June 2023

Corporate governance of ESG issues: Guide for the members of the Board of Directors

Boards of Directors can lead the way on ESG-agenda implementation. Recommendations for practical applications

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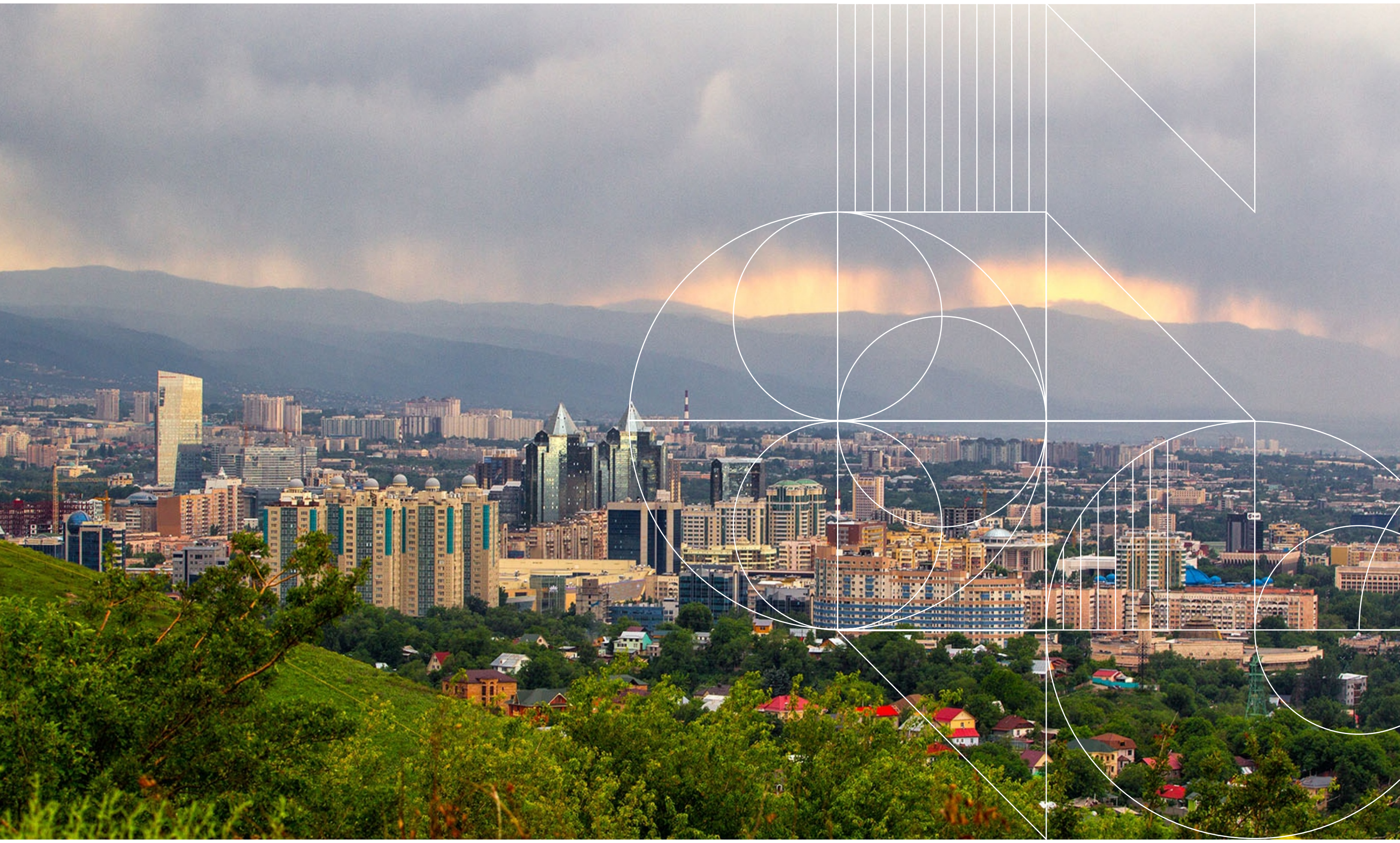
Introduction

For some, the term ESG (environmental, social, and governance) still conjures notions of issues not linked to the financial performance of the company.
But given the heightened focus from a variety of stakeholders (including regulators) today and the growing understanding of its impact on performance, ESG is a critical topic as part of the meetings of the Board of Directors.

Directors have a responsibility to oversee company risk, ensuring material risks are identified, assessed, and mitigated. This includes ESG risks.
The Boards also plays a role in challenging management to think creatively about strategic alternatives and opportunities—including around ESG topics.

Management teams need a strategic plan that takes advantage of market opportunities and addresses material risks. In its oversight role, the Board is responsible for ensuring that the company's strategy is appropriate, takes account of material risks, and is likely to deliver results.
Because ESG is grounded in risks and opportunities, the ESG lens is often a more comprehensive way of packaging existing work and analysis.



Understanding the board's role in overseeing ESG

Companies that embed ESG into their strategy are better-positioned for success. They can spot growth potential in identifying and managing ESG issues. They can also shape the narrative around their brand and practices while expanding their investor base. So, as companies are starting to think about telling their ESG story and integrating it into their strategy, it's important to think through the "how" of implementation. This includes forming messaging, evaluating frameworks, and crafting disclosures.

If the company is already providing ESG metrics in a variety of places (such as on its corporate website or in social responsibility reports), directors may be well served to step back and consider the existing governance structures and if the messaging is clear and consistent across channels. Is it tied to the company's purpose and aligned with the business strategy? Does it focus on stakeholder needs and address material risks?

Purpose and strategy

A company's purpose needs to be aligned to the overall business strategy— how the company will achieve returns year after year. As companies attempt to serve a diverse group of stakeholders, including investors, employees, customers, suppliers, and communities, it shouldn't come as a surprise that many struggle to balance all those interests. To this end, the Board of Directors and management should combine efforts to identify important aspects and evaluate progress.

The company should ensure that its purpose is reflected through its messaging and activities. And as part of its oversight role, it's up to the Board of Directors to make sure these things all tie together.

Key considerations for the Board of Directors:

- Has the company clearly articulated a purpose that considers key stakeholder needs and aligns with business strategy?
- Has the company considered how its purpose compares to that articulated by its competitors?
- Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?

Risks

A key part of the Board of Directors' oversight is taking a broad view of risk, and that may be harder in areas where management has less direct engagement because they may have less experience thinking of ESG topics. However, environmental and social factors heavily influence some of the thorniest business challenges companies must overcome. These include workforce dynamics, innovations, new technologies, supply chain disruptions owing to natural disruptions, and increasing ESG regulation.

The scope of identified risks is expanding and as companies improve how they assess ESG risks, the ERM process often needs to change as well.
As a result, management will have a structured framework to use to manage and mitigate those impacts.

Key considerations for the Board of Directors:

- Does the company's existing risk processes include identification of any ESG risks? Would expanding the risk identification process lead to a broader scope of risks to be captured?
- Does the ERM process include assessment and mitigation plans for all ESG risks that have been identified?
- How does management prioritize ESG risks and opportunities? Are these ESG risks and opportunities included in capital allocation decisions?

Disclosures

Stakeholders need a comprehensive, cohesive story when it comes to ESG. Qualitative ESG messaging should reinforce the company's purpose statement, while quantitative metrics bring that purpose to life and help companies measure their progress toward goals, and communicate it to stakeholders. These ESG metrics also help investors compare companies across industries and set milestones along the way to long-term goals.

In international best practice, Boards of Directors are also concerned with how to ensure the reliability of the information disclosed. This particularly includes understanding the internal controls in place for both the assessment of qualitative information reliability and quantitative metrics. And when choosing to adopt a framework or standard that incorporates specific metrics, that consideration is given to the feasibility of meeting the provisions of the chosen reporting standards.

Reliability of ESG information

Once the company has settled on the qualitative and quantitative messaging it will disclose, the Board of Directors should increase the focus on embedding the internal control system, ensuring the quality information disclosed since the investors and regulators will be using this information to analyze the company's reliability and make investment decisions.

This process starts with assessing the policies and procedures that are in place. The Board of Directors needs to understand the system of internal controls over ESG disclosures. Determining that the right controls are in place to ensure consistency and accuracy of reporting is paramount. The Board of Directors may also want to consider stakeholder expectations for whether the company should consider obtaining some type of assurance over the ESG information disclosed.

Key considerations for the Board of Directors:

- Does the company have robust procedures to ensure the development of its disclosures?
- Do the company's disclosures adhere to the requirements of particular reporting standards? Are disclosures meeting investor expectations?
- Has management found any gaps in the internal controls system, which makes it difficult to ensure the completeness and accuracy of the disclosures? If so, how do they plan on mitigating those gaps? What is the role of the disclosure committee in the process?
- Would stakeholders be confident with the accuracy of the disclosure without independent assurance? Could independent assurance serve as a differentiating factor among peers?

Using compensation as an incentive mechanism

Many investors are focused on the connection between ESG goals and executive compensation. By tying incentive plan metrics explicitly to the company's ESG strategy, the Board of Directors is not only encouraging the achievement of those ESG goals, it is also signaling the importance of those issues. A growing number of investors are asking companies to link the two. In this regard, a number of large companies have already taken the appropriate measures.

As Boards of Directors work to integrate ESG concerns into discussions of company strategy, many are also considering how to create the right incentives for achievement of ESG-related goals. Incentive plans have long been driven primarily by traditional financial goals. That often means quantitative goals related to indicators like revenue, cash flow, units sold, EBITDA, earnings per share, or total shareholder return. But at many companies globally, a shift is underway as ESG goals become more common.

Key considerations for the Board of Directors:

- How does the company's compensation practices benchmark against peers as it relates to tying ESG to executive compensation? Do peer companies use ESG metrics, and if yes, what metrics do they use?
- Which goals are important for the company? What are the interim and long-term goals? And therefore, which metrics make sense for the company to use?

Allocation of responsibilities to oversight ESG issues

Because ESG strategy should align with business strategy and focus on material risks and business factors, the full Board of Directors will want to understand how those risks and opportunities are being addressed. The Board of Directors will also be interested in how management is using ESG to differentiate the company in the market. If this is a new area of focus for the Board of Directors and the company, directors may need to assign detailed oversight to specific committees to help the ESG strategy launch smoothly. Ultimately, though, ESG issues will be relevant to all committees.

Equally important to the Board of Directors' oversight structure is how the Board of Directors and management will interact and where accountability lies within the management team. According to PwC's Global Investor Survey 2022, 66% of investors say that they are more confident that companies are on top of ESG risks and opportunities when someone in the executive management is accountable. But the scope of ESG topics is quite extensive and does not lend itself to a single reporting line. This makes it more important for the Board of Directors and management to articulate how ownership and accountability is established inside the company. Once they are identified, the Board of Directors will engage regularly with individuals responsible for developing and executing the ESG strategy.

Key considerations for the Board of Directors:

- Do we have a committee with the capacity, interest, and skills to take the lead on overseeing the company's overall ESG efforts? If not, will the full Board of Directors take on this responsibility? Or should we create a new committee or hire directors to fill a qualifications gap?

- How will the committees stay aligned on addressing ESG issues? Have the Board of Directors' charters and regulations been updated to clearly communicate that the Board of Directors and the committees are responsible for ESG issues oversight?

The Board of Directors and Committees:

Oversee:

- **Strategy:** Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?
- **Messaging:** Do ESG messaging and activities align with the company's purpose and stakeholder interests?
- R**isk assessment:** Have material ESG risks been identified and accounted for in the ERM system? Has the Board of Directors allocated the oversight of these risks to the full Board of Directors or individual committees?
- **Reporting:** What is the best communication platform to use for the company's ESG disclosures?

Audit committee

Oversee:

- **Disclosures:** Are the ESG disclosures (both qualitative and quantitative) intended for various grades of invetors? Which ESG frameworks and/ or standards are the company using?
- **Processes and controls:** Are there processes and controls in place to ensure ESG disclosures are accurate, comparable, and consistent?
- **Assurance:** Should independent assurance be obtained to ensure ESG disclosures are reliable?

Compensation committee

Oversee:

- **Accountability:** Are the ESG goals and milestones effectively linked to executive compensation plans?
- **Talent and culture:** How is management organized to execute the ESG strategy? A re the right people and processes in place? Does the company have a culture that embraces ESG efforts?

Nomination and Corporate governance committee

Oversee:

- **Engagement:** Is the company's ESG story being effectively communicated to investors and other stakeholders?
- **Board composition:** Does the Board of Directors have the necessary expertise and skills to oversee ESG risks and opportunities?
- **Education:** Does the Board of Directors understand why ESG is important to investors and other stakeholders? Are the members of the Board of Directors appropriately educated on ESG?

Making time for ESG issues on the Board of Directors' agenda

Given the demands and expectations for Board of Directors involvement in ESG oversight, it's important to create the right cadence. The Board of Directors needs to regularly hear from management on ESG strategy, reporting progress against goals, and challenges that have arisen. By taking a considered approach to spreading responsibilities across the full Board of Directors and appropriate committees, and setting expectations for management reporting, the Board of Directors can ensure ESG topics receive the attention they need without putting undue pressure on their time.

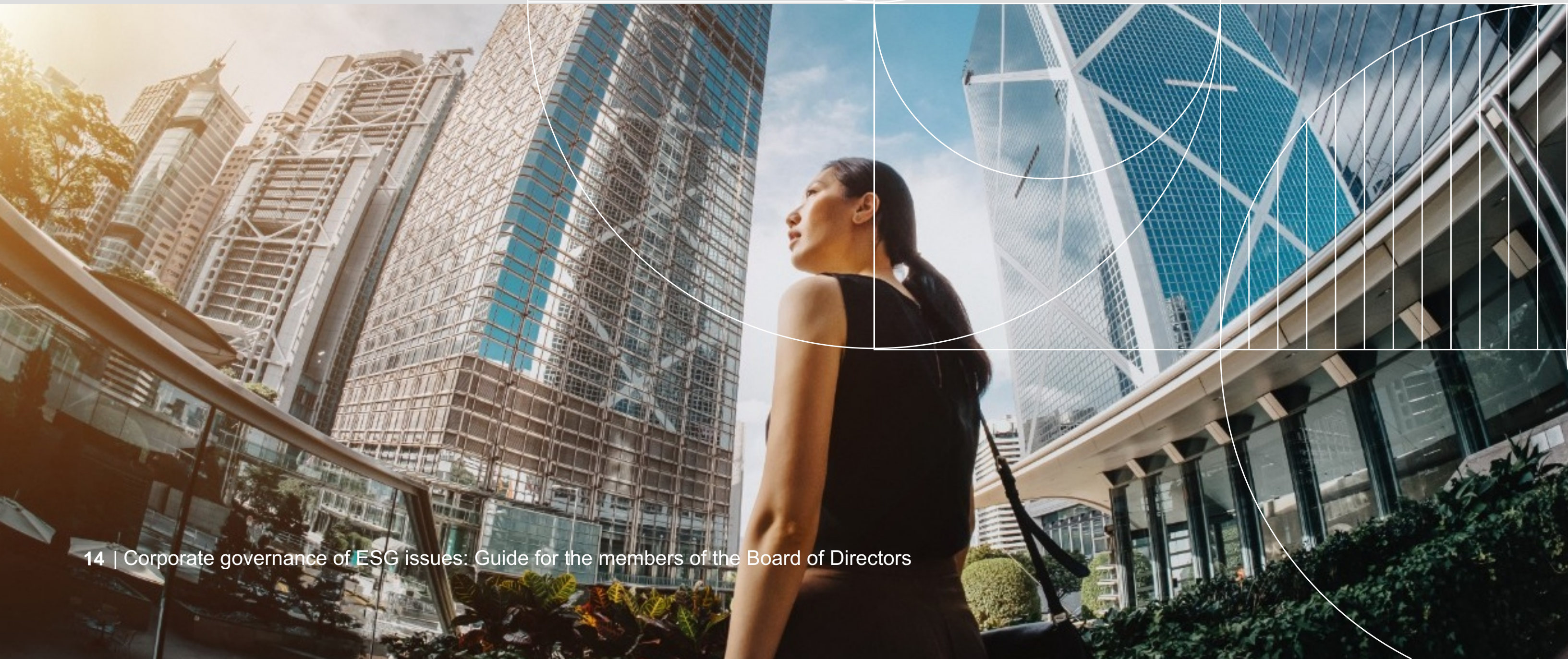
Additionally, high-performing Board of Directors are always embracing educational opportunities. Because ESG topics are wide-ranging and can be very complex, it's an area well-suited to different types of director education. Many Board of Directors engage outside experts to provide briefings and specific training on ESG. Others send directors to intensive programs focused on specific areas of ESG.

Key considerations for the Board of Directors:

- Which topics have a direct impact on near-term performance or capital allocation decisions? Are there topics the Board of Directors needs to monitor but don't require direct input?
- Can performance be monitored using a dashboard or does it require time for discussion on the agenda?
- Are there any skills or qualifications identified during the Board of Directors' evaluation process that should be prioritized for more intensive education programs intended for the Board of Directors?

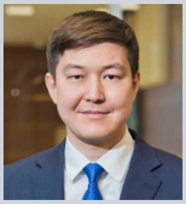
Conclusion

Companies have made rapid strides in unlocking the business value of ESG in recent years. The ESG issues a company faces vary widely by industry and company maturity, and there's no one-size-fits-all solution. Due to rapidly involving regulatory changes, companies should take action now to reduce the burden of future disclosure requirements. Directors have a big role to play in guiding management to allocate the appropriate resources and attention. Forward-looking companies value being a frontrunner on ESG issues because they see the connection to the company's long-term success.



How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact PwC's Corporate Governance and ESG team in Kazakhstan.



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