

The Sustainable Board



Introduction

For a large and growing number of customers, suppliers, employees, investors, and others, sustainability has become a key criterion when determining whether or not they wish to be associated with an organization.

Few other issues are expected to have as significant an effect on organizations, the way they operate, and the products and services they provide as sustainability. Sustainability has been called the next megatrend, which will transform organizations, their markets, and the economy in a way comparable to past megatrends, such as the advent of mass production, the IT revolution, and globalization.

Issues associated with sustainability include corporate reporting, climate change, resource usage, business sustainability matters, labor and community relations, and more. For business, sustainability involves **ensuring that the negative social and environmental impacts of business activities are reduced so as to be consistent with development in a finite planet**. The concept of sustainable business seeks to combine environmental and social improvements with financial success.

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In the past, sustainability practices and their associated issues have been a greater concern for boards of organizations in some industries — those with a direct impact on the environment, such as energy, resources, and manufacturing or those with close customer contact such as retail, fashion, and food — than in others. Today, however, sustainability has become an important concern for all organizations. Sustainability can create business value by building reputation, enhancing employee morale, and strengthening competitiveness. Shareholders and stakeholders of organizations of all types and in all industries are becoming increasingly active around sustainability.

In response, many boards of directors are taking on stronger roles related to their organization's sustainability activities. Some oversee the sustainability reporting in

their organization's public filings, identify stakeholders' concerns and priorities, and help to plan and oversee the implementation of sustainability practices. Others, through the board chair, governance committee or a dedicated sustainability committee, lead their organization's sustainability programs, which includes working closely with shareholders and other stakeholders to identify new initiatives and potential areas for improvement.

On the other hand, there are many boards of organizations that have yet to determine what role, if any, they should take with regard to sustainability and, therefore, rarely discuss sustainability matters.

This publication examines some of the important sustainability issues facing boards today including:

- The business imperative that makes sustainability a top boardroom concern
- Measuring the true value of sustainability initiatives
- The linkages between sustainability, strategy, and risk
- Sustainability as a driver of innovation and growth
- Sustainability transparency and disclosure
- How boards can learn more about sustainability

Each section includes examples of questions directors may wish to ask of themselves and management in order to further their understanding of the topics discussed.

Whether your board is one that has yet to determine the responsibilities it wishes to take regarding sustainability or is one that already includes sustainability as part of its mandate, the topics discussed in this publication will assist you in determining the appropriate role for your board.



The sustainability business imperative: Why it is a board level concern

Sustainability has become inexorably linked to organizational success. Customer demand is creating markets for new, “green” products and services. Organizations in supply chains are insisting that others in the supply chain work with them to improve sustainability throughout the chain or they will be replaced by organizations that will. Ratings analysts give sustainability increasing weight in their evaluations of companies, investors are factoring it into their decision making, and shareholders are holding organizations accountable for their sustainability activities. Growing numbers of workers say their preference is to work for organizations that make a conscious effort to be socially and environmentally responsible. Regulators are focusing on practices related to environmental health and safety, materials bans, packaging and product labels, labor standards, recycling, energy, and, in many jurisdictions, carbon emissions.

In this environment, **boards need to ensure that their organization views corporate sustainability as more than just good corporate citizenship; it must be an integral component of its overall business strategy.** Sustainability initiatives can strengthen an organization’s reputation, competitiveness, the morale of employees, and its ability to attract capital. They have enabled many companies to streamline processes, reduce costs, and strengthen their public image, thereby creating value and improved competitive positioning. At the same time, however, sustainability is also a critical risk consideration. Unanticipated changes in regulations or the sustainability policies of supply chain partners can suddenly transform the business environment in a way that may make existing business models unviable.

In their role as steward with responsibility for the oversight of organizational strategy and the identification and mitigation of risk, boards have a clear responsibility for the oversight of their organization’s sustainability activities. Many boards, however, choose to take on much more robust roles. Given that short-term concerns often demand near total attention of management, it is often up to the board to address the longer-term issues around sustainability, such as by integrating the organization’s sustainability program in the governance structure. These boards believe that If the board doesn’t address sustainability, who will? And if these issues go unintended, what will be the consequences?

Questions for directors to ask

- Does the board understand the sustainability risks not just to the organization, but also to directors? Has the organization carried out a sustainability risk analysis??
- Does the organization’s D&O insurance protect directors if the organization is deemed to have an environmental liability?
- Does our organization have a sustainability strategy supported by suitable sustainability policies? Have they been reviewed and approved by the board?
- Does the board receive adequate educational and briefing information from senior management regarding sustainability issues facing the organization?
- Has the board put an appropriate governance structure in place to effectively oversee the management?
- Is there sufficient expertise within the board regarding the business and strategic implications of sustainability issues?

Measuring the true value of sustainability

Although sustainability initiatives have become an increasingly important component of many business activities, many organizations have difficulty evaluating the financial return on their sustainability strategy.

The potential bottom line benefits of sustainability activities are varied. Direct value may result from the cost benefits of these investments, through reduced costs leading to greater savings, from increased productivity, or from new revenue streams, etc. Other benefits may include the indirect value created when risks are mitigated by a sustainability investment, such as reduced risks of delay or disruption, avoidance of litigation costs, etc.

As with any investment, organizations need to understand the Return on Investment (ROI) and Net Present Value (NPV) of their sustainability activities. (Given the complexity of many organizations, this may be easier to quantify at a project rather than enterprise-wide level.) Tools such as the Deloitte Sustainability Value Map™ can help organizations identify the connection between sustainability actions and the associated stakeholder value that they create.

Boards that want to understand the financial implications of their organization's sustainability initiatives should ask two critical questions: What should be the sustainability investments related to this project? And, what financial return will those sustainability investments bring to the company?

Questions for directors to ask

- What methodologies does our organization use to identify and understand the connections between sustainability initiatives, their impact on the bottom line, and their contribution to creating shareholder and stakeholder value?
- When planning projects, does management calculate the financial and non-financial value of sustainability initiatives? Does management monitor the achievement of these values as projects are executed? Is this information reported to the board?
- Does management identify sustainability KPIs and ROI for the organization? For key projects? Does the board receive reports from management on whether those KPIs and ROI are being achieved?
- Does the organization's risk identification and mitigation efforts, and the board's oversight of them, devote sufficient attention to effect of sustainability initiatives?

Many organizations have difficulty evaluating the financial return on their sustainability.

Sustainability and strategy and risk

Building sustainability into corporate strategy can help organizations to enhance revenue and build brand value; better engage with key stakeholders, such as employees and communities, to protect their license to operate; reduce costs and increase operational efficiencies; and manage risks. A sustainability perspective on strategy can also help identify how sustainability opportunities and risks flow through the extended value chain, allowing that information to drive innovation and further refine longer-term strategies.

Similarly, **organizations must mitigate the risks associated with sustainability exposures**, such as stakeholder activities related to inadequate sustainability reporting and transparency, brand risk related to stakeholder perceptions in the marketplace, and changes in sustainability practices and the expectations of competitors, suppliers, and customers.

Organizations and boards, therefore, need to consider the potential impact of environmental and social issues on their strategic plans. By developing scenarios about the potential impact these issues may have on the business — across its supply chain, its industry, and between other supply chains and other industries — organizations can better identify both the opportunities and threats posed by different sustainability issues. Management can then develop a sustainability strategy to address each of these issues.

In reviewing sustainability initiatives and policies, the board should ensure that these are clearly aligned with the organization's overall corporate strategy. Directors should challenge management on the short-term value and long-term positioning related to the organization's environmental and social performance, and how that compares to the positions of key competitors. The board should engage in a strategic dialogue with management about the activities in which sustainability could or should change critical business decisions, for example the impact of environmental and social issues on decisions about where to invest capital for growth, products and services; where to add or reduce capacity and presence; and which markets to enter, grow or exit.

Questions for directors to ask

- Does the board understand the sustainability impacts along the supply chain and how this might impact competitive advantage?
- Does the board understand the organization's exposure to environmental and social issues across its supply chain, and the actions currently being taken for mitigation and adaptation?
- Does the organization have a sustainability mission statement? If so, has it been reviewed and approved by the board?
- Has management assigned appropriate executives with requisite knowledge the responsibility for dealing with environmental and social issues, including the process for monitoring developments and response strategies?
- Has management identified the principal business risks presented by environmental and social issues including those related to: strategy; regulatory and legal liability; infrastructure; price and market; products, including supply chain; technology; disclosure (e.g. assessments by analysts and credit rating agencies); reputation?
- In its oversight of management's identification and mitigation of risks, does the board devote sufficient attention to sustainability-related risks? Does this risk analysis also focus on corresponding sustainability-related opportunities?

Sustainability as a driver of growth and innovation

For many organizations, the need or desire to reduce or substitute energy, carbon, water, materials, and waste has been the catalyst for developing innovative, more efficient operations. Some organizations have been spurred to design more sustainable products and methods in response to new expectations or demands of other organizations in their supply chain. Meanwhile, growing consumer concerns about sustainability have created new markets into which many organizations have launched new, “green” sustainable products, often at higher prices than their older, less sustainable items.

Boards should address sustainability research and development issues within the context of their primary fiduciary responsibility, which is to help govern the enterprise to attain long-term value creation. Sustainability strategies should be tightly integrated with the organization’s core business strategies — **in fact, for many leading organizations sustainability considerations are embedded throughout the strategy.** Boards should ensure that management is undertaking the appropriate analyses of operational inputs and outputs, profit and loss sensitivity, regulatory risk, customers and competitors, and brand positioning to identify areas where high financial impact aligns with high sustainability priorities. Discrepancies are identified between financial impact and financial priority may indicate that the organization is giving too little or too much attention to one sustainability priority over another.

Since many financial and sustainability considerations extend across industry sectors, boards should encourage management to look beyond their own organization to

identify the sustainability opportunities and risks posed by other organizations in their industry or market. Often organizations find the most effective and efficient way of developing and implementing new sustainability initiatives is in collaboration with others in their industry and their supply chain partners.

Questions for directors to ask

- Does management regularly monitor customer preferences and expectations, and the activities of competitors and supply chain partner to identify new market opportunities for sustainability-related products and services? Does the board review and discuss management the opportunities identified by management?
- How much Board time is spent discussing sustainability driven innovation?"
- Has management incorporated sustainability objectives into business plans and reporting? Is sustainability a key driver in process evaluations and research and development activities? Has the organization identified reliable, timely and understandable key performance indicators to enable it to measure its sustainability performance?
- Has management provided the board with a clear analysis of the financial impact of its sustainability initiatives so directors can determine how well sustainability priorities are aligned with long-term value creation?
- Does the organization link executive pay to achievements in meeting sustainability objectives, including developing new sustainability-related innovations?

Sustainability transparency and disclosure

As investors and other stakeholders continue to pay close attention to corporate sustainability performance, sustainability will increasingly become integrated into mainstream reporting. The better stakeholders understand the organization's sustainability activities, the more likely that initiative is to reap strategic benefits. Communication is the key to building this awareness.

Boards, therefore, should take an active role in reviewing and approving the organization's sustainability disclosures. To be effective in this oversight — including understanding whether all relevant information is disclosed fairly and accurately — the board must be able to effectively monitor sustainability goals, strategies, and objectives on an ongoing basis, rather than as a one-off approval of the sustainability report at the year-end. Boards should consider whether to provide oversight of sustainability matters reported internally in addition to the information that is disclosed publicly.

Boards should begin by determining which sustainability aspects have, or may have, a material impact on the organization's ability to meet its objectives. The board should then ensure that management provides it with appropriate reporting, both in terms of content and frequency, on those aspects so directors can monitor sustainability performance on an ongoing basis. This will include identifying key performance indicators and key risk indicators and putting appropriate internal or external mechanisms in place to ensure the completeness and accuracy of the information management provides to the board on material sustainability aspects. For their part, boards need to ensure that they devote sufficient time and resources to the oversight of sustainability and sustainability reporting. This may involve delegating responsibility to an appropriate board committee; either one dedicated to sustainability or as part of another committee, such as the audit committee.

In some cases disclosure is required if the associated issues are material to investors. Boards, therefore, should ensure that the organization meets the requirements for environmental-related disclosure in securities filings as set forth by International Financial Reporting Standards (IFRS) and other regulations, such as the *SEC Guidance Regarding Disclosure Related to Climate Change*, which requires disclosure of climate risks and opportunities that are material. Even if not required, disclosure of a company's sustainability efforts may now be considered a leading practice. Frameworks developed by the Global Reporting Initiative are becoming widely used to guide sustainability reports. Further into the future Integrated Reporting may become more widely accepted.

Questions for directors to ask

- What are the organization's policies regarding setting goals and measuring performance in economic, environmental and social areas (i.e., internal reporting) and disclosing those activities to investors and other stakeholders (i.e., external reporting)?
- Does management voluntarily disclose sustainability and social responsibility related strategies, performance indicators and risks beyond the general requirements set forth by regulators (e.g., Management's Discussion & Analysis guidance)? Is the board required to review and approve all sustainability disclosures before they are released?
- What information, if any, does management provide on sustainability issues to regulators, customers, suppliers, non-governmental organizations or other stakeholders?
- Does the organization disclose the metrics used to measure performance towards achieving its sustainability objectives? Is there a third party verification process for sustainability reports?
- How does the board satisfy itself regarding the accuracy of the sustainability information that is publicly disclosed?

Communication is the key to building this awareness.

How directors can learn more about sustainability

Since management will always have a greater knowledge of the business and its sustainability activities, the best way for directors to learn is to ask questions of management. In turn, as the responses to directors' queries allow them to learn, this greater understanding of sustainability will enable the board to formulate better questions.

Boards should determine how often they need to discuss sustainability issues with management and set aside sufficient time on their agendas for a full and robust discussion. To facilitate these discussions, boards should ensure that management understands its reporting expectations on sustainability, including the level of detail, format, frequency of reporting, etc. Directors should also determine whether their reporting expectations may differ under certain circumstances, such as requiring more immediate and detailed reporting of sustainability matters that have a mandatory disclosure requirement under IFRS or SEC rules. Boards may also choose to set distinct reporting requirements for specific projects; for example, is the board satisfied discussing sustainability issues related to a major project only at the time the project is approved, or does it require ongoing reports as the project evolves?

Boards need context to fully assess management's reports about the organization and its sustainability activities. To determine whether the organization's activities lag, match or lead those of similar organizations, boards should review the sustainability reports of competitors, supply chain partners, and customers as well as reports by securities analysts and other third-party organizations.

While management is an important first source of information, the board may choose to invite others experts to provide directors with their views of sustainability, such as regulatory authorities, industry analysts or safety experts. Boards may also wish to consider whether a board retreat or other dedicated education session on sustainability would be of benefit.

Questions for directors to ask

- Does management provide the board with the appropriate quality of information for directors to be able understand the organization's sustainability activities, opportunities and exposures?
- Does the board review management's reports in the context of similar reports from peer organizations to obtain a competitive ranking of our organization's activities compared to others?
- Do directors have sufficient confidence in their understanding of sustainability to be able to ask probing questions of management?
- Does the board need education programs to improve directors' understanding of sustainability and ensure that directors fully understand all of the risks, opportunities, trends, and best practices?



Conclusion

Sustainability is an emerging and evolving issue for many boards of directors.

Although sustainability is an important and growing consideration for their organization's stakeholders, it has not yet achieved equal importance on the agendas of all boards. Some boards still rarely discuss sustainability issues, perhaps because they believe sustainability falls outside the board's fiduciary responsibilities, other urgent demands on the board leave little time for discussions about sustainability or the board views sustainability as strictly the responsibility of management.

Among boards that do include sustainability within their mandates, approaches to sustainability may vary considerably from one organization to the next. Disclosures of sustainability, which may not be the same as those applied by other organizations even in the same industry. In addition, their disclosures of sustainability activities may also vary, in terms of format and content; some organizations, for example, do not disclose the way they measure their progress towards achieving their sustainability objectives. All of this limits the ability of investors, stakeholders and others to make meaningful comparisons between different organizations' sustainability initiatives.

However the underlying drivers of sustainability — population growth, an increasing demand for a developed world lifestyle set against limited resources and a finite planet — are not diminishing. Sustainability has moved from an area of regulation driven response to one of strategic necessity.

While the demands and power of non-government agencies increase with the advent of social media, in many cases they now team with business to help find solutions to sustainability

challenges. There are new partnerships developing along supply chains and across industries. The landscape is changing rapidly.

Demand for reporting and disclosure of sustainability performance continues to increase — both as a response to regulation, and stakeholder and investor pressure, but also from internal management looking for better ways to manage risk and measure and improve performance.

Organizations need to be aware of and engaged in these changes. If they do not, their strategic options will gradually lose profitability and relevance. It is up to the directors serving on the board to ensure that their organizations are prioritizing sustainability matters facing their organization.



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