TIME FOR SUSTAINABILITY TO BE AT THE HEART OF BUSINESS

1. INTRODUCTION

ecoDa, the European Voice of Directors, and Mazars, the international audit and advisory firm, held a series of roundtables in late 2019 and early 2020 across a range of key European capital markets. They brought leading directors and investors together to discuss how they can have an effective dialogue, based on a mutual commitment to promoting sustainable success for the benefit of their stakeholders and wider society. The roundtables were organised in co-operation with EFAMA, the representative body of the European investment management industry in Belgium, France, Germany, Italy, the Netherlands, and the UK. ecoDa and Mazars would like to thank Guberna and FEB (Belgium), IFA (Institut Français des Administrateurs - France), AdAR (German Supervisory Board Association); Nedcommunity and Borsa Italiana (Italy); NCD-Nederlandse Vereniging van Commissarissen Directeuren (Netherlands) and the IoD-Institute of Directors (UK) for their contribution to their respective national roundtables and to the AAI – Independent Directors Association in Romania for their cooperation with a survey on Romanian listed companies' compliance with the recommendations of the local BVB Corporate Governance Code.

This publication draws on the discussion at the various roundtables to highlight the progress made by the European business community on the adoption of a sustainable approach to business and the current challenges faced and, having regard to these, maps out a direction for reform.

2. PROGRESS MADE ON ADOPTION OF A SUSTAINABLE APPROACH TO BUSINESS

Many companies are actively integrating sustainability principles into their businesses, and they are doing so by pursuing goals that go beyond marketing and reputation management. Examples of this include, saving energy, developing green products, and retaining and motivating employees.

There is now much more support for adopting a sustainable approach to business by boards of directors and increased reporting on the issue. This has partly been fostered by compliance with regulation and legislation to reduce negative impacts and promoting transparent reporting on the topic. In the European Union the Non-Financial Reporting Directive has enhanced disclosure albeit with a number of questions around its relevance, comparability and reliability.

But companies are also largely responding to pressures from the proponents of sustainability - which include investors, consumers, regulators, non-governmental organizations ("NGOs"), and others - who demand that companies think more broadly about how they do business and about the impacts their operations and decisions have on the environment and society.

There is a widely held belief that by addressing a range of non-financial factors, from climate change to demographic trends and product labeling, businesses can create long-term shareholder value while preserving natural resources, enhancing social stability, and achieving other quantifiable benefits.

Some industries are also taking a more active approach, presumably as a result of their potential regulatory and natural-resource constraints.

Some examples of this include the following:

> **Energy:** there is a move towards renewable energy whilst recognising growing global energy demand.

> **Car industry:** the development of electric vehicles is being accelerated in order to lower emissions.

> **Air transport:** aircraft manufacturers are seeking to produce planes with lower carbon emission.

> **Fashion:** the Fashion Pact agreed in 2019 brings together a sectoral coalition of private sector companies with a commitment to sustainability.

Overall, however, the degree of attention paid to sustainability by different boards and investors was felt by the roundtables to be variable, with many of them still primarily focused on short-term financial performance and using sustainability as a marketing/publicity tool.

3. CHALLENGES IN MOVING TOWARDS A WHOLEHEARTED COMMITMENT TO SUSTAINABILITY BY BUSINESS

The following are currently among the principal interlocking challenges faced in moving towards a wholehearted commitment to sustainability across the business community in Europe:

The lack of a definition of sustainability and of an international agreed common framework

There is no generally agreed definition of sustainability, which leads to differences of view as to its scope and a tendency to define it in regulation by reference to what it is not. One of the causes for this being the various reporting standards and frameworks, which have evolved in response to calls for more reporting, such as the Global Reporting Initiative ("GRI"), Sustainability Accounting Standards Board ("SASB"),Task Force on Climate-Related Financial Disclosures ("TCFD"), and the International Integrated Reporting Framework ("<IR> Framework"). These multiple frameworks must not undermine the importance of the company level. In this regard, collective action as well as the dialogue between directors and shareholders should be enhanced to agree on a consensual corporate definition of what sustainability means.

Tick-box compliance exercise rather than deeply embedded in the business

For too many businesses, the focus on sustainability is still too often seen as primarily a box-ticking compliance exercise rather than about deeply embedding considerations of sustainability across all aspects of the business. Reporting under relevant legislation is seen as the end destination and not an ongoing journey to secure the long-term success of the business. In line with this approach, it is furthermore often seen as being primarily about managing potentially negative risks rather than also exploring opportunities.

Separate from, and not integrated with, core financial aspects of the business

Linked to the above, sustainability is too often viewed as separate from, as opposed to being fully integrated with, the core strategy of the business. This, in turn, tends to entail a failure to recognize that even if not occurring immediately, in some instances a failure to take sustainability issues adequately into account may have deeply negative financial consequences for the business over time, possibly even threatening its survival. Instead they are too often seen as just one aspect of the marketing and

communications or public relations functions, or as matters only concerning a separate department without direct board representation.

Board's attention often still on short term financial results

In businesses where sustainability is seen as separate from the core strategy, the board's emphasis tends to be on short-term financial performance, leaving sustainability considerations without much attention at the board level. In such circumstances, performance related to sustainability factors is unlikely to be seriously linked to the remuneration of the executive leadership team resulting in little discussion of relevant KPIs. In such cases, the board may not have significant knowledge of sustainability matters and may more generally be prone to 'group think' or be reluctant to challenge long-held views.

Poor quality reporting on sustainability

Whilst there are notable exceptions, there is in too many instances a lack of quality and reliability, consistency and comparability in reporting on sustainability. Rhetoric triumphs over action with too much 'greenwashing' and a bias towards selective good news stories. Many sustainability reports are very long without providing a fair, balanced and meaningful review of the overall performance of the business across all relevant dimensions. Businesses report in line with a variety of different frameworks and standards, leading to a lack of comparability of information between businesses. Often, there is also a lack of consistency over time in disclosures by the same business. Furthermore, the gathering of information is often not subject to the same level of controls as for financial reporting, and the remit of internal audit teams may not extend to sustainability issues. Similarly, unlike the financial statements, there is generally no external assurance on sustainability disclosures, and often when this does take place it is very limited as to the scope of disclosures covered and the nature of assurance offered.

Inadequate commitment and engagement by some institutional fund managers

Where institutional investors don't take an integrated approach to sustainability, the responsibility for leading the relationship on these matters with businesses they invest in, often lies with the head of governance. On the other hand the principal focus of the fund manager in such cases is mostly on short-term earnings, which encourages a similar approach by boards in investee companies. With a substantial move towards passive investment and index-tracking in recent years, many institutional investors have very limited time and resources for engagement with investee companies, and where this occurs it is often focused on directors' remuneration.

The absence of agreed benchmarks for measuring performance

With the lack of a broadly accepted sustainability assessment framework there is also often a disparate approach amongst investors to the issue with each submitting their own questionnaire, focused on particular areas of interest, and rankings used to assess performance sometimes based more on perceptions of performance related to profile on topical issues than underlying sustainability performance. *The Economist (1)*, for example, having compared the rating scores of two big ESG systems, found that there was at best a 'loose link' between their respective approaches to measurement. This is hardly surprising given the relative lack of reliable published information as well as the absence of agreement on what is important. It is, however, a growing problem given that ESG scores are gaining in significance with at least $3trn worth of institutional assets now tracking ESG scores, a sum which is rising quickly.

Investor focus is primarily on bottom line results

Investors have traditionally focused on future net cash flows. Sustainability and the impact of a business operation on the environment and society are neither easily nor directly translated into the bottom line of results.

This is particularly relevant when companies start transitioning to more sustainable ways of doing business. This transition is likely to reduce profits for a period in order to secure better average long-run profits. The time needed will vary according to sector and for companies within sectors depending on their current position. This transition will require the appropriate consideration in investors' decision-making processes.

4. TIME FOR A STEP CHANGE TO PUT SUSTAINABILITY AT THE HEART OF BUSINESS

The following are among the principal changes needed in order to address the challenges identified in Section 3 above:

Agreed definition of sustainability

It should be clear that sustainability focuses on the long-term success of the business from a stakeholders' perspective that is broader than just having regard to returns to shareholders and that it must consider environmental, social and governance ("ESG") factors in addition to the financial aspects. There should be a more thorough discussion between the Board and shareholders/investors about the purpose and long-term objectives of the company to reach a common understanding of the expectations. Shareholders and board members have to be aligned when it comes to the corporate purpose.

Fully embedded within the business, its strategy and systems of controls

Sustainability needs to be fully embedded within the business and to form an integrated part of its core strategy rather than being seen as separate from it or supplementary to it. If this is the case, there should be appropriate control systems in place in relation to sustainability, including with regard to the gathering of information in the same way as for financial information. In addition, risks, KPIs and reward systems should consider all relevant aspects of sustainability. In determining the issues for attention, regard should also be had to the UN's Sustainability Development Goals ("SDGs").

Informed board with sustainability fully on its agenda

As an integral and vitally important aspect of their business, boards should ensure that both their non-executive and executive directors have the relevant knowledge and experience of sustainability issues and interest in them. They also need to ensure sustainability is fully on their agenda and carefully considered, and that they have the appropriate means for ensuring that this is so. This will involve considering the most appropriate board structure and the roles represented on the board to achieve these goals. Boards may decide to have one or more of a Chief Sustainability Officer, a board committee on sustainability, an independent director with specific responsibility related to it or an advisory group of independent experts on the topic. All those options can be considered as a start but ultimately sustainability has to be a whole-board responsibility. Boards should also invest appropriate time in training and development on sustainability issues. For instance, we already see national corporate governance codes evolving and covering directors' duties in relation to sustainability. This trend as well as new initiatives need to be developed. Recently, corporate governance codes have shown that they can respond quicker than legislative initiatives to new concerns. New initiatives have been taken to emphasize a multi-objective duty for board members. In addition, reports like the recent FRC Financial Reporting Lab report and AFEP-MEDEF reports incentivize best practices through market pressure.

A single integrated corporate reporting framework

There should be a single widely accepted integrated corporate reporting framework with supporting standards for listed companies and other public interest entities across the EU and with national authorities encouraged to develop appropriate requirements for other entities. The framework should ideally embrace all aspects of reporting, both financial and wider aspects including those related to sustainability, non-financial information, or, if this is not achievable, it should be fully compatible with and linked to that for financial reporting. This framework should require businesses to report on all salient sustainability issues arising from their business and how they are being addressed.

Assurance on integrated reports

Integrated reports could usefully be subject to assurance including on sustainability-related disclosures. This is likely to require further development of standards on assurance and consideration of how best to ensure auditors and other assurance providers have the necessary knowledge and expertise on relevant matters related to sustainability.

A fully integrated approach to sustainability with investment decisions

To enable investors to embed sustainability in their decision-making processes they need to have the right skills and approach. This implies a review in education in the formation period but also highlights the need for evolution of the triple bottom line concept enabling a more complete cost benefit analysis of a company's outputs and outcomes.

Institutional and other investors to have full commitment to sustainability

Institutional investors need to ensure that they are in practice offering full support to sustainability and that this is true in particular for their fund managers, whether in-house or external. To achieve this in practice, Trustees have an important role to play in how they assess their fund managers' performance and in their recognizing they will need to accept businesses in which they are invested may have lower returns during their transition period to full sustainability. There is also a need for institutional investors to review their approach to engagement and whether enough time is spent on that related to sustainability and whether by more collective action they could achieve a better result though this may require some regulatory changes. In that sense, the Investor Forum established in the UK following the findings of the Kay Review of UK equity markets and long-term decision-making is a good example to establish collective engagements by investors in companies. It also means boards do not become overwhelmed by similar requests from multiple investors. Boards have to be open on their long-term strategy to facilitate investors' engagement.

In addition to institutional investors, there should also be a full commitment to sustainability by other major investors such as family groups, foundations, industrial groups with investments in other businesses and the state where it owns other shareholdings in businesses.

5. CONCLUDING REMARKS- A TIME FOR ACTION

Securing the necessary changes will require all key stakeholders, including boards; executive and non-executive directors; employees and their representatives; investors; NGOs; auditors and other assurance providers; customers; and governments, regulators and standard-setters to work together. No 'silver bullet' exists. As identified, a range of measures will be needed to bring about the necessary change.

Businesses should be encouraged to take advantage of the current environment of low interest rates and make necessary investments to tackle climate change and human rights issues, enabling them to become more sustainable.

At this time of profound change in the wake of COVID-19, we believe it is time for a step change to put sustainability at the heart of business. Whilst the areas for action, above, arose from the roundtables, we believe in the new circumstances now prevailing, that their implementation is more important and relevant than ever for the long-term success of business and wider society.

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