European Corporate Governance Conference 2024

How boards can integrate sustainability into business strategy

The European Corporate Governance Conference 2024 explored the opportunities and challenges associated with sustainable value creation.

In brief:

- Shifting to a more sustainable business model can enable European companies to build trust with their customers and gain competitive advantage.
- Companies should continually evolve their risk management practices so they can respond to the threats posed by today's uncertain and volatile business environment.
- Value chain due diligence is a work in progress, while CSRD is a learning curve for audit committees as they oversee their company's sustainability reporting.

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European companies are having to balance their commitment to sustainability with a host of other strategic priorities, including macroeconomic challenges, geopolitical tensions and ongoing supply chain disruption. As a result, many are scaling back their sustainability ambitions. The 2023 EY Sustainable Value Study found that the median target year for companies globally to achieve their climate targets has fallen back to 2050, for example, compared with 2036 in the previous year's study.

It is key that sustainability remains a prominent agenda item for management teams and that companies sufficiently understand both the benefits and challenges associated with long-term value creation. So, how can boards help their companies to better integrate sustainability into business strategy?

This question was central to discussions at the European Corporate Governance Conference 2024, held under the auspices of the Belgian Presidency of the Council of the EU. The conference was organized by the EY organization, in collaboration with Accountancy Europe, BusinessEurope, ecoDa, EuropeanIssuers, GUBERNA and VBO-FEB. Over 500 people, from 48 countries, registered to attend the event, either online or in-person.

While companies' progress against their targets may be stalling, sustainability remains a basic business imperative, EY EMEIA Area Managing Partner Julie Teigland told the conference.

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> It's not something we're doing to be nice, or doing to be good, or doing to be green. It's just good business, she said

Given this imperative, boards should provide greater oversight around sustainability matters, said Sandra Gobert, Executive Director of GUBERNA. That requires them to ask the right questions of management, act with purpose and engage in courageous decision-making. She explained: "There is no corporate governance today without sustainability."

The business case for sustainability

Leontine Schijf, Sustainability Reporting Manager for L'Oréal, set out the business case for sustainability within the beauty company. She said that while sustainability tends to be associated with risk, it also presents opportunity – in fact, opportunity often arises through the process of mitigating risks. "We have an opportunity to create products that do even better for the planet," she said, "creating new innovation."

Sustainability also presents L'Oréal with an opportunity to build trust with its customers. It belongs to a consortium of international cosmetic companies that are working on a labeling system to help consumers compare the sustainability credentials of different products. "We don't want to make sustainability difficult for the consumer to understand," said Schijf.

> "The worst outcome would be that the consumer doesn't trust sustainability information anymore.

As well as driving innovation, a shift to a more sustainable business model can enable companies to operate more efficiently, better manage their risks, benefit from tax incentives and access cheaper capital – helping them to gain a competitive advantage in the marketplace. Additionally, it enables companies to deliver on the expectations of their customers and other stakeholders since a commitment to sustainability is increasingly viewed as intrinsic to their license to operate.

The 2023 EY Sustainable Value Study found that the companies taking the most action to address climate change are 1.8 times more likely to report higher-than-expected financial value from their initiatives, compared with those taking the least action. Sustainability also helps companies to attract and retain talent, especially talent from younger generations who are motivated to work for purposeful organizations. "We need to help boards and those who allocate capital get more serious and open about the value associated with the sustainability pathway," said Gerard Gallagher, EY EMEIA Sustainability Leader.

Regulation such as the Corporate Sustainability Reporting Directive (CSRD) can create opportunities for businesses by pushing them to set more ambitious sustainability-related targets and measure their progress against those targets. CSRD will improve transparency around sustainability and help to standardize reporting so that companies can be more easily compared with their peers by investors and other stakeholders. Significantly, 99% of investors who responded to the 2022 EY Global Corporate Reporting and Institutional Investor Survey said they consider companies' environmental, social and governance (ESG) reporting as part of their investment decision-making process.

Vincent Van Bueren, Corporate Communications & Sustainability Manager for investment company Gimv, confirmed that investors want to invest in companies that are helping to enable the transition to a more sustainable world. They also want to invest in those that are trying to futureproof their business models by transforming their products and processes. "Private equity can help companies by guiding them through that transformation," he said.

Artificial intelligence (AI) is potentially a powerful value driver for companies looking to transition to more sustainable business models. While AI does present social and environmental risks, it can be used to drive long-term value in several ways. These range from enabling new business models and generating new revenue streams through to changing the way business is done. Boards can help management to reconcile the business opportunity of AI with the ethical and societal challenges it presents.

Despite the business case in favor of sustainability, the conference heard that many companies are embarrassed about creating value from their social and environmental initiatives, partly out of a fear of offending activists. As a result, they can be reluctant to allocate capital to sustainability-related projects. Others are treading cautiously because sustainability is a new domain to them, and they are still finding their way. In their leadership capacity, boards can encourage companies to be more proactive about seizing the opportunities associated with sustainability while managing the risks.

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Risk management and internal controls

Strong risk management and internal controls underpin the resilience of businesses in today's complex and volatile world. According to the EY Global Board Risk Survey 2023, the most resilient organizations and boards are effective at managing these five types of risks: emerging risks (such as geopolitical risks), talent and culture, sociopolitical issues, sustainability, and technology.

Adriana Cavaliere, Senior Manager Risk at Belgian air traffic control company skeyes, said that risk management is no longer about recovering quickly, but "about bouncing back better, about anti-fragility". This requires an integrated vision at all layers of the organization that covers risk, strategy and leadership – what she described as "visionary risk management."

The risk management approach at skeyes is based on five key building blocks: risk governance, risk culture, risk methodology and management, risk register and risk reporting. High-level oversight of the company's risk management lies with the board, but the audit committee oversees the effectiveness of skeyes' risk management and internal controls system.

skeyes undertakes both pre-strategy and post-strategy risk management as part of its overall risk approach. Pre-strategy risk management involves using scenario planning to explore the different risks that could impact the company in the long run. Post-strategy risk management is about identifying the risks that could impact strategy execution and implementing internal controls to mitigate these risks.

Cavaliere explained that the more an organization's risk maturity evolves, the more stakeholder value is created. Additionally, due to the complexity of the current environment, companies need to continually evolve their practice of risk management.

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Risk management is not a destination, it's a journey, she said.

The Three Lines model is a very important corporate governance model, said John Bendermacher, President of the European Confederation of Institutes of Internal Auditing (ECIIA). He emphasized that effective risk management starts with the first line of defense – operational management – which also selects the risks that the business will undertake. Internal audit plays a key role in challenging the design and effectiveness of all the controls put in place to manage risks.

Companies should be aware that investors are taking an increased interest in the quality of their risk management. Investors expect companies to have a robust risk management and control system in place, strong risk governance around that system, and a healthy risk culture that starts at the top of an organization. They also want to be able to rely on a company's reporting and to see that it is managing its sustainability-related risks.

A study by economics consultancy Oxera found that Italy's Savings Law of 2005, which aimed to strengthen companies' internal controls, led to Italian businesses enjoying economic benefits as a result of their stronger controls and risk management framework. The research found that companies with a strong approach to risk management benefitted from a lower cost of capital compared with firms in other countries that were not subject to the same reform. Jella Benner-Heinacher, President of investor federation Better Finance, confirmed that investors would take a favorable view of companies with excellent internal controls and risk management systems because of the positive signal they send out about management credibility.

Sven Gentner, Head of the Corporate Reporting Unit, DG FISMA, at the European Commission, said that when it comes to sustainability, society, as a whole, had got risk management "quite wrong" over the last few decades, which is why some adjustment is now needed. This is why the Commission is putting in place new rules around sustainability, including in relation to sustainability reporting and sustainable finance.

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We need to mobilize whatever we can in terms of transforming our economies to become more sustainable, he said.

When polled at the conference, **43%** of audience members said they believed the European Commission could help to improve risk management and internal controls by harmonizing requirements for listed companies and directors across the EU.

As part of their risk management strategies, companies should aim to pursue the opportunities associated with risk management – such as the opportunity to build more enduring relationships with their stakeholders by engaging in important social debates. "Risk isn't just about defense," said Andrew Hobbs, EY EMEIA Public Policy Leader. "It's also about offense."

Due diligence and sustainability

In March 2024, the European Council approved the Corporate Sustainability Due Diligence Directive (CSDDD), which aims to anchor human rights and environmental considerations in companies' operations and corporate governance. The directive takes a risk-based approach and applies to large European companies and to non-European companies with significant turnover in the EU.

Addressing the conference by video, Didier Reynders, the European Commissioner for Justice, said the directive sets out "a binding legal framework to identify, prevent, mitigate and stop adverse impacts on human rights and the environment in own operations, the operations of subsidiaries and the operations carried out by business partners in companies' chains of activities."

He added that the European Commission expects the directive to help promote a new global standard concerning the environment and human rights and have "a significant net positive economic impact, both in Europe and in our trading partners' countries".

Barbara Cooreman, Program Lead Responsible Sourcing, at circular materials company Umicore, explained how her company approaches value chain due diligence in relation to the production of battery materials. The company's due diligence journey began in 2004 when it decided to start screening its suppliers to avoid sourcing cobalt from illegal artisanal and small-scale miners in the Democratic Republic of the Congo. This was among others due to safety risks and the high risk of child labor being used.

Umicore has since developed a sustainable procurement framework for cobalt that covers a broad range of ESG risks and it screens every actor in its supply chain for country risk, supplier risk and material-specific risk. This screening is informed by on-the-ground intelligence and assessments, as well as reports from peers, NGOs and the media. "When risks are identified, engagement with suppliers to improve the situation is a crucial element of mitigating negative impact. Doing due diligence properly requires a lot of effort and comes at a cost for companies," Cooreman said.

Sustainability is now expected to be the norm for European companies, which means they cannot claim a "green premium". Nevertheless, their customers expect them to compete on price with companies in other markets that have lower social and environmental standards. Cooreman said the challenge facing European companies is how they create value out of having high standards of due diligence and ESG.

Discussion at the conference emphasized that due diligence should not be a "box-ticking exercise" on the part of companies. Instead, companies should use it as an opportunity to drive positive change through engagement with their suppliers. It is also an opportunity for them to be more transparent with their stakeholders and to understand the issues on the ground affecting their suppliers.

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Panel 3: In one word, how would you describe the role of policymakers in setting the agenda for sustainability?
Waiting for responses

There is some uncertainty around how the CSDDD will affect businesses, and whether it will have all the desired positive effect when it comes to driving sustainability behaviors, said Maria Larsson, Chair of the Company Law Working Group for BusinessEurope. Businesses want rules that are reasonable and proportionate and can be applied in practice. They want liability and sanctions to be reasonable as well. So, they are concerned by the possibility of being fined up to **5%** of net turnover for non-compliance with the CSDDD. They also believe that it will be challenging to carry out the risk assessment that will enable them to prioritize their most significant environmental and human rights risks. Larsson emphasized that when the directive is transposed into national law, authorities should support companies to take meaningful action and recognize efforts rather than only focus on mistakes made.

Over half (**54%**) of audience members who responded to a poll at the conference thought the CSDDD would significantly impact how businesses operate within and beyond Europe by posing potential challenges. Nearly a fifth (**17%**) were more optimistic, however, believing that the directive would have a significant positive impact.

Dan Dionisie, Head of the Company Law Unit, DG JUST, at the European Commission, specifically addressed what he described as some "myths" associated with the CSDDD. The directive is not bad for business, he argued. On the contrary, sustainability makes business sense. Additionally, it is better to have an EU-wide regime that creates a level playing field rather than different due diligence regimes in different member states, and the directive does not only apply to EU companies, but also to non-EU companies that do significant business in the EU. He also said the directive was not unduly cumbersome, was beneficial to the agricultural sector in the EU, and included support and protection for SMEs. Furthermore, the CSRD reporting requirements that are already in place will make it easier for the companies in scope to carry out their due diligence.

Catherine Clark, from Aviva Investors' Sustainable Finance Centre for Excellence, said the CSDDD is helping to raise the bar when it comes to corporate due diligence and making it easier to fund the transition to a more sustainable economy. She said Aviva Investors wants to support companies that are already doing due diligence well and nudge others to raise their game. "We believe it's important to have these high standards, full stop," she said. Clark added that due diligence is also about managing risk from an investment perspective, saying: "There is information and data that we will be able to draw through the CSDDD process – that we haven't currently got for the companies – that tell us what's happening on the ground. That sort of information could help investors like us to make better informed decisions."

Barry Andrews, Member of the European Parliament, acknowledged that many people in the business world believe that the EU is going too far with CSDDD. He argued, however, that citizens want the legislation, as do many businesses. The legislation is also key to the success of the European Green Deal. "If we are to hit our targets under the Green Deal, we will need to ensure that companies are not just exporting their environmental damage," he said.

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This directive [CSDDD] is a chance to ensure that Europe stays at the front of its climate ambitions.

Sustainability reporting and assurance: audit committee perspective

Audit committees are providing critical governance around sustainability reporting and supporting their companies to comply with the CSRD. They can help to assess whether the organization has sufficiently high-quality data, as well as the necessary resources to produce the reporting. They can also consider the important connections between the financial and non-financial statements.

"We should not underestimate the impact of climate risk in the financial statements, especially when it comes to understanding projections of cash flows when performing impairment assessment," said Jeanne Boillet, EY Global Accounts Committee Assurance Lead. "That's where you need to understand the business model and how this business model is going to be impacted by climate risk moving forward."

Another important consideration for audit committees is the double materiality assessment, which can help organizations to rethink their approach to risk. Risk should be considered in the context of the organization's overall strategy and business model, so that the organization aligns behind the key issues that need to be addressed.

Pascal Chalvon Demersay, former Chief Sustainability Officer of chemical company Solvay, shared some key lessons from Solvay's experiences of producing sustainability reporting to date, and having that information audited. The first lesson was that reporting and auditing in the extra-financial world is very different from reporting in the financial world due to difficulties with collecting data and an absence of documentation among other challenges.

The second lesson relates to scope since extra-financial reporting needs to consider the company's whole value chain. Thirdly, with financial reporting, companies are not expected to plan ahead to the same extent as with extra-financial reporting. Finally, it is essential that boards receive proper training on sustainability and its associated language.

Sustainability reporting requires continuous improvement in terms of governance, policies and internal controls, Chalvon Demersay said. He added that it was important for companies to be sincere about their progress against their sustainability targets and that he had never seen Solvay receive negative feedback because it had declared weaknesses on its sustainability journey. "We have the right not to be perfect," he said, "provided we explain what we're doing."

To provide constructive challenge around sustainability reporting, audit committees are needing to develop new skills. In some cases, they are looking to recruit new members with specialist expertise. Audit committees are also devoting time to discussing sustainability reporting and liaising with their company's sustainability committee where one exists. Whereas the sustainability committee is focused on strategy and setting key performance indicators (KPIs), audit committees are aiming to ensure that there is a robust reporting process behind the KPIs. In future, AI tools may be useful for automating data collection processes for reporting, including processes for collecting data from third parties.

Some audit committees are uncomfortable that their auditors are only providing limited assurance, and not reasonable assurance, on reported sustainability information. In reality, however, companies are not yet ready for reasonable assurance on non-financial information. For the audit profession, sustainability reporting is an opportunity for auditors to showcase new skills and expertise. It may also help them to attract talent into the profession – new generations who are seeking purposeful work.

While companies today are focusing more on sustainability than they did in the past, progress is not happening at the rate needed to address some of the major social and environmental challenges facing the world. Yet the reality is that companies are at different stages of their sustainability journey. While some companies see sustainability as primarily a compliance exercise and are not being as ambitious as they could be, others are fully embracing it and integrating it into their investment strategies.

Remuneration can be used successfully to incentivize management to achieve sustainability targets. Nevertheless, it is important that incentives do not solely relate to the environment. Incentives should also relate to issues such as employee wellbeing and the gender pay gap.

For companies, the cost of doing nothing on sustainability is huge – in terms of their competitiveness, operations, reputation and relationships with their stakeholders. In their leadership capacity, boards and audit committees can help to ensure that their companies take purposeful action on sustainability and that what gets measured gets managed. Mercedes Sanchez Varela, Director of Climate Governance at climate forum Chapter Zero Brussels, told the conference: "Governance is going to be your North Star."

Summary

Summing up the conference, Luc Bertrand, Chair of GUBERNA's Board of Trustees, said that corporate governance is being reshaped by sustainability and the role of companies in society is changing. He emphasized that companies need to take urgent action if they are to succeed in transitioning to more sustainable business models at speed. "We have no time," he said. "We all have to move, and all boards have to change."

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