland**
> EY EMEIA Area Managing Partner; EY Global Leader, Women. Fast forward

[2] "How can corporate reporting bridge the ESG trust gap?", EY, 11 November 2022.
[3] "How can corporate reporting bridge the ESG trust gap?", EY, 11 November 2022.

External viewpoint



In conversation with

Arne Karlsson

Arne Karlsson is chairman and board member at a range of companies, including Maersk, where he is Chair of the Audit Committee.

> “Too often sustainability becomes standalone and not integrated – separated into its own committee or assigned to sustainability experts – and this can become counterproductive.

Q: Given your involvement across a range of companies, what best practices are you seeing emerge in how boards can drive tangible progress on sustainability issues?

A common factor for me is about integration. Too often, sustainability becomes standalone and not integrated – separated into its own committee or assigned to sustainability experts – and this can become counterproductive. It needs to be embedded into the business and governance. For example, at Maersk, we have a head of sustainability, but she’s very integrated with the business and with teams like product development.

On the governance side, all board committees look at sustainability issues. For the audit committee, for example, we will spend say 20% to 30% of the time examining what people see as “classic” audit committee tasks, such as financial statements and reports. But the majority of our time is spent looking at upstream areas, including sustainability and risk. In the six meetings we have per year, we have deep dives into different sustainability-related processes and issues on our agenda, which would then of course be reported back to the board.

Q: Can you tell us about governance best practices that have emerged as companies prepare for the mandatory sustainability reporting regime set out in the EU Corporate Sustainability Reporting Directive?

Mandatory rules, of course, need to be followed in full. However, we have looked deeper into which sections of the rules are particularly important and material to us, and which could usefully be included in other areas, such as internal management reporting or even remuneration systems. At Maersk, we put a lot of effort into these material matters, including using our competent internal audit team to take deep dives into the material areas to make sure that what is presented to the management team and to the board is actually relevant and correct.

External viewpoint

In conversation with

Sebastian Steinhäuser

Chief Strategy Officer, SAP

"

Sustainability needs to be a core principle in everything you do, which means rethinking every major business process and every business model with sustainability in mind.

Q: Can you tell us about SAP's sustainability journey and what you think is important in terms of moving from targets to concrete progress?

Our ambition is to be a role model and an exemplar in our industry. For example, we have decided to accelerate our goal of being net zero along our entire value chain, which includes upstream and downstream Scope 3 emissions, from the original target of 2050 to 2030. The most important factor here is that sustainability is deeply embedded into our business strategy. Sustainability can't be a separate initiative that's run by a chief sustainability officer alone and is treated separately from everything else.

Reflecting this focus, we have embedded sustainability and nonfinancial targets more generally into board compensation, from emissions to employee satisfaction. That said, I've never seen the board reach a decision because they're also remunerated on the issue. Decisions are taken because sustainability is naturally part of our strategy, but I think it's reassuring to know that your compensation is in line with what you think is right.

Q: What do you think are some of the key success factors in delivering against that integrated approach?

The advice that I always give to customers is that you need a solid data foundation to make decisions. This is about capturing the right data and ensuring it is granular enough to use for increasingly big investment decisions. You also need to share and report sustainability data internally, from the insights that supervisory boards require to also sharing progress with wider employees. Finally, there is external reporting, from your level of transparency to meeting an increasingly complex regulatory environment.

Of course, the most important issue is how you act. Sustainability needs to be a core principle in everything you do, which means rethinking every major business process and every business model with sustainability in mind. This, of course, means that our senior leaders and employees need to build their sustainability knowledge. At the board level, we bring in external thought leaders to provide an outside-in perspective, challenge us and build our knowledge. At the same time, all employees need to have a level of understanding. For example, every salesperson at SAP needs a certain level of sustainability knowledge, because it's part of our core offering.

Q: Can you tell us how your role as chief strategy officer aligns with the role of chief sustainability officer?

I have our chief sustainability officer on speed dial, because sustainability is a core part of our strategy and a supervisory board priority. We have a very positive, healthy working relationship – he challenges me on how our strategy can better reflect sustainability and I challenge him on how our sustainability goals can be even more ambitious in line with our strategy. I'm also responsible for our sustainability business, because we feel this is so interconnected to our overall company strategy and needs to be completely aligned.

What is also notable about the research is that this tension between aligning on short-term considerations versus longer-term sustainability investments does not recede for those who are governance experts. In fact, 74% of experts point to strong differences of opinion internally compared with 58% of beginners. This suggests a meaningful opportunity for open debate and collaboration to shape approaches that balance these strategic trade-offs.

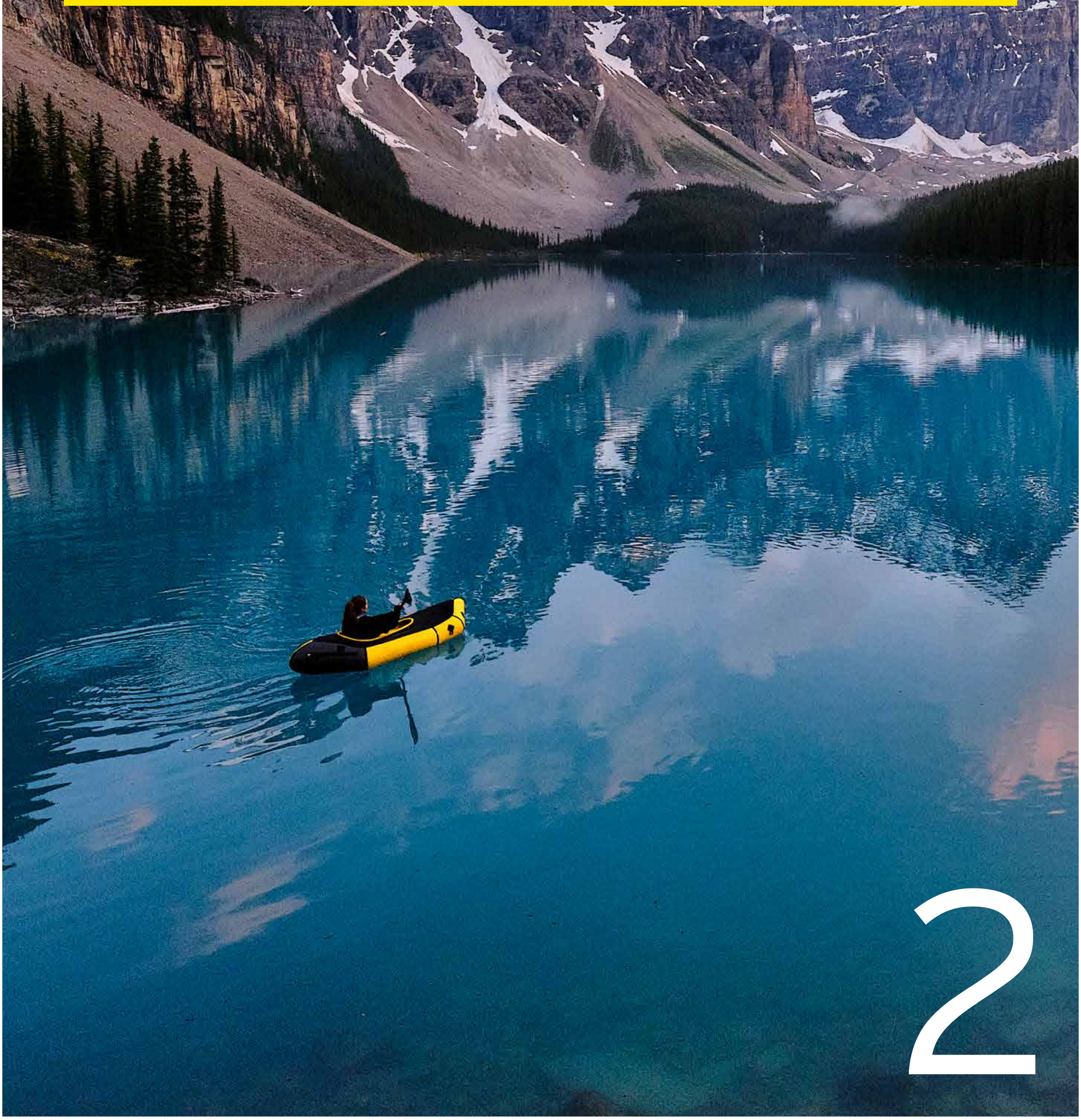
Effective governance is key to achieving alignment with both internal and external stakeholders, from employees to investors, and thereby driving collective action. In the next section, we look at how governance experts are moving faster than others in driving decisive action.

Figure 3: To what extent do you agree or disagree with the following statements on how corporations maintain their focus on ESG priorities and driving long-term value?

Percentage of respondents who say, "There are significant differences of opinion within our leadership team on how to balance short-term considerations with long-term investments and sustainable growth".

Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

Sustainability governance journey has further to go



2

The majority of organizations (72%) have made explicit commitments to support the UN Sustainable Development Goals most relevant to their business. Material sustainability risks and opportunities range from diversity, equity and inclusion to natural capital.

With natural capital, for example, business leaders and boards will need to increasingly focus on how they will measure and mitigate their impact on biodiversity. There is analysis to show that half of the world's GDP is dependent on nature and, given the speed at which ecosystems are depleting, time is running out for the world to act. The Taskforce on Nature-related Financial Disclosures (TNFD) examines risks, impacts, dependencies and opportunities. The TNFD's LEAP framework — locate, evaluate, assess and prepare — allows corporations and investors to assess their exposure to biodiversity-related risks.

However, one of the key differences between the natural domain and some global climate issues — such as emissions affecting the world's atmosphere — is that biodiversity often has a local impact. As a result, boards need to bear in mind that assessing exposure to nature-related risks is not the same as assessing exposure to climate-related risks. As a start point, an organization will need greater volumes of data, a lot of which is complex. At the same time, while climate scenarios are well-developed, the equivalent nature-based scenarios are still a work in progress.

Skill set will also be critical. Biodiversity is an enormous multidisciplinary area, requiring companies to engage with a new type of capability — usually outside their comfort zone. Many of the conservationists brought on board by corporates today are former activists from the "other side." This requires emotional maturity to overcome historical hostility and recognize that corporates and activists will have to work together to protect biodiversity.

"

As a start point, boards can ensure that biodiversity and natural capital are incorporated into their mainstream risk register, understanding how the regulatory environment is likely to change, and the impact of these issues on investors' decision-making.

Alexis Gazzo

EY Europe West Sustainability Co-Leader; EY France Climate Change and Sustainability Services Leader and member of the Taskforce on Nature-related Financial Disclosures (TNFD)

> Today, while more corporates have signed up to targets such as net zero, there is evidence that many indicators of environmental and social sustainability are heading in a negative way.
>
> **Matt Bell**
>
> EY Global Climate Change and Sustainability Services Leader

Moving sustainability goals from promises to action

To assess how organizations are progressing against their sustainability targets, this section focuses on climate change. This reflects that it has been on the leadership agenda for longer and there are greater expectations around companies having a mature approach.

Today, there is increasing disquiet among stakeholders that companies are not injecting enough urgency into addressing climate priorities: 55% say, "Our employees do not feel we are moving quickly enough on climate issues." This growing impatience reflects concern that a company's statements about its intentions are not translating into meaningful outcomes and do not provide an authentic picture of the challenges it faces.

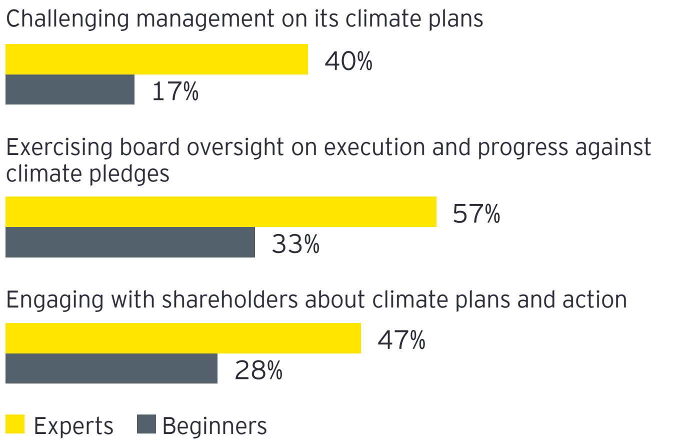
This prevailing sentiment will put companies' track records under the spotlight and heighten demands that leaders and boards drive a systematic sustainability transformation. It will raise questions, for example, over whether the many companies that have made a commitment to sustainability targets are also driving the action necessary to make a difference. As well as concern about whether enough progress is being made on climate issues, the world has lost nearly 50% of biodiversity within the last four decades. Levels of modern slavery are also at a historical high. Therefore, there is a need for systematic transformation.

For organizations, this raises a range of questions. Now that you have set out your ambition for the next 30 years, what have you achieved? What is your plan, how does that impact your business model, what does that mean to your valuation, and how have you considered climate risk on your asset revaluation or your value-at-risk returns?

As we saw earlier, the experts are making greater progress in terms of their climate targets (52% vs. 13% for beginners). However, while they are driving better outcomes, even the experts recognize that they have further to go in refining critical elements of their governance around climate change topics. Take the role of the board as a critical example: Less than half of experts (40%) feel they are "extremely effective" when it comes to "challenging management on its climate plans," and this drops to 17% for the beginners (see Figure 4).

Figure 4: How effective do you feel your board is today in the following areas?

Percentage who believe their board is "extremely effective" in the following areas:



Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

In the final section, we look at some of the key areas and practical actions that leaders can focus on to refine their approach to sustainability governance.

External viewpoint

In conversation with

Catherine Guillouard

Catherine Guillouard is a director at a range of companies, holding roles as chairwoman and chair of the audit committee.

> "It's so important that sustainability targets are integrated into the daily operational life of the team for the approach to be effective.

Q: Can you tell us what success factors are critical for companies delivering against their sustainability ambitions?

The first area is "transversal" leadership of sustainability – by that, I mean coordination across areas ranging from operations to supply chain. Without this, it's difficult to have a complete view of what needs to be done. The second area is about making it concrete – setting targets and operationalizing the sustainability strategy. It's so important that sustainability targets are integrated into the daily operational life of the team for the approach to be effective. If you set company targets but people think they are just high level, then employees won't understand how they can really participate in driving the sustainability agenda. The third area is about collaboration. For example, setting up sustainable supplier councils so that you have dedicated governance for collaborating with suppliers on issues like Scope 3 emissions.

Q: What do you see as some of the benefits of driving sustainability outcomes?

We cannot give the burden of environmental problems to the next generation. But that overall goal also relates to talent. In the public sector, for example, it can be more challenging than in the private sector to attract top-notch people because of the constraints on wages. But I have seen how being super serious about sustainability has allowed us to recruit a number of talented young people. If you show that you are super serious on sustainability, and show people the granularity of what you are doing, then it's a very effective lever for attracting talented people.

Three priorities for systematic, accountable and authentic governance

3

Systematic: better dynamics; greater knowledge

It almost goes without saying that companies need strong and competent boards that can make informed and inclusive decisions. To achieve this, companies have put in place a wide range of structures to integrate sustainability into the board's decision-making, with no one approach dominating. For example, 28% assign oversight to a dedicated sustainability committee, while 23% assign it to an existing committee, such as risk or audit. However, while the structures for oversight may be in place, there are still question marks over whether sustainability is a systematic, intrinsic part of how the board operates:

- Only 7% of all respondents feel that sustainability issues are fully integrated into their board's structures and decision-making processes (which is an issue that also came across strongly in the interviews we conducted with directors, and which feature in this report).
- Over a quarter (27%) believe that significant change is still needed for sustainability issues to be fully integrated.

This reflects that, while the right structure is important, effective governance also depends on having enough time to devote to sustainability, so that organizations unlock value and do more than just protect existing value, e.g., compliance requirements. Being effective also requires the ability to bring new perspectives to the debate:

Experts	Beginners
83% are effective at "managing the board agenda to ensure long-term ESG risks and opportunities are always discussed, not just near-term business issues."	**52%** In comparison, only around half find themselves effective.
86% are effective when it comes to "increasing boardroom diversity and ensuring new voices are given equitable speaking time to provide fresh perspectives on ESG topics."	**36%** Only a minority feel they are effective in this area.

Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

Effective oversight and decision-making demand the right competence: It is central to driving innovation and the agility to respond to a fast-changing sustainability landscape. But when the survey asked respondents what internal hurdles stood in the way of generating long-term value through a strong sustainability proposition, the chairperson and board members in the survey made lack of knowledge in key areas one of their top two challenges (selected by 38% of this board director cohort). Again, this is something that experts are actively tackling: 88% say they have an effective approach when it comes to "routinely inviting external experts to educate the board on the complex and fast-moving ESG landscape" (this drops to 49% for beginners).

> "Quality time spent by willing boards who have experience and skills in ESG topics is more important to progressing against sustainability objectives than formal structures like sustainability committees.
>
> **Andrew Hobbs**
> EY EMEIA Public Policy Leader

In conversation with

Maria Pierdicchi

Maria Pierdicchi is a Director at UniCredit, Autogrill and Chairwoman and Board Member of NED COMMUNITY.

> “In companies with a less mature approach to sustainability, the board may have to push management a bit more and be very clear on remuneration.

Q: In your experience, what are some of the key success factors for ensuring boards are able to fulfil their oversight role with sustainability?

For companies that have an ESG committee, it needs to be closely linked with strategy so that sustainability is not detached from strategy. In my roles, I have proposed – for example – that there is a single strategy and sustainability committee. This is working well, but of course does depend very much on having a CEO and first line that are committed to the approach.

Committee composition also has to be reviewed very carefully. You need former executives, so that you have managerial and operational experience, and are not only going on theory. You need people with significant risk experience, as well as the relevant industry specialists. You may also need, in certain instances, champions in diversity and inclusion. This could be people, for example, with HR or HR-related experiences in large, multinational organizations.

Q: What practices are you seeing in terms of how companies link ESG metrics into executive remuneration?

There are companies that have sustainability in their DNA and culture, based on the views of their CEOs or shareholders. But for others, it's a new journey. In companies with a less mature approach to sustainability, the board may have to push management a bit more and be very clear on remuneration. This is because I think there is some reluctance around remuneration – some managers are reluctant to accept remuneration that is really linked to ESG Key Performance Indicator (KPI) because they are afraid that they will lose some of the upside. Part of that clarity is around the mix of short- and long-term, which can be quite difficult as benchmarks for long-term are not easy to find. In the banking industry, we are quite advanced on this topic – we look at both short- and long-term, and the two are connected.

Key takeaways

- Integrate sustainability into strategy and governance structures so that it becomes part of the board and committee "business as usual."
- If you are going to have a "sustainability committee," be very clear on its purpose and terms of reference as well as how it adds value.
- Look for creative ways to bring additional diverse skills and experience into the board's decision-making, e.g., shadow boards, advisory boards, expert advisors, accessing more of management and refreshing board composition.

Key questions for boards

- How confident are we that the board has access to all the skills it needs for good decision-making on development and execution of its sustainable strategy? If not, how can it access those skills?
- What gives us confidence that we have identified the sustainability objectives that are material to successful delivery of our long-term strategy?
- How have we integrated those sustainability objectives into the company strategy, governance and operations?
- How are we measuring progress toward these objectives?

Accountable: a bold approach to sustainability-linked remuneration

In this year's research, "changing our approach and structures for rewards and incentives, including executive remuneration," is one of the top two priorities when it comes to governance transformation. It was also the number one priority in last year's survey, which suggests boards are finding it both a major focus area and a challenge at the same time.

Defining "remuneration-grade" KPIs for sustainability objectives – which constitute a meaningful proportion of total reward and help to hold management teams accountable – is challenging. However, there remains a compelling case to do so: Implementing effective variable remuneration schemes supports the delivery of outcomes and progress against sustainability objectives.

A robust approach will need to take account of a number of challenges:

- **Multiyear time horizons.** For survey respondents, the number one challenge is the difficulty of aligning the time horizon of annual salary and variable remuneration with sustainability goals that often have five- to 10-year targets (selected by 39% of respondents as one of their main obstacles).
- **Unintended consequences.** As well as how you execute, there is also the risk of unintended consequences. How do companies ensure that including stock options as part of sustainability-focused remuneration supports long-term value creation? If there is too much emphasis on stock, could that lead to the pursuit of short-term performance achievement to increase the share price?

"Ensuring a meaningful portion of total remuneration is linked to sustainability objectives and driving "long-termist" behavior is critical.

Katherine Savage
EY Partner, People Advisory Services; EY EMEIA Reward Sustainability Advisor

> Remuneration committees have a compelling opportunity to act as change catalysts: helping drive sustainability progress with their willingness to either experiment with introducing sustainability metrics within variable pay plans, or enhancing existing schemes.
>
> **Martha Cook**
> EY Global & EMEIA Total Rewards Leader

There is also the question of "what matters?" What topics do stakeholders think leaders should be assessed against? What financial, social and environmental impacts are these priority topics meant to achieve? Some companies, for example, will focus on the social pillar of the ESG framework, by identifying key diversity, equity and inclusion (DEI) KPIs that are best aligned with their purpose and sustainability agenda. This approach can help companies align and balance executive goals with broader workforce goals by fostering inclusion, equity and transparency on key DEI topics.

Once materiality is assessed, it is important to determine priorities – or the weighting of incentive scheme metrics – to drive the right behaviors. This could include being relatively granular about the smaller goals that cumulatively need to be achieved to meet a company's sustainability goals. For example, developing lower-carbon components and raw materials upstream in the supply chain, and so on.

Companies also need to consider how metrics can be cascaded through the organization. This allows schemes to not only drive a long-term orientation among top executives but also the mid- to near-term operational focus required of middle managers and employees. Examples in the DEI space could be:

- **Top executives:** workforce gender and ethnicity representation to reflect markets served
- **Middle management:** diversity-focused recruitment – job descriptions, career sites, employee referrals
- **Employees:** unconscious bias training and development or reverse mentoring programs

These complex issues do raise the risk of inertia or incrementalism. In other words, the sheer challenge of incorporating ESG metrics into variable remuneration schemes becomes a reason to do nothing or to "play it safe." In fact, the research shows that less than half of organizations (47%) have made sustainability a significant element of remuneration today. However, the experts are much more likely to have an advanced approach:

Experts	Beginners
61%	**29%**
The majority of experts include SG metrics as a significant element when setting the compensation of senior executives (with 34% as a limited element).	In compariso, less than third of beginners include ESG metrics as a significant element (with 59% as a limited element).

Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

Making real impact requires a shift in mindset. C-suites, boards and remuneration committees need to be pragmatic and agile when establishing ESG-based KPIs that continue to evolve. They can also benefit from being more open and transparent with their stakeholders – ensuring they engage with them fully on this critical topic and share details of their sustainability journey. As the global sustainability ecosystem continues to evolve, sustainable incentivization will play a critical role in driving progress on companies' sustainability agendas.

External viewpoint

In conversation with

Rachel Davis

Rachel Davis is Vice President and Co-Founder at Shift, the leading center of expertise on the UN Guiding Principles On Business And Human Rights.

> "I have never seen a situation where getting insight into the perspectives of the affected people on the ground does not help a company better manage impacts on those stakeholders.

Q: For companies and boards looking to drive meaningful progress and action on social issues, such as human rights, what are some of the key priorities and success factors in your view?

Clearly, every company has a workforce, and it's therefore very achievable to drive better human rights impacts in your own workforce, starting with issues like a living wage and equality. But the UN Guiding Principles, as well as new sustainability reporting and due diligence laws, make clear that companies need to look at three other broad categories of people who could be impacted as well – workers in their wider value chain, communities that are affected by the operations of the company or its value chain partners, and consumers and end-users of its products and services – and identity where the most severe risks to people are across these four populations.

But this is not just about information-gathering – companies then need to put in place meaningful targets, supported by KPIs, to drive action on some of those priority risks and impacts. By that I mean targets that are directed toward improving actual outcomes for people, not just measuring the numbers of activities carried out, and changing behavior in areas that the company itself controls, like its own purchasing, R&D and sales practices – which can have a huge effect on risks to people both up and down its value chain.

Q: How do companies approach engagement with affected stakeholders, and what can boards do about this topic?

Companies are very used to engaging with influential stakeholders such as governments or big investors, but it is seen as more challenging to engage with affected stakeholders, like local and Indigenous communities. But these are exactly the people who are most impacted by the company's own operations and value chain. The companies that are making most progress are the ones that are serious in focusing on how they improve the quality of that engagement. I have never seen a situation where getting insight into the perspectives of the affected people on the ground does not help a company better manage impacts on those stakeholders. It just makes sense that it would.

There are many different systems for getting insight into the perspectives of affected stakeholders and engaging with them, such as whistleblower hotlines, stakeholder advisory councils, global framework agreements with trade unions, site visits and customer or end-user feedback processes. The board plays a critical role in overseeing the appropriateness of those systems. For example, the board needs to ask the right questions about whether stakeholders actually trust and use the organization's whistleblowing hotline. We need the board to be asking the right questions about the effectiveness of all these systems and not just leaving it to the operational level.

Addressing these issues is a significant opportunity for remuneration committees. They have an important role to play in holding decision-makers – notably CEOs, executive committees and senior leaders – to account and incentivizing their delivery of ESG outcomes. Ensuring a meaningful portion of total remuneration is linked to sustainability objectives and driving long-termist behavior is critical.

As boards embrace this opportunity, a pragmatic approach will be important. The global sustainability landscape is complex, with many forces unintentionally creating organizational confusion around sustainability requirements, definitions and KPIs. As a result, the metrics are not always perfect. Aiming for a "right-first-time" solution can lead to organizational inertia on the topic. Doing nothing is no longer a viable option, and remuneration committees have an exciting opportunity to help drive change in this critical area.

Key takeaways

- Design executive compensation policy based on ESG-based KPI targets that are aligned with your organization's business strategy, including material sustainability objectives.
- Select ESG metrics that are meaningful and material to your business.
- Assign sufficient weighting (proportionality) to ESG KPI targets selected for use within variable incentive programs.
- Review and refine the overall executive remuneration to ensure all aspects of executive variable pay plans are reviewed annually to assess impact and effectiveness.

Key questions for boards

- What sustainability impact or outcome does the organization aim to achieve with its executive compensation policy?
- What meaningful ESG metrics should be included in our executive compensation policy? How are we assessing their effectiveness regularly?
- How well do the variable pay performance metrics in place for executives (both short-term and long-term) reflect and align with our corporate values, purpose and sustainability priorities?
- How have we integrated and balanced financial and nonfinancial performance metrics across our executive scorecards and variable pay plans?
- How confident are we that we can avoid unintended consequences, e.g., focusing on ESG metrics at expense of other metrics?
- Do the ESG-based targets in the executive compensation policy align with our sustainability objectives and do they reflect meaningful stretch targets (e.g., achievement is not automatic or guaranteed each year)?

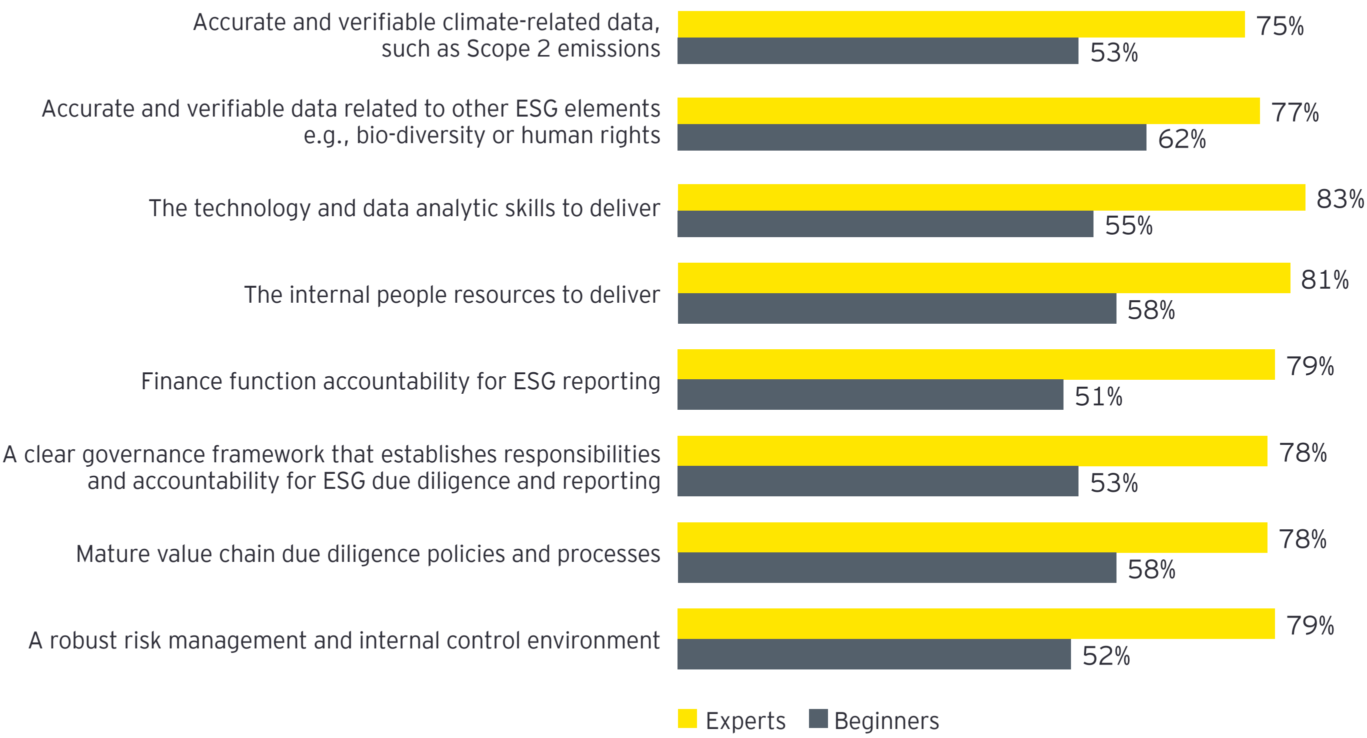
Authentic: material, trusted and credible disclosures

Authenticity in the context of reporting and disclosure is the willingness to not only share successes and targets but also to confront the challenges and difficulties the organization faces on its journey. Stakeholders want to know where you are today, where you are going and how you plan to get there – they do not want greenwashing or greenwishing. They want a focused, authentic story, "warts and all," about what really matters.

Leading companies have made more progress in embedding sustainability into their strategy, with KPIs in place for managing the business too. This makes it much clearer what is material to the business and therefore what needs to be measured. This clarity of purpose could explain why the sustainability governance experts are better prepared for the changing regulatory environment that will come into force with the EU's Corporate Sustainability Reporting Directive (CSRD), as Figure 5 shows.

Figure 5: How prepared is your organization in the following areas to respond to the EU's impending regulation on corporate sustainability reporting and due diligence?

Percentage of respondents who are "prepared" or "completely prepared"



Source: *EY Europe Long-Term Value and Corporate Governance Survey, March 2023* (total respondents: 200).

"

Businesses will be required to disclose more sustainability-related information than ever before, including information about their business models, strategy and their wider value chain.

Charlotte Söderlund

Associate Partner, Climate Change and Sustainability Services, EY Sweden and member of EFRAG Sustainability Reporting Board

External viewpoint

In conversation with

Sonia Tatar

Sonia Tatar is Executive Director, INSEAD Corporate Governance Centre and INSEAD Wendel International Centre for Family Enterprise.

> “
> If boards are not finding enough time to spend on strategizing and integrating ESG into the business, it will be difficult for their sustainability agenda to progress.

Q: In terms of your work with company leaders, what are some of the governance areas that they are focused on, especially when it comes to driving progress against ESG goals?

One fundamental issue is ownership. Boards need to be clear about who is responsible and how they ought to organize themselves; should they create a committee or assign responsibility to an individual? Given the transverse nature of ESG, I find it challenging for a single person to be made accountable – how can they influence the whole board or the whole organization to change and take specific sustainability actions?

The ESG paradigm is getting more and more complex, and regulations are evolving quickly. Even if the board has created a sustainability committee or an advisory board, these cannot work in isolation: Sustainability issues are multidimensional and involve areas such as remuneration, risks, opportunities, audit and broader stakeholder engagement. To effectively address ESG in a holistic and strategic way, concerted efforts are required, and the need to work with the different committees and the executive team is paramount.

The second issue I hear from a recent research study we have conducted is that 91% of board members want to spend more time on strategy. However, with mounting macroeconomic and geopolitical tensions, with the continuous shifts and a changing regulatory environment, their scope is expanding, and a multitude of emerging issues keep landing on the boardroom table and need dealing with. Therefore, boards are to review their engagement time, structure and composition to be able to allocate more time to strategy. A big component of ESG is having it as part of an integrated business strategy. So, if boards are not finding enough time to spend on strategizing and integrating ESG into the business, it will be difficult for their sustainability agenda to progress while the clock is ticking!

Q: And what are you seeing in terms of boards building their understanding of sustainability issues?

Currently, there are different practices, and resources boards are adopting to build their knowledge and understanding on these issues. Boards should invest time in dedicated training on topics related to sustainability. There could be a program, for example, that focuses on climate, on how to create a sustainable value chain, to envision future sustainable business models for competitive advantage and more.

Interestingly, we notice most board members who join INSEAD's open programs are self-paying, and ad hoc custom programs for boards are on the rise. I believe that corporates, if they are really serious about helping their boards address the sustainability issue, can allocate budget for their training, allowing them to attend programs at least once a year to help them understand the key questions relative to sustainability and the implications at the strategic and organizational level. This, in turn, upskills their knowledge for effective governance of environmental and social issues in the short and long term. Alongside that, of course, individuals should continue leveraging learning opportunities by attending conferences, joining networks, engaging in dialogue sessions to broaden their perspectives and learn about best practices.

Lastly, understanding of sustainability cannot be confined to the board — there needs to be alignment and shared understanding across the organization and different stakeholders: the C-suite as well as other employees concerned with ESG. They are the ones on the ground who will be influencing, championing, making a difference and actually putting concrete actions for effective execution in place. Otherwise, sustainability just stays "at the top."

> There will need to be a connection and consistency between financial reporting and areas like nature- or climate-related risks.
>
> **Jan Niewold**
> EY EMEIA Climate Change and Sustainability Services Leader

The CSRD presents a great opportunity, playing a vital role in the transition to a comprehensive global framework for corporate reporting, including sustainability matters. It also will give investors greater transparency into how companies are actually delivering against their climate and other targets. As sustainability becomes more closely linked to strategy and capital allocation decisions, it also raises significant questions for boards and their audit committees. Boards will need to access critical areas of expertise in finance, control, risk and operations as they oversee key areas for implementation, such as internal controls for sustainability information, and also clarify the remit of the CFO and finance function in sustainability data governance and reporting.

This also raises a question for boards on their communications strategy. In the annual report, for example, how do you present one holistic risk profile bringing together the financial risks and the sustainability risks? And, in turn, who is responsible for signing off on an integrated risk statement? A more holistic approach is going to be required, but that means the organization as a whole must take a holistic and strategic approach to sustainability rather than seeing itself in terms of different functions, like procurement, sales, finance and so on.

At the heart of an authentic approach, there is not only a need to be transparent, but also to drive the connectivity between financial reporting and sustainability disclosures.

Key takeaways

- Consider whether the CFO and finance function should take the lead in implementing the company's response to CSRD and reporting under European Sustainability Reporting Standards, as they have the experience and skills to ensure the integrity of the reporting and are able to make the connection between financial and sustainability reporting.
- If not done so already, perform a robust materiality assessment to identify the most important ESG KPIs.
- Assess whether you have the right risk management and internal controls to measure and report against those KPIs and any consequent impacts on the financial statements. Test their effectiveness.

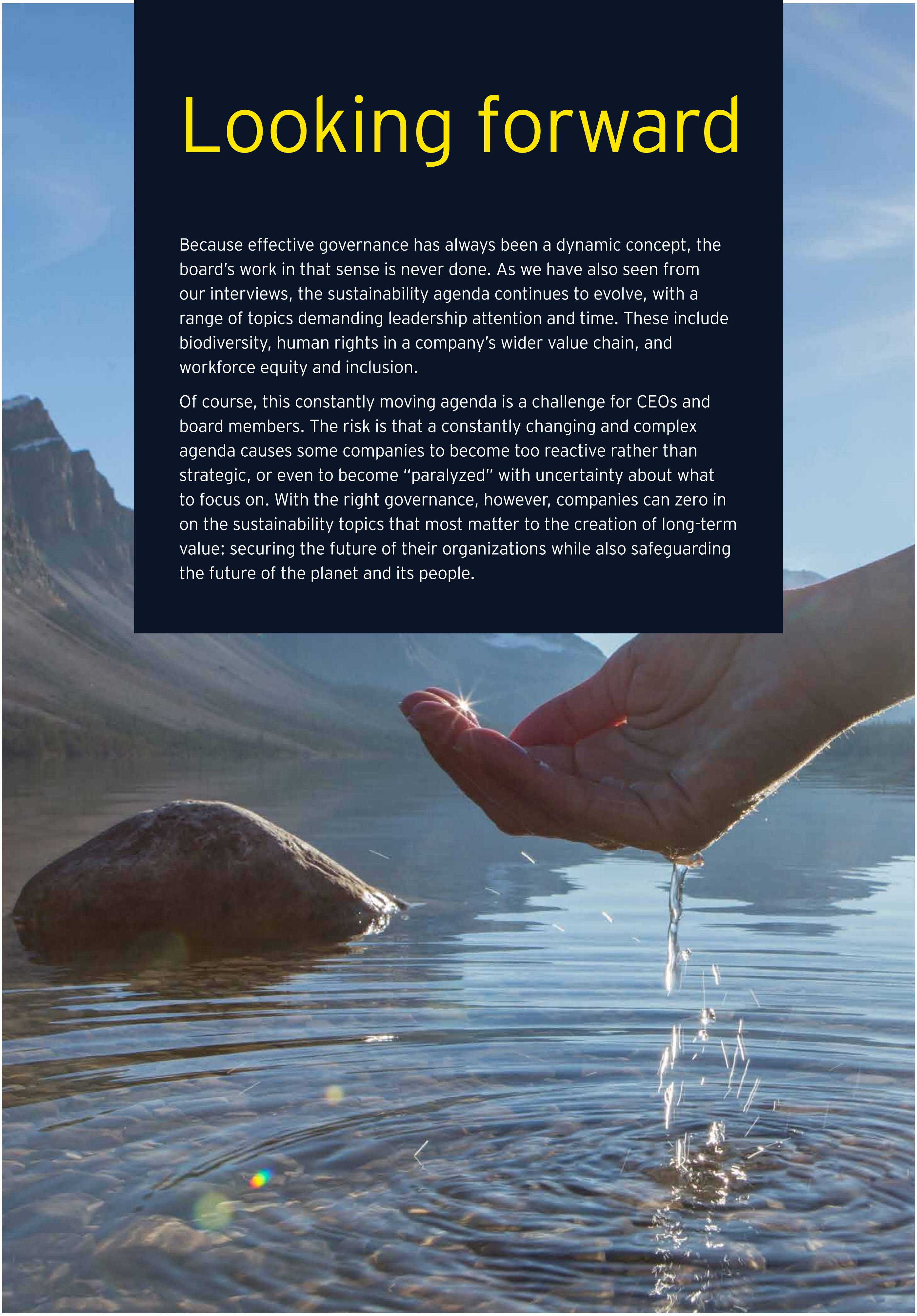
Key questions for boards

- How is management organized to produce high-quality, reliable and coherent financial and sustainability reporting? Do we have the right skills, experience, reporting lines and accountabilities in place to support this?
- What changes to the company's risk management and internal controls systems are needed to produce high-quality, reliable and coherent reporting?
- What actions do we need to take in these areas between now and when CSRD takes effect?

Looking forward

Because effective governance has always been a dynamic concept, the board's work in that sense is never done. As we have also seen from our interviews, the sustainability agenda continues to evolve, with a range of topics demanding leadership attention and time. These include biodiversity, human rights in a company's wider value chain, and workforce equity and inclusion.

Of course, this constantly moving agenda is a challenge for CEOs and board members. The risk is that a constantly changing and complex agenda causes some companies to become too reactive rather than strategic, or even to become "paralyzed" with uncertainty about what to focus on. With the right governance, however, companies can zero in on the sustainability topics that most matter to the creation of long-term value: securing the future of their organizations while also safeguarding the future of the planet and its people.



About the survey

Two hundred corporate directors and senior managers were surveyed to understand their progress and challenges in driving long-term value and the implications for corporate governance. Twenty percent were chairpeople or nonexecutive directors of the board, 20% were CEOs, and the remainder were drawn from across the C-suite. Half of respondents' organizations have revenues of more than €1 billion a year, with the other half between €100 million and €999 million. Respondents were split across 15 European countries and 26 industry segments.

Long-term value, sustainability and ESG — clarifying our terms

In this report, we examine a number of concepts, including long-term value, sustainability, and environmental, social and governance (ESG). For the purposes of this report, we mean that company leaders frame their strategy around long-term value, factoring in a range of issues that are critical to the long-term future of the enterprise, ranging from sustainability to digital transformation. The company's sustainability agenda, in turn, is built on an understanding of its material ESG risks and opportunities. So, for example, a company's approach to sustainability may be focused on biodiversity as a material risk or opportunity, as well as ethical practices as a governance risk or opportunity (governance factors contribute to long-term, sustainable growth in a range of ways, from better control mechanisms to improved stakeholder relationships — factors that are key to protecting and growing long-term value).

We therefore tend to defer to using "sustainability" as our key term, using "ESG" when we are referring to it as a specific, criteria-based framework, and referring to "environmental sustainability" when it is particular to that domain.

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