

Board Perspectives: Risk Oversight

The Relevance of Sustainability Performance to Board Risk Oversight

As if it's a double-edged sword, the pursuit of aggressive environmental, economic and social sustainability goals presents both opportunity and risk. Likewise, a minimalist approach to sustainability is not without risk. This uncertainty and the growing interest of investors in sustainability performance warrant the board's close attention.

As discussions of sustainability move beyond financial performance, they tend to spawn divergent views. Many frame the term as what constitutes responsible behavior in driving continued development and growth without deteriorating the environment, depleting natural resources, or creating conditions that destabilize the economy and vital social institutions. Still others prefer to embrace the traditional view of the corporation and remove external stakeholders, the environment and social considerations altogether to focus solely on the sustainability of the business and its profits.

The type of short-term thinking applied when formulating policy and the kind of long-term thinking that drives sustainability development discussions are like oil and water. In business, short-termism on the part of senior management is a sustainability killer. Without a long-term outlook in both the private and public sectors, the sustainability discussion is over before it begins.

Straight talk about sustainability leads to acknowledgment of several important realities:

- Sustainability performance without acceptable financial performance is untenable. The two must be integrated, and neither is a substitute for the other. Overreach in pursuing either preempts long-term progress.
- Many directors and senior executives believe it is inevitable and, of necessity, strategic. That said, some constituencies still believe that investments on the environmental, social and governance (ESG) fronts are incompatible with positive near-term returns.
- Reasonable people can differ in their views as to the appropriate sustainability objectives for a given organization, based on its industry, stakeholder interest and long-term outlook, as well as the time frame in which the entity should pursue those objectives (the so-called “time horizon disconnect”).

- Finally, a meaningful impact is only possible through the collective efforts of multiple entities in the private sector, sound policies in the public sector, cross-border global cooperation and investors committed to the sustainability agenda.

The time horizon disconnect drives a wedge in the dialogue as sustainability proponents want immediate action and an aggressive pursuit in implementing that action. Meanwhile, business leaders must deal with the reality of financial and resource constraints. And the strategy taken by investors in this age of sustainable development is challenging perceptions of the role of the corporation in society. Accordingly, the questions around sustainability — and how hard management should drive it as a goal — require serious reflection in the C-suite and boardroom.

Key Considerations

The concept of selective investing — ESG — offers a set of standards for a company’s operations that socially conscious investors use to evaluate investment alternatives. The criteria related to environmental issues examine how a company performs as a steward of the natural environment in which it operates. Social criteria examine how a company manages relationships with its employees, suppliers, customers and the communities where it operates. Governance deals with a company’s leadership, executive pay, control environment, assurance functions and shareholder rights. ESG is relevant to sustainability performance because it is influencing how asset managers and long-term investors evaluate investment portfolios.¹

As professionally managed funds deploying ESG factors to screen investments have increased assets under management into the trillions of dollars,² directors and executives have taken notice. Last year, Vanguard issued an open letter addressed to

directors of all public companies calling on U.S. companies to improve their governance practices and outlining factors that were increasingly important in its evaluation of such practices, including those related to diversity and climate issues.³ This year, BlackRock issued a letter to chief executives calling for a “positive contribution to society” beyond financial performance in realizing their organization’s full potential, with emphasis on “understand[ing] the societal impact of [their] business as well as the ways that broad, structural trends — from slow wage growth to rising automation to climate change — affect [its] potential for growth.”⁴ Over time, as these demands have increased, so have requests for increased transparency.

Governance — the “G” in “ESG” — has steadily emerged as a significant differentiator and, increasingly, a make-or-break factor for investors. Bad corporate behavior during the Enron era at the turn of this century, reckless risk-taking precipitating the 2007–2008 financial crisis, catastrophic cyber breaches, egregious violations of laws and regulations, and wanton disregard of safety considerations in addressing cost and schedule pressures have accentuated the importance of effective governance and the strong organizational culture it encourages. As important as these matters are, they’re mere table stakes. The focus on sustainability raises the bar further, with the BlackRock letter calling for a “new model for corporate governance.”

ESG criteria have evolved into an investment methodology that embraces sustainability factors as a means of identifying companies with superior business models, offering added insight into the quality of a company’s management, culture and risk profile. But there are other reasons why ESG is important. For example, younger generations place high importance on sustainability issues, so a focus on sustainability goals is essential to talent

¹ “Environmental, Social and Governance (ESG) Criteria,” Investopedia: www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.

² “The Results Are In: Sustainable, Responsible, Impact Investing by U.S. Asset Managers at All-Time High — \$8 Trillion!” by Hank Boerner, Governance & Accountability’s Sustainability Update blog, November 16, 2016: <http://ga-institute.com/Sustainability-Update/2016/11/16/the-results-are-in-sustainable-responsible-impact-investing-by-u-s-asset-managers-at-all-time-high-8-trillion/>.

³ “Vanguard Calls for More Diverse Corporate Boards, Better Climate-Change Disclosures,” by Ryan Vlastelica, *MarketWatch*, September 1, 2017: www.marketwatch.com/story/vanguard-calls-for-more-diverse-corporate-boards-better-climate-change-disclosures-2017-08-31.

⁴ “A Sense of Purpose,” Larry Fink’s Annual Letter to CEOs, January 16, 2018: www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

acquisition and retention. Indeed, a recent survey noted that 56 percent of public company directors believe that a corporate social responsibility policy increases a company's ability to attract and retain employees.⁵ Also, deploying cost-effective technologies to increase process efficiencies and develop environmentally friendly products and services has become attractive in many sectors. While there is a long road to travel, littered by brutal politics and more questions than answers, world opinion has nonetheless been coalescing around achieving the goal of sustainable development.

According to reports from both Glass Lewis and Ceres, more companies — utilities and industrials, in particular — have started linking ESG performance to executive compensation. While this linkage is most often focused on goals driven by compliance with laws and regulations, there are leaders who focus on other sustainability targets.⁶

Take the automotive industry. With demanding emissions standards surfacing all over the world and governments and regulators considering timelines that could eliminate gasoline-powered vehicles within a generation, General Motors (GM), Ford, Volkswagen, Daimler and Volvo are among the automakers committed to converting their lineup to all-electric and hybrid vehicles. For example, GM announced plans in the fourth quarter of 2017 to offer 20 new all-electric models by 2023, including two within the ensuing 18 months.⁷ The following day, Ford announced a plan to invest US\$4.5 billion over five years with the objective of adding 13 electric models to its offerings.⁸ These companies have signaled their commitment to drive increased usage and acceptance of electric vehicles, even though current sales of such vehicles along with plug-in hybrids amount to only 1 percent of the current market.

This accelerated pace of development is integrated with plans of building fleets of autonomous vehicles for ride-hailing services to achieve a world described by the GM chief executive as “zero crashes, zero emissions, and zero congestion.”⁹ To refer to this vision as a major departure from the status quo is an understatement. The current lack of a definitive time frame reflects the reality that no one really knows how this revolutionary future will evolve, including the regulatory environment and consumer tastes and demand.

The point is that sustainability is not just another trend or buzzword, nor is ESG another acronym soon to be forgotten. The world is changing as advanced technologies make feasible what was impossible a decade ago. Global population growth continues to explode, and changing demographics and resource scarcity affect operations.

With change comes more demanding expectations from investors seeking socially responsible behavior and increased oversight by executives and boards. As its nexus with financial performance increases, ESG performance sets a high bar for companies accountable for delivering acceptable returns to shareholders, requiring them to be more innovative, agile and strategic in their approach to integrating the two, leading to breakthroughs in process design and new products and services that offer global solutions and open new markets.

A company's commitment to sustainability and ESG issues might seem self-serving if it is pursued in the interests of the enterprise's long-term survival. That said, the real objective of sustainable development is to extend the life expectancy of ecosystems, societies and economies through collaboration with other organizations — for profit and not-for-profit, in the private and public sectors, and across borders on a

⁵ “The ROI of Corporate Social Responsibility,” by Melanie C. Nolen, Corporate Board Member, 2018: <https://boardmember.com/the-roi-of-corporate-social-responsibility/>.

⁶ “Why Most Companies Don't Link ESG Performance to Executive Pay,” by Jessica Lyons Hardcastle, *Environmental Leader*, January 29, 2016, www.environmentalleader.com/2016/01/why-most-companies-dont-link-esg-performance-to-executive-pay/.

⁷ “GM and Ford Lay Out Plans to Expand Electric Models,” by Bill Vlasic and Neal E. Boudette, *The New York Times*, October 2, 2017, www.nytimes.com/2017/10/02/business/general-motors-electric-cars.html.

⁸ “Ford Reveals Its Electrification Plans,” by Patrick Olsen, *Consumer Reports*, October 3, 2017, www.consumerreports.org/ford/ford-announces-electric-car-plans/.

⁹ “Zero Crashes, Zero Emissions, Zero Congestion,” by Mary Barra, chairman and CEO of General Motors, LinkedIn, October 3, 2017: www.linkedin.com/pulse/zero-crashes-emissions-congestion-mary-barra/.

global scale. That means sustaining natural resources, the cultures and communities that enable commercial activity, and the governance structures and financial and other markets essential for corporate competition and viability. The question is: What does the organization do about sustainability?¹⁰

Every organization needs to answer this question based on the nature of its industry, culture, markets, stakeholder priorities, regulatory environment, appetite to lead and invest, intrinsic challenges from an execution standpoint, and long-term outlook. With that in mind, below is an approach for management and directors to consider:

- **Articulate sustainability guiding principles and core values** — Clarify directionally what the company wants to accomplish from a sustainability standpoint to drive strategy-setting and internal and external communications.
- **Assess current ESG performance** — Identify areas where management sees the greatest opportunity for impact.
- **Conduct an assessment of opportunities and risks** — Considering the current ESG performance, assess the upside of taking steps to improve that performance against the risks associated with inaction.
- **Assess the organization's sustainability infrastructure** — Understand and evaluate the effectiveness of the current policies, processes, organizational structure, reporting, methodologies and systems supporting the pursuit of sustainability objectives.

- **Formulate a sustainability strategy** — Based on the guiding principles and core values and the assessment of opportunities, risks and current sustainability infrastructure, define a road map of key initiatives for accomplishing sustainability objectives. Formulate the strategy to execute the initiatives outlined in the road map.
- **Establish accountability for results** — Set targets, assign executive sponsorship, define initiative ownership and specify the appropriate performance metrics. Integrate ESG performance monitoring with financial and operational performance monitoring and the reward system.
- **Establish disclosure controls and procedures** — Establish the appropriate controls and procedures to ensure reliable internal and external ESG reporting.

A strong commitment to sustainability places an emphasis on actions, not words; on disruptive innovation, not “business as usual”; and, most importantly, on leadership, collaboration and transparency. Indifference to sustainability issues in business carries with it the risk of reputation damage, brand erosion, loss of talent, increased shareholder activism, business decline and, ultimately, business failure.

Likewise, everything else being equal, ESG criteria offer powerful differentiators for screening investments. Depending on the sector, they provide insight regarding opportunities for enhancing returns and the potential for increased future risk. Accordingly, they are worthy of attention in both the C-suite and boardroom.

Questions for Boards

Following are some suggested questions that boards of directors may want to consider, based on the risks inherent in the entity's operations:

- Does the organization have a clear long-term vision regarding sustainability? Is that vision responsive to investor and stakeholder expectations regarding socially responsible behavior for the industry?
- Is the board sufficiently engaged in developing the entity's long-term strategy and plan to create long-term value for shareholders? Is the board satisfied that its composition, diversity and structure reduce the risk of groupthink or missing opportunities for long-term growth or new threats to the company's business model?
- Does the company's sustainability reporting provide sufficient insight into its nonfinancial activities related to ESG matters? Is it sufficiently focused on the ESG criteria being used by investors and asset managers following the industry?

¹⁰ *The A to Z of Corporate Social Responsibility*, by Wayne Visser, Dirk Matten, Manfred Pohl and Nick Tolhurst, John Wiley & Sons, 2010, page 115.

How Protiviti Can Help

Protiviti assists boards with their assessment of the enterprise's risks and evaluation of the effectiveness of the entity's capabilities for managing those risks, either across the organization or at various operating units. The firm works closely with companies to

ascertain the most effective ways to integrate risk within their core management processes. The firm assists with both assessing and improving the enterprise risk management process, as well as implementing strategies, tactics and success measures for managing and reporting specific strategic, financial, operational, technological and other risks.

Is It Time for Your Board to Evaluate Its Risk Oversight Process?

The TBI Protiviti Board Risk Oversight Meter™ provides boards with an opportunity to refresh their risk oversight process to ensure it's focused sharply on the opportunities and risks that truly matter. Protiviti's commitment to facilitating continuous process improvement to enable companies to confidently face the future is why we collaborated with The Board Institute, Inc. (TBI) to offer the director community a flexible, cost-effective tool that assists boards in their periodic self-evaluation of the board's risk oversight and mirrors the way many directors prefer to conduct self-evaluations. Boards interested in using this evaluation tool should visit the TBI website at <http://theboardinstitute.com/board-risk-meter/>.

Learn more at
www.protiviti.com/boardriskoversightmeter

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