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Event report

Driving the evolution of sustainable corporate governance

Reflections on the future role of audit committees

Contents

Note

This report, which is co-sponsored by Accountancy Europe and ecoDa, reflects the outcomes of discussions at a workshop held in February 2021. The workshop was facilitated by EY and enabled by its Wavespace™ technology. All discussions took place under the Chatham House Rule, with participants being engaged in a personal capacity. As a result, the conclusions in this report may not reflect the views of the co-organisers or of certain participants.

Introduction and event summary

Companies will play a key role in addressing the environmental and societal challenges that we face today. We have seen this clearly during the COVID-19 pandemic, when manufacturers pivoted to produce vital equipment for fighting the virus and life sciences companies produced vaccines at speed. What's more, the expectations of consumers, investors, policymakers and regulators is that companies should indeed play this role – while creating long-term value for a broad set of stakeholders in the process.

As European companies come under pressure to transition to more sustainable business practices, there is a need for corporate governance to evolve alongside. Increasingly, boards are expected to factor environmental, social and governance (ESG) considerations into their decision-making and strategies. This will require them to have a deep understanding of their organisation's sense of purpose, connect with its stakeholders, and establish accountability for long-term value performance.

As a significant operating committee of the board, the audit committee can play a key role in supporting the evolution of sustainable corporate governance. This evolution is likely to gather pace in response to developments such as the proposed Corporate Sustainability Reporting Directive[1] and the European Commission's recent consultation around a possible initiative on sustainable corporate governance[2].

So, how can audit committees themselves evolve in response to the new realities they face?

In February 2021, a dedicated workshop was held to answer this specific question. The workshop brought together board and audit committee members, business leaders and investor representatives from across Europe, along with policymakers, representatives of non-governmental organisations and the accountancy profession. Its objective was to facilitate a wider dialogue about what an evolution in corporate governance would mean for the future role of audit committees.

A number of important topics were discussed at the workshop. These included board attributes; risk oversight; shareholder and stakeholder engagement; and authentic reporting disclosures that establish accountability for long-term value performance.

The extensive discussions that took place at the workshop, and a number of the ideas put forward by participants, are summarised in this report. Some of the ideas will appear more feasible and more practical to implement than others. Nevertheless, taken together, these reflections should help to shape the evolution of audit committees, and build on their existing responsibilities, while stimulating innovation in policymaking in the area of sustainable corporate governance.

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[1] Proposal for a Directive of the European Parliament and of the Council, European Commission website, https://ec.europa.eu/finance/docs/law/210421-proposal-corporate-sustainability-reporting_en.pdf, accessed 26 April 2021.

[2] Sustainable Corporate Governance, European Commission website, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/public-consultation, accessed 31 March 2021.

A virtual collaboration experience

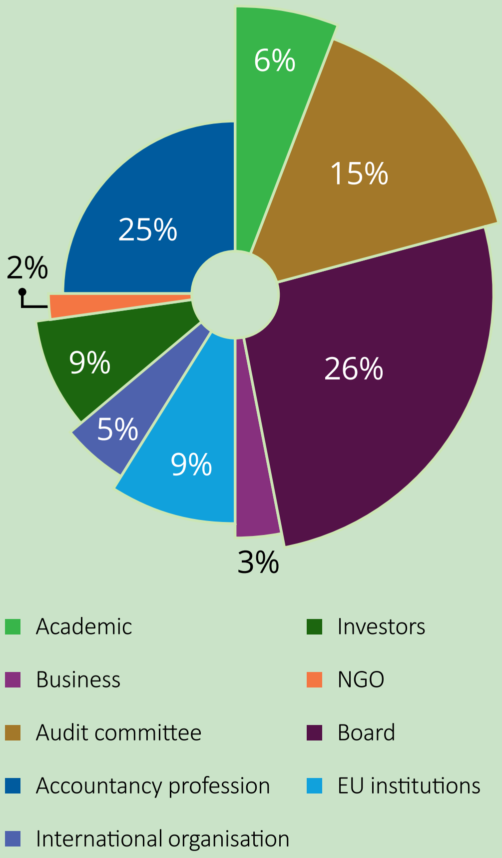
The interactive workshop, entitled *Sustainable Corporate Governance: Future role for audit committees* took place virtually on 5 February 2021. Its aim was to facilitate multi-stakeholder collaboration around the theme of sustainable corporate governance, using the virtual breakout sessions and digital collaboration tools provided by EY Wavespace. In total, 65 participants attended the event.

Participants

The workshop was a multi-stakeholder conversation, involving representatives from academia, audit committees, boards, business, EU institutions, international organisations, investors, non-governmental organisations and the accountancy profession.

Small groups, supported by a facilitator, addressed specific topics during the breakout sessions, with a diversity of views encouraged and disagreement in opinion expressed. The groups looked at what the future could look like with regard to their topic, including best case, worst case and business-as-usual scenarios, barriers to progress, and potential solutions. All discussions were held under the Chatham House Rule .

Participants to the workshop



The four topics addressed in the breakout sessions were:

- If directors are given duties towards the broader stakeholder community, what does this mean for the role of audit committees?
- How can audit committees support the board in risk management and risk oversight in relation to environmental and social matters?
- How should the role of the audit committee evolve in the context of the EU's sustainable finance agenda and the review of the Non-Financial Reporting Directive?
- How can audit committees and other board functions contribute to the success of sustainable finance and what role should they play in sustainable corporate governance?

Executive summary

Participants at the workshop identified a number of key themes that could support the evolution of sustainable corporate governance. They also looked at the role audit committees could play in supporting this evolution.

These are some of the key themes that emerged:

- **Stakeholder engagement** – if they are to drive long-term value for all their relevant stakeholders, boards need to improve engagement with their different stakeholder groups. The CEO and board chair could meet with investors to deliver a social strategy and risk report.
- **Risk oversight** – audit committees could oversee a single risk matrix that integrates medium- to long-term ESG risks with all other risks.
- **Communication and reporting** – non-financial information is more valuable if it is integrated with financial information. For investor-focused reporting and the transparency of global capital markets, there is an urgent need for globally consistent standards. This ideal solution may take time to achieve, however. In the meantime, cooperation and alignment between different initiatives is key.
- **Legislation** – boards could be given responsibilities under EU law to duly consider relevant stakeholders' interests. Requirements should be principles-based and not overly onerous, however.
- **Chief value officers** – the CFO could be repositioned as the company's chief value officer. They would work alongside the audit committee to establish robust processes for reporting on non-financial, as well as financial, information and communicate authentically around the net value creation process.
- **Remuneration** – boards should incorporate ESG-related key performance indicators into long-term incentive plans, setting targets that are ambitious but realistic.
- **Tone at the top** – the board must be independent and diverse in composition. It should ensure that sustainability is embedded in the company's purpose and strategy, and at every level of decision-making.

Chapter 1

Mainstreaming sustainability: overview of the current business and regulatory landscape

Sustainability was steadily rising up the business and policy agenda even before COVID-19 struck. Two significant developments came in 2015 with the adoption of the landmark Paris Agreement on climate change and the setting of the United Nations' Sustainable Development Goals. These developments both sent a clear signal about the way policymaking would head in future and the likely expectations of stakeholders around the role of business in driving sustainability.

Following these developments, momentum behind the concept of sustainable business continued to accelerate. Over the past few years, companies have come under increasing pressure to prioritise the creation of long-term value for all their stakeholders – in a way that is in line with their societal purpose – above the single-minded pursuit of short-term profits for shareholders.

In 2019, the influential Business Roundtable in the US issued a statement[3] that redefined the purpose of a corporation as being to serve all its stakeholders. This statement was effectively a rebuttal of the long-accepted doctrine put forward by influential economist Milton Friedman[4] that a company has no social responsibility to the public or society – its sole responsibility is to deliver profits to shareholders.

Impact of COVID-19

The COVID-19 pandemic has highlighted how a systemic threat to human wellbeing can have far-reaching implications for businesses. As a result, it has underlined the benefits of a corporate strategy that creates value for a broad set of stakeholders. According to research by EY organization[5], 66% of European C-suite leaders and board members believe that COVID-19 has increased stakeholders' expectations that companies will drive societal impact, environmental sustainability and inclusivity.

At the same time, investors have increasingly begun to prioritise sustainability in their investment strategies since evidence suggests that companies with a strong ESG performance can generate superior financial performance over the long term and in challenging market conditions[6]. Larry Fink, CEO of a major investment management firm BlackRock, wrote in his 2021 letter

[3] "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'", Business Roundtable, https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans, accessed 8 March 2021.

[4] A Friedman doctrine – The Social Responsibility of Business Is To Increase Its Profits, Milton Friedman, The New York Times, https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html, accessed 3 March 2021.

[5] *Will there be a 'next' if corporate governance is focused on the 'now'? EY Long-Term Value and Corporate Governance Survey,* February 2021, EY, 2021.

[6] "Sustainable Funds Outperform Peers in 2020 During Coronavirus", Morgan Stanley, https://www.morganstanley.com/ideas/esg-funds-outperform-peers-coronavirus, accessed 3 March 2021.

to CEOs[7] that "companies with a well-articulated long-term strategy, and a clear plan to address the transition to net zero, will distinguish themselves with their stakeholders". He highlighted in his letter that between January and November 2020, investors in mutual funds and exchange-traded funds had invested $288 billion globally in sustainable assets, a 96% increase over the whole of 2019.

European policy developments

To meet the demands of politicians, investors, employees, customers and other stakeholders in organisations, corporate governance must evolve in support of the trend towards sustainability. At the time the workshop took place, a number of significant policy developments were underway in Europe to support this evolution, including:

- The EU taxonomy for sustainable activities[8]. This classification system, which entered into force in July 2020, sets out the overarching conditions that an economic activity has to meet in order to qualify as environmentally sustainable. It will help to scale up sustainable investment and implement the European Green Deal[9] – the European Commission's plan to help the EU economy become more sustainable and achieve a target of climate neutrality in 2050.

- Review of the Non-Financial Reporting Directive[10]. During 2020, a consultation took place to see how this directive could be revised to improve the way in which companies and financial institutions disclose non-financial information. Following the consultation, a draft Corporate Sustainability Reporting Directive was published on 21 April 2021.

- Potential development of EU sustainability reporting standards[11]. The proposal is that these standards, which are included in the draft Corporate Sustainability Reporting Directive, would be overseen by the European Financial Reporting Advisory Group (EFRAG). In March, EFRAG published its recommendations[12] for developing these standards.

[7] "Larry Fink's 2021 Letter to CEOs," BlackRock website, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter, accessed 3 March 2021.

[8] EU taxonomy for sustainable activities, European Commission website, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en, accessed 8 March, 2021.

[9] A European Green Deal, European Commission website, https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en, accessed 8 March 2021.

[10] Non-financial reporting by large companies (updated rules), European Commission website, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation, accessed 8 March 2021.

[11] Invitation to contribute to the ad personam mandate of EFRAG board president Jean Paul Gauzès on non-financial reporting standard setting, EFRAG website, https://www.efrag.org/News/Public-256/Invitation-to-contribute-to-the-ad-personam-mandate-of-EFRAG-Board-President-Jean-Paul-Gauzs-on-non-financial-reporting-standard-setting, accessed 8 March 2021.

[12] Proposals for a Relevant and Dynamic EU Sustainability Reporting Standard-Setting, EFRAG, 2021.

- The Sustainable Finance Disclosure Regulation[13]. Like the EU taxonomy, this regulation is part of the EU's sustainable finance action plan[14]. It aims to prevent 'greenwashing' by requiring financial market participants in the EU to make disclosures on ESG risks, with additional requirements for products that promote ESG characteristics or that have sustainable investment objectives.
- The Sustainable Corporate Governance Initiative. This initiative aims to improve the EU regulatory framework on company law and corporate governance by enabling companies to focus more on long-term sustainable value creation. It is looking at whether companies should be required to address adverse sustainability impacts, such as environmental damage and human rights abuses in their operations and supply chains. It also looks at directors' duties with regards to stakeholders.

While the EU continues to be out in front with regard to policy initiatives in support of sustainability, other international efforts are also afoot. In particular, there are some endeavours to create consistent frameworks and standards for long-term value-focused corporate reporting, including the World Economic Forum's Stakeholder Capitalism Metrics[15]. Two other significant developments are financial standard-setter the IFRS Foundation's proposed creation of a new sustainability standards board (SSB)[16] and the planned merger of the International Integrated Reporting Council and the Sustainability Accounting Standards Board to form the Value Reporting Foundation[17].

The important role of audit committees

It is not yet clear what the long-term outcomes of all these different policy initiatives will be. What is evident, however, is that a long-term, multi-stakeholder strategy requires strong governance and the provision of high-quality information to those charged with governance, as well as stakeholders. Strong governance and internal controls will be key to this journey. They will ensure the integrity of the new metrics and protect against greenwashing and fraud. For that reason, audit committees have an important role to play in the evolution of sustainable corporate governance.

[14] Sustainable finance, European Commission website, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en, accessed 8 March 2021.

[15] Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation, World Economic Forum website, https://www.weforum.org/reports/measuring-stakeholder-capitalism-towards-common-metrics-and-consistent-reporting-of-sustainable-value-creation, accessed 8 March 2021.

[16] IFRS Foundation Trustees consult on global approach to sustainability reporting and on possible Foundation Role, IFRS.org, https://www.ifrs.org/news-and-events/2020/09/ifrs-foundation-trustees-consult-on-global-approach-to-sustainability-reporting, accessed 3 March 2021.

[17] IIRC and SAS*B intend to* merge, iasplus.com, https://www.iasplus.com/en/news/2020/11/iirc-and-sasb-intend-to-merge, accessed 3 March 2021.

Q&A with

Karim Hajjar,
Chief Financial Officer of Solvay

At the workshop, Andrew Hobbs, EY EMEIA Public Policy Leader, gave an overview of the EU policy landscape around corporate governance. He was followed by Karim Hajjar, Chief Financial Officer of Solvay, who shared his personal views on sustainable corporate governance in a Q&A with ecoDa Director General Béatrice Richez-Baum. Accountancy Europe also continued this discussion around the CFO's perspective with Karim Hajjar in an episode of the podcast *Because People Count*.

Q. Why are you passionate about ESG?

A. Throughout my career I've worked in businesses that have done very well on sustainability, but I never saw it as my job in any particular way. It wasn't that I didn't care – I just didn't see a link between sustainability and my job as a CFO.

But then, four years ago, my son challenged me about Solvay's CO2 emissions and I started to look for a legitimate way to contribute through my role. It was then I realised that value creation cannot simply be defined on the basis of financial metrics.

Q. What happened after you made that realisation?

A. We started defining Solvay's value creation in terms of planet, people and society, as well as profit, cash and returns, and we put metrics in place. As CO2 was the biggest strategic risk, we decided to focus strongly on climate and we aligned our remuneration strategy with emissions reduction targets.

Q. What role did the audit committee play in this process?

A. The audit committee suggested that we talk about integrated thinking – integrating sustainability with how we do business. We took gradual steps towards that and our external auditors were asked to validate everything we published of a non-financial nature. We were an early adopter of the framework of the Task Force on Climate-Related Financial Disclosures.

Q. How can a CFO help to stimulate integrated reporting and integrated thinking?

A. It's not about telling stories. It's about managing differently. We started the journey by including the cost of CO2 in every single investment decision, even in markets like the US where the cost is zero. More recently, we've adopted science-based targets. You have to integrate the elements of sustainability into decision-making on a day-to-day basis and you then have to report transparently on progress.

Q. What are the challenges with integrated reporting?

A. It requires a dose of courage. I don't know how many CFOs and audit committees are comfortable seeing a report with a qualification. We had to do that. There are holes in the racquet when you do things on sustainability – you're not perfect. You have a choice: you can say, "I'll wait, I'll perfect everything and then I'll publish", or you can say, "If we want to generate confidence and trust, we can start now to disclose in our integrated reports that we're not particularly perfect on every single thing, but we're determined and committed to improve." That's a cultural shift – but the Solvay leadership and board had the willingness to go there.

Another huge cultural shift involves moving from the simple world of financial KPIs to the complex world of integrated accounting and decision-making within your day-to-day business. How do you manage this shift? All I can say is be curious, ask questions and make a start. The rest will follow. If you're an executive, be exemplary in raising the bar. If you're the chair of an audit committee, broaden the agenda and ask different questions – not to embarrass or shame executives, but to help them focus on what is material and pertinent.

Q. How should audit committees think about value creation when engaging with ESG?

A. Audit committees have a huge role to play on many angles. It's not just about reporting, but challenging management. Do they have the right risk management? What are they doing on prosperity? Where does diversity feature?

Q. What type of skillset do you have in the boardroom and on your audit committee?

A. The finance team at Solvay has the usual traditional skills, but when we went down the integrated reporting route, we contributed process discipline and put in place a reporting framework. We use the clear skillsets of finance professionals to generate reliable, consistent information while working in partnership with the sustainability and industrial teams to generate insights and improve decision-making.

On the board we have a broad range of skills, but we have reinforced that with deep, specialised training sessions on sustainability. It's also important not to underestimate the power of the innocent question from a non-expert, because that can solicit a lot of insights. You don't have to be an expert to join the conversation.

Q: Have you noticed a change in how investors and the public are looking at Solvay since you embarked on your ESG integration journey?

A. There is a huge change and this is just the beginning. Change will be magnified and accelerated, not just because of standard-setters but also because investors are working with companies to develop an ESG framework. I hope that investors can use the information that we publish. I would also like them to start questioning us on our progress against 19 out of the 21 KPIs recommended by the World Economic Forum's International Business Council.

Q: Do you think that companies like Solvay are doing enough to address climate change?

A. We can never do enough. We can always do more. We need to continue to innovate and make progress.

Chapter 2

Role of the audit committee today

1

As they shift towards sustainable business strategies, companies will need to ensure that the control environment for producing non-financial metrics and goals is just as strong as the control system around their financial metrics, financial objectives and financial reports. This is where the audit committee comes in.

Today, audit committees already further sustainable corporate governance in a number of important ways:

The governance of risk

The vast majority of boards delegate most risk oversight in the first instance to their audit committees, with this being particularly the case for new risks that come onto the horizon, such as cyber risks. Many discussions around sustainable corporate governance begin with the topic of ESG as a risk to be managed and then later move onto ESG as a value-creating opportunity. Audit chairs increasingly see themselves as responsible for tracking ESG risks and ensuring that people within the organisation are accountable for them.

2

ESG reporting

At the request of the board, audit committees may be responsible for ESG reporting, or at least deeply involved with it. Since ESG reports are often a reflection of the fundamental strategy of the business, full boards will always be concerned with these disclosures. Nevertheless, audit committees review the processes and assumptions behind the data and they also check to see if controls are strong enough to ensure the quality of the information. Research by Tapestry Networks has found that ESG reporting has been gaining traction and drawing increasing audit committee attention in recent years[18].

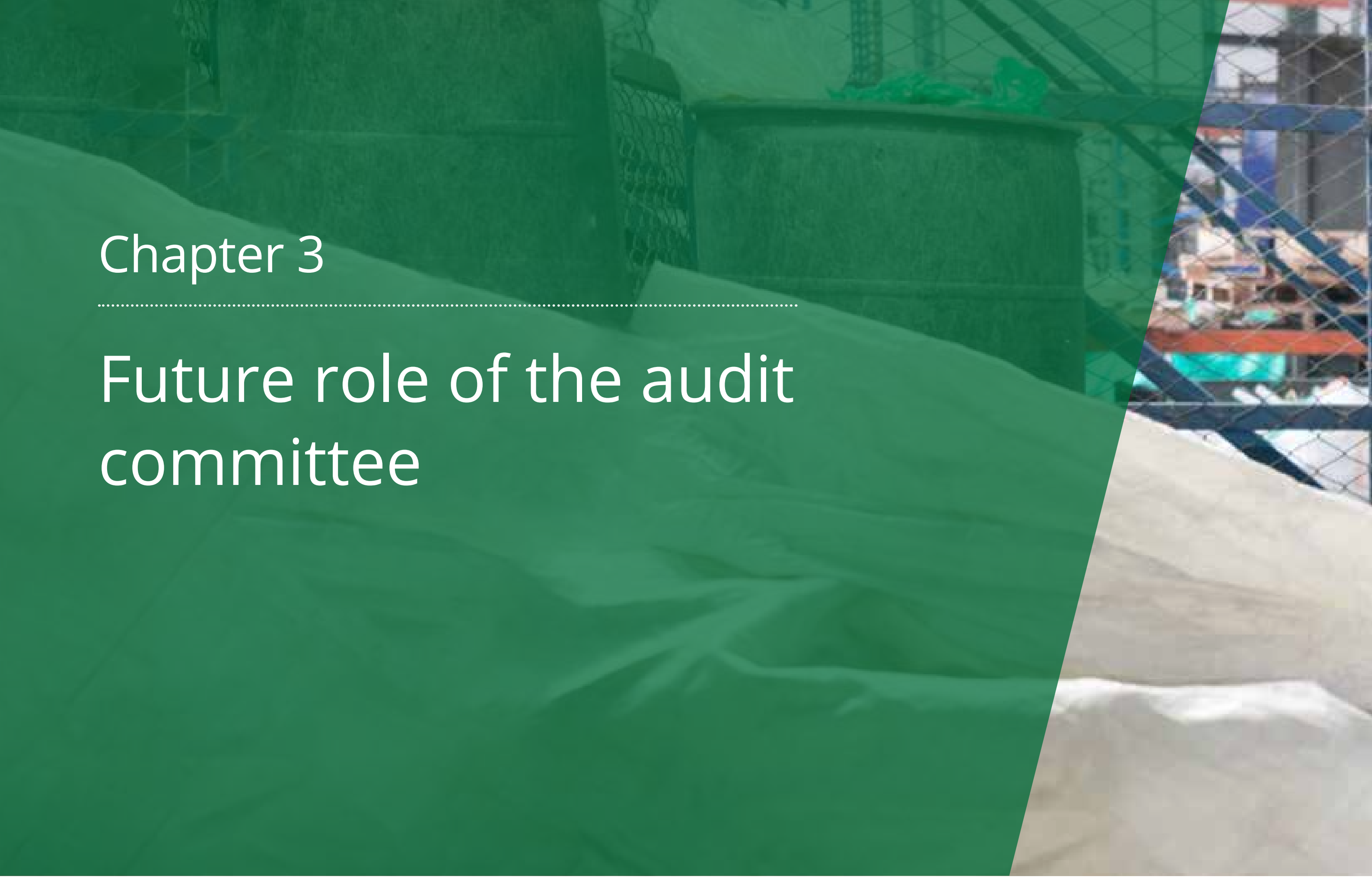
3

Oversight of external assurance

Increasingly, external third parties are being brought in to provide formal assurance of ESG reports. These external 'ESG auditors' may be the same as the company's statutory financial auditor, enabling alignment with financial reporting. Alternatively, they could be specialised consultancies or non-governmental organisations. Audit committees must be involved in choosing the company's external ESG auditor, and in ensuring its findings are integrated with those of the financial auditor.

While audit committees are already investing time in furthering sustainable corporate governance today, and often have significant responsibilities in this area, there is scope for their role to evolve further in future. This evolution will demand that they enhance their capabilities around ESG and devote more effort and time to ESG matters. As a result, audit chairs, in particular, could perform a much bigger and more challenging role.

[18] *Audit Committee Realities,* Tapestry Networks, 2020.



Chapter 3

Future role of the audit committee

In lively, interactive breakout sessions, participants at the workshop discussed how audit committees, in particular, could help drive the evolution to sustainable corporate governance in future. Since the audit committee is a subset of the main board, many of the findings were naturally applicable to the main board as well. Inevitably, since topics are interlinked, a number of common themes emerged during the breakout group discussions.

Some of the key themes included:

Stakeholder engagement

Sustainable corporate governance involves ensuring that a company provides value for its stakeholders over the long term. Nevertheless, it can be difficult for boards to know what this means in practice – often because they don't know who all their company's stakeholders are, and what expectations they have. As a result, there was a strong view among workshop participants that many boards can appear distant and disconnected to certain stakeholder groups.

A priority for boards is to identify the company's relevant stakeholders – and which they need to consider on a permanent basis – including customers, employers, investors, regulators and suppliers, as well as their local communities. They also need to recognise that different stakeholder groups are not homogenous within themselves – a wide range of views and interests can exist within each stakeholder group.

Boards should consider which channels they can use to strengthen stakeholder engagement. These might include dedicated bodies that represent specific groups of stakeholders to the board, such as stakeholder advisory committees.

The way in which boards engage with their investor stakeholders is likely to vary depending on the ownership structure of the business – whether it is owned more by institutional investors or by family members, for example. Yet with institutional investors, in particular, having a clear appetite for investing in sustainable assets, there is clearly merit in boards finding opportunities to deepen their engagement with investors around ESG issues. Ultimately, the full board needs to be involved and responsible for stakeholder engagement. Nevertheless, it might be helpful for the CEO and audit committee chair to meet with investors to deliver a social strategy and risk report.

Key reflections

- Boards should ask management to identify the company's relevant stakeholders and oversee that this has been done, recognising that there will be a divergence of views both within, and between, stakeholder groups.
- Dedicated bodies could represent specific stakeholder groups to the board.
- Boards should meet with employees below senior-management level to get a broad perspective of the organisation's pursuit of sustainability.
- The CEO and audit committee chair could meet with investors to deliver a social strategy and risk report on behalf of the board.

Risk oversight

To be truly resilient, companies should have a holistic view of all the financial and non-financial risks they face. Nevertheless, workshop participants felt strongly that many companies fail to give proper consideration to environmental and social issues during their strategic planning. For example, they may be ill prepared for the risks that climate change could inflict on their businesses – risks such as heavy flooding at manufacturing facilities, or stranded assets like decommissioned oil rigs. Or they could potentially incur large fines for non-compliance with environmental or human rights legislation.

Another significant risk facing companies is the possibility they produce inaccurate ESG reporting. This leaves them open to accusations of greenwashing, potentially leading to reputational damage and financial difficulties, especially if these accusations cause investors to take flight.

Historically audit committees have largely provided oversight around the financial risks facing their company, especially the risk of fraud and shortcomings in internal controls.

Going forward, however, stakeholders will increasingly demand that boards adopt a more holistic approach to risk, integrating financial and non-financial risks in their risk management strategy. It is likely that this holistic risk management oversight will be delegated to audit committees.

Audit committees could potentially oversee a single risk matrix that integrates medium- to long-term ESG risks with all other risks and aligns those risks against the stakeholder outcomes that are necessary for the business to execute its long-term strategy. To provide effective oversight of both financial and non-financial risks, the audit committee needs to have a deep knowledge of the business and its business model and know how to evaluate mitigation of these risks. It can acquire this knowledge by asking management to supply relevant information about the company's value chain and by visiting sites and talking to stakeholders.

Going forward, risk analysis should be better integrated with the timing of the strategic planning and budgeting process. Additionally, while audit committees are not information providers today, in future they could, on behalf of the board, use their reports as an opportunity to share insights into the long-term risks that the company faces, including sustainability risks.

Key reflections

- Currently, many companies do not sufficiently consider environmental and social issues during their strategic planning.
- Audit committees could potentially oversee a single risk matrix that integrates medium- to long-term ESG risks with all other risks.
- Risk analysis should be better integrated with the timing of the strategic planning and budgeting process.

Communication and reporting

Non-financial information pertaining to a company is more valuable if it is integrated with financial information. Today, however, the reporting of financial and non-financial information tends to be treated as separate activities, potentially undertaken by separate teams and with the information reported subjected to differing internal processes and levels of assurance. Non-financial and financial reporting need to be integrated, so that when a company announces its 'results', these results incorporate all types of value generated by the business.

If non-financial and financial reporting processes and results are integrated, then it makes sense that the board's oversight is supported by one committee, which is not necessarily happening in every company today. In the workshop, it was proposed that the audit committee's terms of reference could be amended to provide oversight of both financial and non-financial information.

Some participants suggested that it would be useful for the skills of the audit committee, when taken as a whole, to include ESG experience. This could be a legal requirement in the same way that, under European law, the audit committee of a public interest entity is required to have a least one member who is competent in accounting and/or auditing. Other participants took the view that an ESG requirement should not be mandated, however.

Data is crucial if audit committees are to provide effective oversight of both the financial and non-financial reporting processes. Committee members will need data to understand the key drivers of value creation within the business and what information should be reported. Audit committees should also challenge management around how the company is managing its ESG risks and how it is innovating to take advantage of ESG opportunities – for example, in the circular economy. They also need to know how to probe for evidence of greenwashing. This is especially important since the EU taxonomy could result in companies with a detrimental impact on the environment being viewed less favourably by their stakeholders, including investors.

External assurance – which could be provided by a statutory auditor, specialised consultancy or non-governmental organisation – is vital for providing verification to stakeholders, including investors, that any non-financial information reported by a company is accurate and robust. Since audit committees are already responsible for appointing their company's external financial auditor, and monitoring their work, it would make sense for them to also appoint and monitor the non-financial auditor. At present there is a challenge for auditors when it comes to providing assurance around non-financial information, however, since there is a lack of auditing standards in place.

A barrier to more effective communication and reporting around holistic value creation is the proliferation of frameworks that exist for reporting on non-financial information. Certain frameworks – such as Mandatory Greenhouse Gas Reporting and the Greenhouse Gas Protocol – focus on enabling large companies to adequately disclose their emissions and energy usage. Other frameworks have a broader sustainability remit, considering a range of important ESG issues. These include the Global Reporting Initiative guidelines, the standards set by the Sustainability Accounting Standards Board, and the recommendations of the Task Force on Climate-related Financial Disclosures.

While each framework is individual, the different frameworks share similarities and overlap with one another. So, it can be confusing for companies to know which one is most appropriate for their business. As a result, they may end up using none at all. Furthermore, many of the frameworks are burdensome and highly detailed, which acts as another barrier to uptake and also results in the provision of information that is not necessarily comparable or relevant to stakeholders.

Workshop participants were in widespread agreement that there is a strong need for a globally accepted set of standards for all forms of investor-focused reporting. While initiatives are underway to consolidate existing frameworks or to establish a single sustainability standard-setter, either in Europe or globally, we still appear to be some way off achieving this objective. In the meantime, investors will struggle to get accurate, consistent and comparable information about companies' ESG performance – which could soon start to impact on companies' ability to secure finance.

Key reflections

- Non-financial information is more valuable if it is integrated with financial information. A company's 'results' should incorporate all types of value generated by the business.
- Boards might consider whether to amend their audit committee's terms of reference to provide oversight of both financial and non-financial information.
- The audit committee should review their composition and assess their skills and experience regarding ESG matters.
- External assurance would provide verification to stakeholders, including investors, that any non-financial information reported by a company is accurate and robust.
- There is a strong need for a globally accepted set of standards for all forms of investor-focused reporting.

Legislation

EU legislation could help to further sustainable corporate governance by giving boards legal responsibilities to consider stakeholders' interests. If properly implemented, legislation would also help to foster a level playing field between companies. Workshop participants thought that if any rules were developed, they should be a set of common frameworks and principles.

Legislation could be used to embed important principles such as board diversity and transparency into corporate governance. This would help to improve company performance, raise standards of corporate governance and build trust between companies and their stakeholders. There could also be a requirement for audit committees to demonstrate knowledge of ESG matters and to monitor and communicate about their company's ESG performance. Boards, including audit committees, could be legally obliged to consult with stakeholders and consider their interests as part of their decision-making. They could then report on their stakeholders' views, with that reporting subject to external assurance.

Nevertheless, there was a divergence of opinion among participants as to whether the enactment of European hard law was even desirable at all. Some participants suggested that overly onerous sustainability requirements – for example, disproportionate expectations around directors' personal liability – could result in companies choosing not to list on stock exchanges or even existing public companies deciding to delist. Furthermore, ineffective legislation could affect EU companies' ability to compete with companies in other parts of the world.

Another concern was that regulation could be a heavy burden on certain SMEs, but it would not necessarily be appropriate to exempt all SMEs from sustainability-related rules. An alternative to comprehensive legislation might be to have a code of conduct that outlines directors' responsibilities in relation to ESG, supported by a minimum level of hard law.

Key reflections

- EU legislation could help to further sustainable corporate governance by giving boards legal responsibilities to consider stakeholders' interests.
- Legislation could be used to embed important principles such as board diversity and transparency into corporate governance. This would help to improve company performance, raise standards of corporate governance and build trust between companies and their stakeholders. Any rules developed should be a set of common frameworks and principles.
- Boards should be obliged to consult with stakeholders and consider their interests as part of their decision-making.
- Overly onerous sustainability requirements could result in companies choosing not to list on stock exchanges or existing public companies deciding to delist.

Chief value officers

To embed sustainability within its business, a company should have a robust, structured process for collecting, analysing and reporting on non-financial information. It should carefully select a range of appropriate and robust non-financial indicators to monitor over time, so that it can measure its progress against

these targets. Yet, in most organisations, there is no clear member of the executive team responsible for overseeing this process and for helping to ensure that sustainability is considered at every level of decision-making.

As the CFO already oversees a clear, structured process for producing and reporting financial information, their role could be expanded to provide oversight of non-financial information. This would mean they effectively oversee the entire value creation process. It might then make sense for the CFO to be repositioned as the chief value officer, working alongside the audit committee to communicate authentically around the full breadth of the company's value- creation activities.

The idea of a chief value officer, originally proposed by corporate governance expert Professor Mervyn King, is advocated in a thought leadership paper promoted by Accountancy Europe, *10 ideas to make corporate governance a driver of a sustainable economy*[19]. A chief value officer is responsible for ensuring that every aspect of a company's financial and non-financial value creation (and destruction) is accounted for and communicated to its board, management team and external stakeholders[20].

To date the concept of the chief value officer has not taken off. More common appointments are chief sustainability officers, who are responsible for integrating sustainability into the company's strategy and for monitoring the organisation's impact on the environment and society. Unlike a chief value officer, however, a chief sustainability officer does not have responsibility for measuring, and reporting on, financial value creation.

Where a company is pursuing a purpose- driven, sustainable long-term strategy, and wants to measure both financial and non-financial performance, then it could make sense for the CFO to evolve into the chief value officer. Nevertheless, it is not the sole responsibility of the CFO-turned chief value officer to ensure that sustainability considerations are integrated throughout the whole organisation. That critical responsibility belongs to the full board, as well as the CEO.

Key reflections

- A member of the executive team should be responsible for ensuring that the company has a robust, structured process for collecting, analysing and reporting on non-financial information.
- The CFO could be repositioned as the chief value officer, working alongside the audit committee to communicate authentically around the value creation process.
- Integrating sustainability considerations into the company's strategy and operations is the responsibility of the full board, as well as the CEO.

[19] *10 ideas to make corporate governance a driver of a sustainable economy*, Cogito Paper – Accountancy Europe, 2019.

[20] "From CFO to chief value officer", Delphine Gibassier, AB Magazine, https://abmagazine.accaglobal.com/global/articles/2020/ab-oct-2020/business/from-cfo-to-chief-value-officer.html, accessed 6 March 2021.

Remuneration

Boards should consider how they can incorporate quantitative climate-related key performance indicators (KPIs), such as carbon dioxide emissions reductions, into long-term incentive plans. Workshop participants emphasised the importance of setting ESG targets that are ambitious, yet realistic, so that executives are not rewarded for greenwashing, but for making real changes to the way the business operates. Participants' views were supported by EY research, which found that one of the most critical attributes of boards that demonstrate sustainable corporate governance is the establishment of management remuneration schemes that are linked to long-term value goals[21].

While the remuneration committee would continue to be responsible for setting executive remuneration, the audit committee can contribute by ensuring that both the financial and non-financial metrics on which the remuneration is based have been prepared properly and robustly and are as free as possible from manipulation. They can do this by overseeing the establishment of reliable systems and controls and by securing the provision of true and fair assurance over the results.

Key reflections

- Boards should incorporate ESG-related key performance indicators into long-term incentive plans.
- ESG targets should be ambitious, but realistic.
- Audit committees can work with the remuneration committee to ensure that executive remuneration is based on robust financial and non-financial metrics.

Tone at the top

Sustainability should be embedded into a company's purpose and strategy. This approach requires the board to focus on value creation more broadly. While sustainability features on board agendas today, it is often considered at a high level, meaning there is a need for more in-depth discussions on the issue. Workshop participants believed that board chairs have an opportunity to prioritise sustainability by taking greater control of the meeting agenda and preventing it from being occasionally dominated by the short-term concerns of the executive team.

The board is ultimately responsible for ensuring that the company sets the right tone at the top around sustainability. It needs to monitor whether management is communicating a clear vision, helping to break down silos that may obstruct progress, and ensuring that ESG is embedded in the company culture and considered within

[21] *Will there be a 'next' if corporate governance is focused on the 'now'? EY Long-Term Value and Corporate Governance Survey, February 2021*, EY, 2021.

Final reflection

While audit committees can play a very important role in driving the evolution of sustainable corporate governance, ESG matters should not be delegated to them entirely. Instead, workshop participants felt that sustainability should be pervasive in all board activities, and at every level of organisational decision-making – from budgeting and strategy, through to remuneration and risk management.

decision-making at every level of the organisation. Audit committees can play a specific role here by pushing for the right controls and processes to be put in place, reviewing policies and monitoring the development of culture.

Boards will be more effective at discharging their responsibilities in relation to ESG if they acquire relevant expertise in sustainability, by undertaking training and consulting with external experts. Education will help them to develop 'integrated thinking' – where they focus not just specifically on the E or even the S in ESG, but think holistically about human, social and environmental capital in addition to financial capital, and consider how ESG performance can be integrated into the strategy of the business. Integrated thinking is also about understanding how to make the connections between financial and non-financial performance.

It is essential that the board is independent and diverse in composition so that it avoids bias and groupthink, and effectively considers a broad range of risks – including ESG, financial and other risks. While diversity certainly relates to gender, it also relates to criteria such as age (youth and maturity), culture, geographical location, and professional background and expertise. It may be necessary for boards to increase their proportion of independent board members and to establish a self-assessment test since it is not always clear what the concept of independence means. Boards should look to recruit members who have experience, knowledge and skills relating to environmental, social and governance matters.

Ultimately, to be truly effective at driving value-led sustainability, boards need directors who can demonstrate personal courage. Understandably, individuals fear the consequences of encouraging their company to invest in expensive sustainability initiatives that may not end up delivering the expected financial returns.

Key reflections

- Value and sustainability should be embedded into a company's purpose and strategy.
- The board should focus on value creation rather than short-term financial results.
- Setting the right tone at the top is key – it is down to the board to ensure that ESG is embedded in the company culture and considered within decision-making at every level of the organisation.
- Audit committees can push for the right controls and processes, review policies, and monitor the development of culture.
- The board must be independent in viewpoint and diverse in composition.

Conclusion: an evolution in corporate governance

Companies have made progress in recent years with integrating sustainability into their strategies. Nevertheless, current climate modelling suggests that the planet will be between 3 and 4°C warmer than pre-industrial levels by 2100. This would make parts of the world virtually inhabitable, with coastal cities flooded, food security threatened, water scarcity exacerbated and people in many regions subjected to unbearable heatwaves[22].

The goal of the Paris Agreement was to keep the global warming increase this century to between 1.5 and 2°C above pre-industrial levels. Yet there are serious implications associated with global warming of even 1.5°C. In this scenario, around 14% of the world's population will be exposed to severe heatwaves at least once every five years, with that figure jumping to 37% if warming reaches 2°C[23].

It is clear that much more needs to be done if we are to address this urgent issue. In its *State of the Global Climate 2020* report, the World Meteorological Organisation highlights that stabilising the global mean temperature at 1.5 °C to 2 °C above pre-industrial levels by the end of this century "will require an ambitious reduction of greenhouse gas emissions, which must begin to occur during this decade"[24]. So, businesses will need to adapt their thinking of they are to be part of the solution when it comes to delivering on the objectives of the Paris Agreement, as well as achieving the United Nations' Sustainable Development Goals.

Boards and audit committees are increasingly aware of the imperative to embed ESG within company strategy – an imperative that is likely to become even stronger following this year's COP26 global climate change summit. Nevertheless, it is not necessarily clear to them how they can go about doing this in ways that will add value to their company in both the short and the long term. What's more, a company's sustainability-related risks and opportunities can vary considerably depending on the sector it belongs to, and the geographies where it operates. The reflections shared in this report should help companies to evolve their corporate governance in ways that make a positive difference.

Our workshop set out to establish how audit committees could play a role in furthering the transition to sustainable corporate governance. In this report, we have highlighted a number of ways in which boards and audit committees can integrate sustainability into their practices and strategy going forward. We hope that all those involved in the corporate governance ecosystem will consider the reflections in this report when they look to effect change as it is the entire system that needs to change, not just a single jigsaw piece like the audit committee.

The sustainability challenges we face today are so massive that they cannot be solved by any government individual, company or organisation acting alone. They have to be addressed through cooperation, innovation and an extraordinary collective effort. Only by working together will we succeed in transforming our economies so that the planet remains a place where we can live and do business.

[22] *"Series: Turn Down the Heat," World Bank website, https://www.worldbank.org/en/topic/climatechange/publication/turn-down-the-heat*, accessed 28 April 2021.

[23] "A Degree of Concern: Why Global Temperatures Matter," NASA, https://climate.nasa.gov/news/2865/a-degree-of-concern-why-global-temperatures-matter, accessed 28 April 2021.

[24] *State of the Global Climate 2020*, World Meteorological Organisation, 2021.

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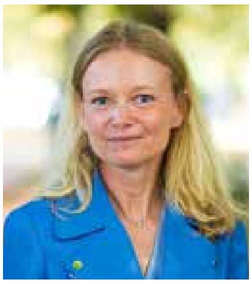

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