Lead Director Network

March 2021

LDN

SUMMARY of THEMES

Oversight of ESG and nonfinancial matters

The rise to prominence of environmental, social, and governance issues (ESG) has caused boards to assess how best to oversee these matters. Investors and other stakeholders are calling for both concrete actions and heightened disclosures on a range of nonfinancial topics, most notably those related to the environment and the workforce. Companies and boards are scrambling to respond, while also striving to clarify the link between ESG, financial performance, and long-term strategy.

During a February 25 virtual meeting, Lead Director Network (LDN) members were joined by Neil Stewart, director of corporate outreach for the Sustainability Accounting Standards Board (SASB), and Yumi Narita, executive director of corporate governance at the Office of the New York City Comptroller, for a discussion about ESG priorities and reporting. Members then participated in a separate dialogue about board oversight of ESG issues.

This *Summary of Themes* provides a brief overview of the meeting. *For a full list of meeting participants, please see page 5.*

Investors, employees, customers, and other stakeholders are driving companies to focus on sustainability

Companies are responding to the push to make their businesses more sustainable by making significant investments of money, time, and other resources. LDN members described a range of steps that some companies have taken, including the following:

- Elevating ESG issues on the board agenda and stepping up board education
- Adding environmental expertise to the criteria for evaluating board performance
- Creating a board-level committee to oversee ESG issues
- Identifying and empowering a senior executive to lead the company's sustainability efforts, in some cases reporting directly to the CEO
- Integrating sustainability into executive performance goals and objectives

Companies are enhancing their ESG reporting even as they wait for existing standards to converge or new standards to emerge

One member summed up the status of ESG reporting: *"The process by which companies interrogate themselves about each of these issues is growing more sophisticated and resulting in robust reporting. We will do it in the same way we prepare financial reports—with a process set up, lots of people involved, and significant investment, both internally and externally."* But companies and boards face significant challenges in making ESG disclosures meaningful and robust. Another member said, *"We want to do the right thing, and we're making investments, but we're trying to figure out what's a good, consistent, objective way to communicate and to put controls and discipline around it."*

Mr. Stewart explained to members how SASB—an independent non-profit organization that sets sustainability disclosure standards—established a reporting framework to meet investors' need for data that is *"consistent over time, comparable, and reliable."* He said, *"Data needs to focus on financial materiality—what matters to financial and operational performance, the balance sheet, and cost of capital."* Ms. Narita pointed out that investors, including portfolio managers making buy and sell decisions, are increasingly incorporating nonfinancial data into their decision-making. She cautioned that absent robust disclosure, investors turn to alternative sources to obtain data about companies: *"They use any data they can get hands on. It is their job to find any scrap of data that will help them assess a particular company."*

One key to effective disclosures is to present meaningful data in a digestible format; this often requires aligning the disclosures with one or more well-established reporting standard. It is also important to establish the audience for a company's ESG disclosures. Mr. Stewart said that SASB's framework, although primarily aimed at investors, can be useful to boards and senior managers too: *"The process can be a real tool to identify risk and align the business with sustainability goals. It's not just about disclosure but also about connecting these issues to strategy and risk management."*

Members raised two challenges for companies seeking to enhance ESG disclosures:

- **ESG metrics are hard to compare across companies.** One director noted that the relevance of different metrics varies from company to company: *"How do you connect what an investor might think are factors that matter and what a company might think are factors that matter, when you have very different business models for companies that look similar, but are very different?"* Mr. Stewart acknowledged this challenge, noting that SASB's standards *"focus on industry-specific sets of topics and metrics."* Each industry standard, he continued, *"distills a subset of topics and metrics that are likely to be material in a given industry, but it's still up to each company to do its own materiality assessment."*

- **All the different standards and frameworks can lead to confusion.** The multiplicity of reporting frameworks also presents reporting challenges for companies. One member said, *"With the alphabet soup of ESG standard setters, we are interested in convergence—where that stands and where it might go."* Mr. Stewart explained that there is significant momentum toward convergence of ESG standards, with investors, standard-setting bodies, and regulators pushing for standardization and harmonization.

Third-party audits are not yet the norm but are becoming more common

As ESG reporting becomes more quantitative and the link between ESG and financial performance becomes clearer, LDN members are interested in how boards—and, by extension, investors and other stakeholders—can gain comfort about the accuracy and quality of the data. Mr. Stewart told members, *"If this information is to be investor grade, it should have the same system of governance, internal controls, and management and board oversight as what is used for financial reporting. That implies assurance, though no one demands it yet."* Ms. Narita said that assurance remains a secondary concern for the investor community: *"Right now, we just want the data. Assurance is still a long way down the line. Investors have to trust that companies are disclosing information that is valid. We don't want assurance to be a stumbling block to reporting."* Nevertheless, there is a clear trend toward greater assurance. Mr. Stewart noted that companies that report using SASB standards are increasingly seeking third-party attestation: 42% of such publications were externally verified, up from under a third in 2019.

The COVID-19 pandemic and Black Lives Matter movement have raised the profile of human-capital disclosures

Ms. Narita emphasized that for the Office of the New York City Comptroller and its pension holders, workforce diversity issues have taken on added importance in the wake of the protests for racial justice that emerged in 2020. *"Hopefully we can come to better disclosures around human-capital management,"* she said. *"So far, we've talked a lot, but there is not much good, quantifiable data."* To get better data, the comptroller's office has launched an initiative requesting that companies disclose the workforce demographic data they report to the government. *"You've made these statements about inclusivity, but what's important is that you ensure diversity and inclusion in your company. So please disclose your EEO-1 [equal employment opportunity] reports so we get a sense of the demographics within your organization."*

LDN members said that diversity and inclusion can be a value driver for companies. One emphasized the business impact of a company's sustained emphasis on diversity and inclusion: *"The results in financial performance have been remarkable. People have been inspired."* Other members noted that their companies have set diversity goals in areas like employee recruitment, retention, and development while also doing more to assess engagement and the employee experience, particularly for racial and ethnic minorities.

Climate risk is emerging as the next big governance challenge

Mr. Stewart emphasized that climate risk affects all companies and responding to climate change goes beyond reducing greenhouse gas emissions. He said that investors are asking for companies to demonstrate *"their plan for how their business model is compatible with the transition to a low-carbon economy."* He added that, more and more, investors expect the board to have *"sufficient fluency in climate risk"* to be able to assess the company's strategy, plans, and targets. While some stakeholders would like to see board members with specialized environmental expertise, LDN members emphasized that it is more important for directors to bring the ability to make judgements even where they are not experts. In addition, they pointed out that, especially on ESG issues, directors often have skills or experience derived from personal experience or interests.

Boards are examining new ways to incorporate nonfinancial goals into pay plans

Several members said that their boards had begun to incorporate ESG targets and metrics into executive compensation plans, but doing so is not straightforward. One member, noting that major shareholders had been asking whether ESG was factored into compensation, asked, *"When will a company feel comfortable enough on ESG to make it a significant part of pay, not just on the upside but also on the downside? How do you get a comfort level with the measurements you have?"*

Another director suggested that questions of urgency and maturity influence a board's decision to pay for ESG-related performance, particularly diversity and inclusion. For some companies it represents a *"burning platform"* issue that requires action, and tying compensation to diversity goals sends a loud signal. For other companies that have placed a longstanding emphasis on diversity, there may also be an opportunity to measure these efforts and incorporate them into pay decisions. However, for companies just beginning the journey to improve diversity and inclusion, *"it's hard to start with pay."*

Meeting participants

The following Lead Director Network members participated in the meeting:

Alan Bennett , Lead Director, Fluor and TJX

Don Cornwell, Former Lead Director, Avon

Paulett Eberhart, Former Lead Director, Anadarko

Donald Felsinger, Lead Director, Archer Daniels Midland and Northrop Grumman

Alexis Herman, Lead Director, Cummins

Mel Lagomasino, Lead Director, Coca-Cola

Jay Morse, Lead Director, AES

Bob Murley, Non-Executive Chair, Stericycle

Henry Nasella, Lead Director, PVH

Chuck Noski, Non-Executive Chair, Wells Fargo; Lead Director, Bookings Holdings

Craig Omtvedt, Former Non-Executive Chair, Oshkosh Corporation

Pam Reeve, Independent Chair, American Tower

Chris Thompson, Lead Director, Jacobs Engineering Group