



Commentary on “the governance of sustainability”

Introduction

On November 28, 2007, members of the European and North American Audit Committee Leadership Networks met for the second time. Members discussed the competitiveness of global capital markets, regulatory balance, and the governance of sustainability.¹ For further information on the networks, see “About this document,” on page 7. During the discussion on sustainability, members compared practices on:

- **Defining sustainability**
- **Identifying drivers and benefits of sustainability**
- **Finding a home for sustainability oversight**
- **Sustainability reporting and assurance**

Network members participating in all or part of the discussion, who sit on the boards of more than 40 large-, mid-, and small-cap public companies between them, included:

- Mr. Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Mr. Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr. Jan Hommen, Audit Committee Chair, ING
- Mrs. Judy Richards Hope, Audit Committee Chair, Union Pacific
- Mr. Laban Jackson, Audit Committee Chair, JPMorgan Chase
- Dr. DeAnne Julius, Audit Committee Chair, Roche Holding
- Mr. Oscar Munoz, Audit Committee Chair, Continental Airlines
- Mr. Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Ms. Pam Patsley, Audit Committee Chair, Texas Instruments
- Sir Ian Prosser, Audit Committee Chair, BP
- Ms. Guylaine Saucier, Audit Committee Chair, Areva
- Dr. Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr. Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

Members from Ernst & Young participating in the discussion included:

- Mr. Tom Flannery, Americas Director, Audit Committee Communication
- Mr. Steve Howe, Americas Managing Partner
- Mr. Tom McGrath, Managing Partner, Northern Europe, Middle East, India and Africa Client Service
- Mr. Christian Mouillon, Managing Partner, Continental and Western Europe Client Service

ViewPoints reflects the networks’ use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations.

¹ See also Audit Committee Leadership Summit, “Discussion with Treasury Secretary Hank Paulson,” *ViewPoints*, January 23, 2008, available at http://www.Tapestry_EY_Summit_View4_Jan08.PDF, and “Working with the SEC,” *ViewPoints*, January 23, 2008, available at http://www.Tapestry_EY_Summit_View3_Jan08.PDF.



Executive summary

This issue of *ViewPoints* can be read as a companion piece to the research on the governance of sustainability first published in European *InSights* in November 2007 and included in the back of this document.² The audit committee chairs attending the summit discussed many of the findings in that publication and added their own perspectives on what is fast becoming a new topic in corporate governance: how companies are addressing the challenge of sustainability. The discussion at the summit centered on the four topics summarized below, with further detail on the following pages:

- **Defining sustainability** (*Page 3*)

Some audit chairs in both Europe and North America are concerned that sustainability lacks a commonly agreed-upon definition. Many companies use a definition similar to that employed in the Dow Jones Sustainability Indexes (DJSI) described on page 3. However, sustainability is also seen as an umbrella term that needs to be defined uniquely by each company, depending on the impact the company has both on stakeholders beyond its immediate customers and on the planet itself.

- **Identifying drivers and benefits of sustainability** (*Page 3*)

The discussion at the Audit Committee Leadership Summit reaffirmed the main drivers of corporate sustainability identified in *InSights*: investors looking for long-term value creation, younger customers choosing to purchase strong brands that are socially and environmentally responsible, and employees choosing a workplace on a similar basis. Members also suggested that economic and political pressure from governments and nongovernmental organizations (NGOs) is also driving companies to develop coherent approaches to sustainability.

- **Finding a home for sustainability oversight** (*Page 5*)

European and North American companies manage and oversee sustainability differently, depending on local custom, law, and regulation. Companies often decide where to place sustainability oversight based on whether sustainability is viewed primarily as a risk or as a business opportunity. Broadly speaking, members felt that the board itself should be involved, particularly if the company issues a public sustainability report. Many North American audit chairs said that if sustainability is discussed at the board level, then it is likely to end up with the audit committee because of the related risk component.

- **Sustainability reporting and assurance** (*Page 6*)

Members whose companies publish sustainability reports said that the reports are intended to help those companies manage their reputation with different stakeholders. Several members suggested that such reports needed to be credible to stakeholders, and therefore the reports need independent assurance from the external auditor or another audit firm.

² Tapestry Networks and Ernst & Young, "The governance of sustainability," European *InSights*, November 16, 2007. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_InSights_Nov07.pdf.

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Defining sustainability

The discussion on sustainability started with a challenge from one U.S. audit chair to define the term. One widely used definition of sustainability in Europe and North America comes from the Dow Jones Sustainability Indexes (DJSI): “A business approach that creates long-term shareholder value by embracing opportunities and managing risks deriving from economic, environmental and social developments.”³

However, without a universally accepted definition, many companies think about sustainability in the same way as one European audit chair: “*At my company, sustainability is an umbrella term. In economic terms, it’s a way of measuring externalities, effects beyond our immediate customers.*” This member continued, “*Sustainability ... [is] a way to give focus inside [the company and] get board input. It’s also about forward planning for [issues] that management might push aside as not being an immediate risk. The benefit is moving us ... to a broader view of how our portfolio interfaces with society.*”

This member’s company used the target of obtaining a listing on the DJSI and the FTSE4Good index as a means of driving sustainability throughout the company and used the indexes’ metrics to measure performance. “*We picked the two indices and used the metrics they developed,*” the audit chair said. “*We wanted to be listed on both within two years of starting.*”

Inclusion in the FTSE4Good index, for instance, requires eligible companies to “meet criteria requirements in five areas: working towards environmental sustainability, developing positive relationships with stakeholders, upholding and supporting universal human rights, ensuring good supply chain labour standards, and countering bribery.”⁴

Identifying drivers and benefits of sustainability

European *InSights* highlighted several key drivers for companies undertaking sustainability efforts: “Audit chairs agree that a potent cocktail of investor activism, consumer spending power, and demographic shifts in the workplace as companies seek to attract more young people has forced sustainability issues higher up the board agenda.”⁵ At the Audit Committee Leadership Summit, members reaffirmed these drivers of corporate sustainability, expanded upon several of them, and discussed the pressures exerted by governments and nongovernmental organizations (NGOs).

Investors: long-term value creation

Members noted that in some industries, sustainability can have a direct and long-term positive impact on the business. One North American member said, “*The value of the board is to add long-term value ... If you’re focusing on the three-month stock price, [sustainability efforts] are difficult ... If you look at the concept of*

³ Dow Jones Sustainability Indexes, *Corporate Sustainability*. Available at http://www.sustainability-indexes.com/07_html/sustainability/corpsustainability.html.

⁴ FTSE, *FTSE4Good Index Series Inclusion Criteria* (London: FTSE Group, 2006), 1. Available at http://www.ftse.com/Indices/FTSE4Good_Index_Series/Downloads/FTSE4Good_Inclusion_Criteria_Brochure_Feb_06.pdf.

⁵ Tapestry Networks and Ernst & Young, “The governance of sustainability,” 1.

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sustainability, economic growth, and shareholder value, over the long term they will converge ... If you have a short-term view, sustainability is a problem.” A European audit chair, speaking of the approach they took while they were in management, added, *“I thought it was good to combine sustainability with health and safety because it wasn’t abstract; it got traction and buy in ... It brought positive financial results and added value to the business.”*

This member added that many private equity investors were starting to add a review of sustainability practices to their due diligence process: *“I have heard of private capital going into companies they’re considering acquiring and looking at sustainability.”*

Consumers: valuing brand reputation

Members noted that consumers are beginning to *“focus more on brands”* when making purchasing decisions, which means that brand reputation has become *“a major issue.”* One member indicated that *“if your brand is damaged from sustainability issues, it’ll take years to fix it.”* This is especially true now that *“one of the biggest consumer groups is young people,”* who both focus heavily on brands and have strong feelings about corporate sustainability efforts. One European audit chair, who sat on the board of a company with strong, visible sustainability efforts, said, *“[Our sustainability policy] has held us in good stead in the public eye during bad times.”*

Employees: recruiting and retaining talent

Sustainability can affect not only the public’s purchasing decisions, but also their employment decisions. Many members indicated that strong sustainability efforts helped them attract and retain talent, especially among younger employees. One North American member commented, *“It’s increasingly important to our employees – they expect it and demand it, and that’s increasing with time. It’s a way for us to attract employees ... We commit resources to mentoring and education, [so] sustainability is connected to our workforce.”* A European audit chair noted that sustainability *“is tied into human resources. Employees get asked questions and need some grounding in why the company does what it does,”* so they can reply when challenged and feel comfortable with the decisions that are being made.

Governments and NGOs: a license to operate

Members noted that in Europe, governments are putting pressure on companies to encourage sustainability efforts. *“In Europe, there’s pressure to provide more than just financial returns,”* one European audit chair stated. *“Governments are driving a tougher agenda. If you want to do business with the government, and if you’re not [carbon] footprint neutral, you’re not going to be able to do business with them. It’s driving the behavior of corporations, and that’s why it should be a business issue. There’s a connection to risk management, safety laws, and the agenda is building. There’s significant traction and speed that was not seen 18 months ago. Everyone is pushing in that direction. It’s more and more important.”*

Other members spoke of the risk that the pressure NGOs put on their business could lead management to overstate the company’s environmental credentials. One European member said, *“Management pressure from environmentalists [can] go too far. You have to ask if the action is good for shareholders ... There’s*



pressure in [my country] that we have to have something. It doesn't help anything; it's just greenwashing." However, another audit chair talked about how the pressure from NGOs can also lead to a substantive change in company policy: *"Remember what happened to Shell in the North Sea? Greenpeace cost them hundreds of millions."*⁶

Finding a home for sustainability oversight

European and North American companies manage and oversee sustainability differently in many different places, depending on local custom, law, and regulation. The role of boards differs according to whether companies have a single-tier board (common in the United States) or a two-tier board comprising both supervisory and management boards (common in Germany). The role and number of board committees can also vary by country and company. Members were quick to note that a director's responsibility is determined by *"your specific role on your specific board."*

European *InSights* showed that companies often determine the right home for sustainability oversight based on whether sustainability is viewed primarily as a risk to be mitigated or a business opportunity to be maximized. A European member spoke up for a more nuanced approach, however. For one company on whose board the member sits, *"[sustainability is] a risk that isn't a financial risk, and while it can be a risk, it can also be a benefit. For us, it's considered [a part of] risk management."*

Members felt that the board itself should be involved if the company was issuing a public sustainability report, especially if the information in that report is also used in the annual report. Said one member, *"If it's in an annual report, it's a board issue."* Many North American audit chairs said that if sustainability is going to be discussed at the board level, then it is likely to end up on the audit committee's agenda because of the related risk component. However, as sustainability efforts grow, or as the company shifts its view of sustainability to a business opportunity focus, the audit committee may no longer be the right home.

One European member reported that *"sustainability left the audit committee [because] the scope had become too big. We would have had to double the number of face-to-face meetings each year."* In this situation, the board set up a separate committee to oversee sustainability, a solution that enabled the board to focus its talents in an optimal way: *"The kinds of members who can add value in these two committees are quite different. I can't ask [sustainability] questions, but others can. It's [about] capability."*

However, some felt confident in the audit committee's ability to handle sustainability, with one U.S. audit chair noting that *"members of the audit committee [may not] have the right capability, but we know who to turn to in the company."* Other members reported involvement of other committees: in one company on whose board a European member sits, the remuneration committee is also involved because *"the compensation of management is tied into [sustainability] controls."*

⁶ In 1995, Greenpeace activists occupied Shell's Brent Spar oil storage facility in the North Sea and stopped the installation from being scuttled at sea.



Sustainability reporting and assurance

Audit chairs participating in the discussion found themselves divided on the need for a company to issue a public sustainability report. Should a report be issued, for example, if, as in the experience of one U.S. member, the company undertook a number of activities relating to sustainability, but the activities were “*not done under that wrapper*”? At the company in question, such activities are “*never talked about as corporate social responsibility ... Our efforts are tied to certain markers, but they’re not published as ‘look at us and how good we are.’ They’re not touted; they’re not visible.*”

Other audit chairs indicated their desire to see companies undertake sustainability efforts and make their work public. “*It’s good business to publish the report,*” one European member said. Another European audit chair agreed and noted, “*There’s no question in my mind that interest in sustainability is growing. If we produce financial [reports], why shouldn’t we do the same on environmental impact?*” This member cautioned companies to avoid turning the sustainability report into “*a glossy handout,*” however.

For many European companies, once having agreed to publish a sustainability report, the next important decision is whether the information contained in the report should be assured by an independent body. If the report is being published to help the company manage its reputation with different stakeholders, several members suggested that the report needs to be credible to those stakeholders, particularly given the temptation to indulge in overstatement or greenwashing. One European audit chair remarked, “*What do you put into the air? The ground? Those things can be measured.*”

As to who can help with the assurance, another European audit chair said, “*The external auditor was the best possible [resource]*” for assurance, permitting the company to “*say the figures were audited.*” Another European member agreed in principle, but noted that “*we use a different audit firm just because of [the issue of the proportion of] non-audit fees going to the auditor.*” Among the benefits of having an audit firm provide assurance is the confidence that comes from knowing the reporting “*was done correctly.*” Several European members also noted that “*a number of data points [from the sustainability report] go into the annual report*” and would need to be audited anyway.

Conclusion

During research for the November 2007 issue of *InSights*, it became clear that there is a high level of interest in the governance of sustainability on both sides of the Atlantic. Members of both networks are interested in what emerging best practice looks like on their own side of the ocean and on the other side too.

Many companies are still struggling with defining sustainability for themselves and deciding what efforts to undertake and how to report back to their stakeholders. However, there is an emerging consensus that this topic will grow in importance in the future, with the main drivers of change identified in *InSights* (investors, consumers, and employees), along with those mentioned in the summit discussion (governments and NGOs), likely to continue to push for more sustainable business strategies, products, and services. Investors will increasingly look to board directors for reassurance that sustainability risks have been mitigated, that opportunities have been optimized, and that the company is seriously engaged in the effort.

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About this document

The Audit Committee Leadership Networks in Europe and North America are groups of audit committee chairs drawn from leading global companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives this document may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European and North American Audit Committee Leadership Networks. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

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The governance of sustainability

Executive summary

This issue of *InSights*¹ has been developed to help board directors to understand better the growing stakeholder interest in sustainability and how companies are responding. We explore the governance and reporting of corporate sustainability, provide audit committee members with insights and emerging best practices, and identify differences and similarities in how large public companies in Europe and the United States (US) approach the subject.

The research for *InSights* has drawn on a variety of sources. These include discussions with 24 members of the Audit Committee Leadership Networks in Europe and North America,² managers responsible for sustainability in several public companies, and subject matter experts from various organisations. We also reviewed the sustainability or similar reports for network members' companies, conducted an anonymous online survey distributed to members of the North American regional audit committee networks,³ and undertook a review of other publicly available research.⁴

In this issue of *InSights*, we focus on three themes:

- **Approach to sustainability: business opportunity and/or risk management?** (Page 2)

In Europe, the term 'sustainability' is better understood than it is in North America, where the term 'corporate responsibility' is often preferred. Most audit chairs mention environmental issues and health and safety in their definition. Research participants agree that a potent cocktail of investor activism, consumer spending power, and demographic shifts in the workplace as companies seek to attract more young people has forced sustainability issues higher up the board agenda. However, companies in our sample take different views of sustainability. Some, mostly European but including some high profile US companies, see sustainability as a business opportunity embedded in business strategy; others, mostly North American, see it as a risk mitigation exercise. The view that companies take colours how their boards and board committees discuss sustainability. It is an open question whether those companies taking a risk-orientated approach are likely to evolve to a value creation approach.

- **Sustainability governance: the role of the board and board committees** (Page 4)

All of our research participants said their boards discussed sustainability. If a company views sustainability as embedded in the business, it will come up in board discussion of business strategy. If, on the other hand, sustainability is viewed as being about risk management, it will be discussed as part of a risk assessment or as a single-issue item when a deeper discussion is required. In Europe, a

¹ For more information about *InSights*, see *About this document* on page 11.

² For a full list of audit committee chairs and members who participated in the research, see *Appendix 2* on page 13.

³ Tapestry Networks distributed an online survey to 68 members of various audit committee networks convened by Ernst & Young and orchestrated by Tapestry Networks in the US and Canada. The response rate was 32 percent. The members of these networks typically represent public companies with \$2–10 billion of revenue and therefore results need to be viewed in that light.

⁴ *InSights* reflects the use of a modified version of the Chatham House Rule whereby names of participants and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Unattributed quotes from participants in the conversations drawn upon for this document are shown in italics.



separate board committee tends to oversee sustainability. In North America, the role may fall to the audit committee. Whether US practice will converge with European practice has yet to be determined.

• **Sustainability reporting: a true reflection of the business or just ‘greenwashing’?** (Page 6)

Even in Europe, board directors are not very involved in discussing sustainability reports. A number of audit chairs are concerned about sustainability reporting being used as a marketing tool for ‘greenwashing’ a company, rather than to present investors and other stakeholders with verified, quantitative data. The board may avoid this by encouraging the company to root its sustainability reporting in existing frameworks and reporting standards and by seeking external assurance to validate the numbers.

Approach to sustainability: business opportunity and/or risk management?

Sustainable development was defined 20 years ago in the Brundtland Report. In 1987, the United Nations (UN) adopted the report, stating: “Sustainable development, which implies meeting the needs of the present without compromising the ability of future generations to meet their own needs, should become a central guiding principle of the UN, governments and private institutions, organisations and enterprises”.⁵ Interest in sustainability escalated after the UN’s 1992 ‘Earth Summit’ in Rio de Janeiro and the foundation of the World Business Council for Sustainable Development. Most recently, public debate has been shaped by the activities of former US Vice President and now Nobel Laureate Al Gore, who told *McKinsey Quarterly* earlier this year: “As stewards of shareholder interests, boards should be focused on the long-term sustainability of the firm rather than on market noise”.⁶

In research published by Ernst & Young and Oxford Analytica, ‘radical greening’ was ranked ninth in the top ten strategic risks companies anticipate facing in 2008. Radical greening refers to “increasing environmental concerns which could be the result of a wide range of pressures – from the voluntary world of corporate social responsibility (CSR) to hard regulatory and economic necessity”.⁷

Defining sustainability

Sustainability is a difficult issue to address in part because there is no uniform definition in use worldwide. One audit chair remarked: “*The issue of sustainability covers more than the green movement and covers more than is [often] understood*”.

⁵ The United Nations World Commission on Environment and Development (Oxford University Press), *Our Common Future*, 1987. Available at: <http://www.un.org/documents/ga/res/42/ares42-187>.

⁶ Lenny T. Mendonca and Jeremy Openheim, *Investing in sustainability: An interview with Al Gore and David Blood*, *McKinsey Quarterly*, May 2007. Available by subscription at: http://www.mckinsey.com/clientservice/ccsi/pdf/Investing_in_Sustainability.pdf.

⁷ Ernst & Young (London: Ernst & Young and Oxford Analytica), *Strategic Business Risk 2008 – the Top 10 Risks for Business*, 2007, page 13. Available at: [http://www.ey.com/Global/assets.nsf/International/EY_Strategic_Business_Risk_2008/\\$file/EY_Strategic_Bus_Risk_2008.pdf](http://www.ey.com/Global/assets.nsf/International/EY_Strategic_Business_Risk_2008/$file/EY_Strategic_Bus_Risk_2008.pdf).



One of the most widely-used definitions of sustainability comes from the Dow Jones Sustainability Indexes: **“A business approach that creates long-term shareholder value by embracing opportunities and managing risks deriving from economic, environmental and social developments”**.⁸

European businesses and their audit committee chairs use the term ‘sustainability’ more frequently than their North American counterparts, who prefer to use the term ‘corporate responsibility’ – with or without the ‘social’ in the middle. When asked what sustainability meant to them, most European and North American audit chairs cited environmental issues (including those at a plant level, as well as broader concerns such as climate change) and health and safety. Many audit chairs also widened the net to include public policy, security, company involvement in local communities, human resource policies, human rights, philanthropy and anti-corruption efforts.

Drivers of company focus on sustainability

During our research, we found intense interest in this topic among board directors in both Europe and North America. Clearly, such directors are engaged in thinking about the governance of sustainability in their companies. What is driving this interest? Audit chairs agree that investor activism, consumer spending power, and demographic shifts in the workplace as companies seek to attract more young people has forced sustainability issues higher up the board agenda.

- **Investors.** One US manager responsible for sustainability said: *“We occasionally get a question from investors but there is definitely a trend out there to see questions coming from shareholders”*. However, a European audit chair commented: *“[We] have never once been asked a question about sustainability. On the other hand, [we] also haven’t told [investors] that this is something they should be asking about”*.
- **Consumers.** One audit chair said: *“My experience is that [sustainability] is taken very seriously because [the company] sees the customer [interest in] their CSR ... as being very important”*. A US manager responsible for sustainability added: *“There are major customers of ours who want us to work with them on these issues”*.
- **Employees.** One European audit chair said: *“I think the next generation will be hesitant to join a company if they don’t like the CSR. They are very black or white”*. Another agreed, saying: *“People who love the products sell in much more volume because of our strategy. There is also a sense of colleague advocacy. Our employees are happy to be here because of our philosophy”*.

Moving from risk management to revenue opportunity

One transatlantic distinction that became apparent from our research was that most European audit chairs we spoke to tend to see sustainability as being a key part of their company’s business strategy – and as being as much about opportunity as risk. US audit chairs, with some notable exceptions, mostly view sustainability through the prism of enterprise risk management.

⁸ Dow Jones Sustainability Indexes, *Corporate Sustainability*. Available at: http://www.sustainability-indexes.com/07_html/sustainability/corpsustainability.html.



In 2007, *Compliance Week* ran a series of articles about sustainability in the US and commented that efforts often began as “a thrust toward risk reduction and efficiency management”.⁹ One US audit chair told us: *“The lack of good environmental practices can be a very big risk. Typically, that is how we would shape the conversation but sometimes we have to shape it as a safety conversation, sometimes in terms of reserves. The question really becomes ‘How do we lower the enterprise-wide risk?’”*.

Most European companies involved in the research (as well as some US companies) endorse the definition associated with the Dow Jones Sustainability Indexes and view sustainability as a business opportunity. For these companies, sustainability is embedded in business strategy and the company’s ways of doing business. However, the companies that look for opportunity do not ignore the risk element. One European audit chair said: *“[Sustainability] is about limiting our liabilities. [But] it is also about looking at the core of our strategy, to get the biggest return”*. One US manager responsible for sustainability agreed: *“We look at it from the perspective of being able to manage the risk and increase opportunities to create extra shareholder value. We have a very broad definition of sustainability”*.

Several European audit chairs said there was an evolution for their companies, moving from a purely risk-orientated approach to sustainability to a broader perspective of value creation. One French board director, speaking about a company’s response to legislation governing sustainability reporting, said: *“When it was created and enforced, the first reaction of the company was ‘again, another burden and more paperwork to complete’. It was difficult. Now, most companies understand that sustainability is an important issue, that there are value creation opportunities, and that there is more and more sensitivity among investors to select companies that are good citizens”*.

Sustainability governance: the role of the board and board committees

The difference in approach between companies that regard sustainability as an opportunity and those that focus mostly on the potential risks influences how sustainability is discussed by the board, as well as which board committees oversee sustainability. All of our research participants said their boards discussed sustainability (although not all of them would use that word to describe the topic under discussion, as we noted earlier). Participants noted four types of board discussion:

- **Sustainability strategy.** Where sustainability is embedded in business strategy, it is discussed as part of the board’s contribution to developing the company’s business strategy, typically during the longer board retreats used for strategy development. One US manager responsible for sustainability said that the most important thing that emerges from board conversations about sustainability is a *“set of concepts consistent with the culture, traditions and values of [the company]”*.
- **Risk management.** For those companies that view sustainability as part of enterprise risk management, as well as for those companies that take a broad view of sustainability, discussion often takes place as part of the board review of the company’s risk assessment.

⁹ Jaclyn Jaeger, *Sustainability as Corporate Growth Strategy*, *Compliance Week*, 10 October 2007. Available by subscription at: http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3709.



- **Specific sustainability issues.** For both types of company, the board may discuss key individual issues relating to sustainability, such as environmental and labour practices, health and safety reporting, and ethical concerns. Because of the need to conduct thorough assessments of these issues, one audit chair said that, in effect, sustainability issues are always discussed at the board.
- **Business operations.** Several participants agreed that sustainability discussions are most productive when looked at from the perspective of the business' different operations. One European audit chair said: *“We have started understanding the links between our business lines, the synergies of these businesses ... This has become our strategy”*.

Who in senior management is driving the sustainability discussion inside the company? Many participants agreed with one European audit chair who said that *“sustainability is not driven by the board; it is driven by the CEO”*. Just over half of the North American audit chairs who responded to our online survey identified the CEO as the main driver of sustainability in the company, while the remainder identified various senior managers, including the chief legal officer, the chief risk officer, the heads of operations and, in one case, the director of marketing communications.

Europe often has a dedicated committee; the US relies more on the audit committee

Board committees serve different functions in various European countries – some prepare material for the board meeting, for example, while others oversee particular issues in depth – but even given that diversity, it is possible to make one general observation from our research. We had gone into the research to determine the level of involvement of the audit committee. What we found was that European companies did not give responsibility for sustainability to the audit committee. In fact, they were more likely to create a new board committee to deal with sustainability or rely on a risk or governance committee, whereas a quarter of US companies in our online survey did use the audit committee for this purpose.

Why this difference in approach? It may be that because sustainability has been a business issue for longer in Europe than in the US, European companies have had more time to streamline the processes associated with the governance of sustainability. Indeed, two European audit chairs noted that, prior to the creation of a distinct sustainability committee, the audit committee had been responsible for overseeing sustainability. In both cases, the audit chairs felt that a separate committee ensured adequate attention would be given to sustainability.

Board-level committees overseeing sustainability operate under various names:

- sustainability committee
- social responsibility committee
- public policy committee
- health, ethics and environmental committee
- health, safety, environmental and security committee
- governance and environment committee



Why might the audit committee handle sustainability?

Participants suggested three reasons why the audit committee might be given responsibility for overseeing sustainability:

- **It has responsibility for overseeing risk.** Sarbanes–Oxley and several European national corporate governance codes give the audit committee responsibility for overseeing the risk management process. If a company’s approach to sustainability is primarily risk-orientated, then the audit committee may be the most logical committee to oversee particular sustainability risks, particularly if there is a potential impact on financial statements. One US audit chair commented: *“Everything has a financial aspect – then it should go to the audit committee”*.
- **It is the board committee of last resort.** One European audit chair told us that all too often *“the audit committee ... can be a dumping ground for things that don’t necessarily fall under other committees or other topics”*. In part, this is also because the audit committee meets more often and for longer, so other directors believe it has the capacity to handle such topics.
- **It may be the only committee of independent directors.** In some European countries, the audit committee is the only board committee with a majority of independent directors. One audit chair commented: *“I wanted the audit committee to get involved with all sorts of stakeholder issues ... For instance, we worked on potential privacy issues. I think because of the type of work that the audit committee is given, they should have some sort of stakeholder orientation”*.

Sustainability reporting: a true reflection of the business or just ‘greenwashing’?

It is important to note that although both European and North American boards discuss the issues associated with sustainability in some depth, the boards do not spend much time discussing the sustainability report that ultimately forms part of the company’s disclosure to investors and other stakeholders. One European audit chair said: *“We never see a draft of the sustainability report, which I think is a pity, but the report itself is very well done”*.

According to participants, board directors rarely have an impact on the final report produced by management. Many board directors commented that they often do not see the sustainability report until it is in its final form, so their review becomes a formality. Or, as one audit chair commented: *“The reports are ‘tacitly’ approved by the board”*.

Company reporting on sustainability has evolved over time. In an article on the history of sustainability reporting, William Baue noted: *“Corporate reports covering non-financial information – variously called sustainability, triple bottom line, CSR, and environmental, health and safety (EHS) reports – are relatively young compared to financial reports. However, non-financial reporting is growing in significance as corporations and their shareowners and stakeholders recognise that non-financial issues impact financial performance”*.¹⁰

¹⁰ William Baue, *A Brief History of Sustainability Reporting*, 2 July 2004. Available at: <http://www.socialfunds.com/news/article.cgi/article1459.html>.



Baue's article continued: "Sustainability is increasingly becoming the umbrella term under which all non-financial reports fall ... AccountAbility, a UK-based institute promoting accountability for sustainable development, and CSRNework, a UK-based CSR consultancy, released a study lumping social, citizenship, and EHS reports under the sustainability rubric. The AccountAbility Rating, which rates sustainability reports from the Fortune Global 100 (or G-100, the world's 100 companies with the highest gross revenues), finds significant growth in sustainability reporting. Almost three-quarters (72 percent) of G-100 companies issued sustainability reports by 2004, whereas less than half (48 percent) had done so by 2003".¹¹

Baue reported that the upward trend was most conspicuous in the US, where the percentage of reporters in the G-100 rose from 18 percent to 49 percent in one year. However, two-thirds of the North American companies that responded to our online survey (and do not appear in the G-100) do not issue any external report at all. Clearly, there is some way to go before sustainability reporting in the US begins to match European levels of disclosure.

The two leading European countries in sustainability reporting are France and the UK. France was the first country in Europe to mandate sustainability reporting. The Nouvelle Régulation Économique (2001) stated that French public companies should comment on their social and environmental impact in their annual report. French companies also have their social and environmental impacts assured by an external auditor.¹² The UK's new Companies Act (2006) increases a director's responsibility, requiring a director to consider "in good faith" how a wide variety of factors, including the company's impact on the environment, are likely to impact the overall success of the company.¹³

Complaints about the quality of sustainability reports

While the number of global companies issuing sustainability reports is on the rise, so are complaints about the quality of those reports. SustainAbility's survey of reports issued in 2006 states: "Investors and financial analysts are becoming more interested in a range of risk and opportunity drivers – particularly in such areas as climate change. But only rarely do they find what they are looking for in today's reports".¹⁴

Environmentalist Chip Giller commented: "Companies are doing a lot of greenwashing through the media, so you need a sceptical eye".¹⁵ Environmentalists are not the only ones commenting on this concept of greenwashing. Audit chairs also struggle with ensuring that a company's sustainability report is more than just a marketing tool. One US audit chair told us: "*Most programmes are sort of greenwashing. Everyone is pretending to be green all of a sudden*". A European audit chair agreed: "*Sustainability means different things to different people. The word [sustainability], in [all] my years on various boards, has seldom come*

¹¹ Ibid.

¹² For more information on France's sustainability activity, see: http://www.accaglobal.com/documents/france_esra.pdf.

¹³ For more information about the new Companies Act of 2006, see: http://www.opsi.gov.uk/acts/en2006/ukpgaen_20060046_en.pdf.

¹⁴ SustainAbility (London), *Tomorrow's Value: The Global Reporters 2006 Survey of Corporate Sustainability Reporting*, page 8, 2007. Available at: http://www.sustainability.com/downloads_public/insight_reports/tomorrowsvalue.pdf.

¹⁵ Sam McManis, *Media Savvy: It isn't easy getting a grip on global warming*, *Sacramento Bee*, 9 October 2007. Available at: <http://www.sacbee.com/107/v-print/story/421283.html>.



up. It is not because we don't focus on those areas, because we do. But in fact putting them all together is fashionable. The word ['sustainability'] is fashionable”.

There are ways for companies and their boards to avoid the charge of greenwashing in their sustainability reports. One method is to use a recognised framework to structure reporting. There are a wide variety of methodologies a company can employ when preparing to report on sustainability, including AccountAbility's AA1000, launched in 1999,¹⁶ the Global Reporting Initiative's Sustainability Reporting Guidelines,¹⁷ and the Ceres Principles, from the Coalition for Environmentally Responsible Economies.¹⁸ Additionally, companies can choose to create their own reporting criteria, combining guidance from these formal frameworks with their own requirements.

Separate report versus inclusion in the annual report and accounts

Most European companies in our research issue a stand-alone sustainability report annually. This practice is not common in the US. Just under a third of the North American audit chairs that participated in our online survey issued a sustainability report at all. One of the companies issued a stand-alone report, and two companies issued their sustainability report as part of their annual report.

Several companies in Europe also include their sustainability reports in their annual report. Those audit committee chairs noted that including the sustainability report as part of the annual report guarantees that the board directors have seen and accepted the report. However, it is unclear how much focus the sustainability information gets when it is included in the annual report. As one European audit chair commented: “[Our annual report] just includes a couple of pages about our social commitment ... we just accept the information as part of that”. For more details about what is included in a sustainability or similar report, see *Appendix 1: What is in a sustainability report?* on page 12.

Balance between quantitative and qualitative information

One of the main challenges of sustainability reporting is finding a balance between presenting quantitative and qualitative information. Investor advocates are arguing for more quantitative measures. For instance, in September 2007, a group of mainly US activist investors petitioned the SEC to “urge the Commission to clarify that corporations should assess their climate risk, analyse whether that risk is likely to have a material impact on them, and if so, disclose it to the public as required under the Commission's rules”.¹⁹

According to Richard Shepard, President of Applied Ecosystem Services, the lack of “quantified measures of sustainability also leaves investors, analysts, and non-governmental organisations (NGOs) unsure of a

¹⁶ For additional information about AccountAbility's AA1000, see: <http://www.accountability21.net/default.aspx?id=42&terms=AA1000>.

¹⁷ For additional information about the GRI Sustainability Reporting Guidelines, see: <http://www.globalreporting.org/ReportingFramework/ReportingFrameworkOverview>.

¹⁸ For additional information about the Ceres Principles, see: <http://www.ceres.org/coalitionandcompanies/principles.php>.

¹⁹ California Public Employees' Retirement System and other petition signatories, *Petition for Interpretive Guidance on Climate Risk Disclosure*, submitted 18 September 2007. Available at: http://www.environmentaldefense.org/documents/6986_SECPetition_ClimateDisclosure.pdf.



corporation's status with regard to its written commitment to corporate environmental and social responsibility".²⁰

One manager responsible for sustainability said: *"I think here we have pretty good quantitative metrics in the areas ... you are able to have them. We have lots of quantitative data in environmental materials. But by no means are our metrics complete. As part of our report, we publish a table of metrics but there is lots of room for improvement. We work hard to make sure there is a balance between quantitative and qualitative"*.

Audit chairs, who are used to operating in a world of quantitative information, are less convinced of the value of purely quantitative information. One European audit chair said: *"You can come up with metrics but that isn't what it is all about. We have gone much more towards the qualitative"*. The audit chair continued: *"We moved from a highly quantitative approach to a much more qualitative approach because we learned you can't quantify everything"*.

External attestation and questions of expertise

An article published in 2000 foreshadowed the current debate about the need for external attestation in sustainability reporting: "When quality, consistency and value can be assured, companies will recognise that third party statements are an essential part of the reporting process".²¹ The Global Reporting Initiative (GRI) believes that a trend toward increased external assurance will continue in 2008, with more shareholders asking for external verification of sustainability reports.²² Some US audit committee chairs are disappointed by this trend. One told us: *"I am sorry to hear that shareholders are starting to ask for more formal disclosures on these things"*. Another remarked: *"This type of thing can be done in 20 lines. But in most other companies, they go on and on..."*.

Attestation is far more common in Europe than it is in North America. In fact, none of the North American companies participating in our survey who issued a sustainability report had any independent validation of the data it contained.

Given the unique skill set required to review sustainability reports, research participants acknowledged that it can be very difficult to find a source of external expertise. One European audit committee chair said: *"The bigger question for me is, what third party is qualified enough to actually review on it? I think the caution should be to ensure that attestation is defined in a way that ... good results come from the definition. There is a role for [attestation], but I don't know what it is"*. With this difficulty understood, companies have turned to four sources for external assurance:

- **External auditor.** If sustainability data is issued as part of the annual report, companies often turn to their external auditor for attestation. One audit chair said: *"Having the auditor attest it gives a little bit*

²⁰ Richard Shepard (Troutdale/Applied Ecosystem Services), *Quantifying sustainability: A Pragmatic Approach*, 2006. Available at: <http://www.appl-ecosys.com/publications/quantifying-sustainability.pdf>.

²¹ Paul Scott, *The Truth about Verification*, *Environmental Science*, September 2000. Available at: <http://www.nextstep.co.uk/uploadedfiles/pdf/article6.pdf>.

²² Alyson Slater, *The Economist asks what's ahead in '08 for sustainability reporting*, *Sustainability Reporting Central*, 3 September 2007. Available at: <http://globalreporting.blogspot.com/2007/09/trends-in-sustainability-reporting-for.html>.



more credibility to the numbers". The French Nouvelle Régulation Économique includes external attestation of sustainability reports. Even with such a law on the statute books, the level of attestation cannot be compared with that used for the financial reports. Regarding the external auditor, one European audit chair commented: *"They read what [management] propose to have in the report. If they find something that they don't like, they will say that and instead say they want something else"*. Of those audit chairs we spoke to whose companies had had their external auditor undertake assurance on the sustainability report, only one had been involved in the decision to give pre-approval for the non-audit-related service.

- **Another audit firm.** This option was used by several companies who did not feel that their own external auditor had the skills to undertake a sustainability audit while still providing assurance for the sustainability report.
- **Specialist assurance or consulting firm.** Some companies chose to employ a specialty firm to provide independent verification of their sustainability reports. One audit chair commented: *"I give lots of credence to making sure the data is definitely assured. We have very specialised experts versus the auditors"*. However, one European subject matter expert believes these third parties will not last long in the reporting arena: *"In the end, I think it will be the Big Four who will take the lead, especially when it comes to the quantitative reporting"*.
- **Specialist advisory board.** An interesting trend among some companies is the creation of a panel of external experts who participate in the sustainability conversations and are acknowledged in the final external report. This advisory board may be composed of academics, lawyers, NGO representatives and industry experts and focuses on ensuring the validity of any quantitative data as opposed to the content of the narrative.

Conclusion: what does the future hold for sustainability reporting?

Alyson Slater of GRI explored what she believes the future holds for the sustainability debate in 2008. Topics she raised include the rise of sustainability reporting through the supply chain; a marked increase in sustainability reports from Russia and India; a continued and successful push by investors in the US for more transparency and reporting; the possible emergence of eXtensible Business Reporting Language (XBRL) as a sustainability reporting tool; and climate change and human rights emerging as mainstream agenda items.²³

Audit committee chairs may have a unique role to play in the evolution of sustainability governance reporting. With their experience of dealing with quantitative financial reports, they are well placed to push for more quantitative non-financial reports and a fuller discussion of those reports by boards and the appropriate board committees. As the board director responsible for the company's relationship with the external auditors, they are also in a good position to consider how best to provide assurance for the sustainability report.

²³ Ibid.



The drivers of change identified earlier – investors, consumers and employees – are likely to continue to push for more sustainable business strategies, products and services. Activist and ethical investors will increasingly look to board directors for reassurance that sustainability risks have been mitigated, that opportunities have been optimised, and that the company is seriously engaged in the effort rather than attempting to greenwash. Audit chairs have the opportunity to help shape a company’s response.

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members in Europe. Initially, *InSights* will be distributed to members of the European Audit Committee Leadership Network who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

The views expressed in this document represent those of the European Audit Committee Leadership Network, the Audit Committee Leadership Network of North America, and other audit committee networks – groups of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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Appendix 1: What is in a sustainability report?

As part of the research for this issue of *InSights*, we conducted a review of 28 sustainability or similar reports. These reports all came from companies on whose board sits a member of the European or North American Audit Committee Leadership Network.

Most frequently included topics in sustainability or similar reports:

- **Environmental issues and/or climate change.** All of the reports comment on the company's impact on the environment, particularly on carbon emissions. Industries that are more likely to have a greater environmental impact – such as the energy, oil and gas, and transportation industries – devote a significant portion of their report to the methods they employ for mitigating environmental risks.
- **Relationship with the local community.** All companies report on their commitment to the local community. This covers the company headquarters and other global locations. These parts of the reports often include details about the company's community-wide initiatives, such as their volunteer programmes.
- **Ethics and governance.** Only two of the 28 reports reviewed do not refer to the company's ethics and governance policies, while all 28 provide access to these materials on their websites.
- **Health and safety.** All but two companies state their commitment to high quality working conditions, the safety of their employees, and the health and safety of their products.
- **Human resources.** Only five companies – mostly German – formally detail their company's policies on human resources in their sustainability report.
- **Philanthropic activities.** Four companies clearly define their philanthropic activities in their sustainability report. However, many companies detail this information in a separate report.
- **Other content.** Companies are able to customise their sustainability reports to reflect the full scope of their practice. Other topics covered in the reports include short- and long-term sustainability strategy, engagement with the supply chain or with shareholders and industry, regulatory topics specific to the company, and a statement from the company's CEO and/or chairman giving their perspective on sustainability.



Appendix 2: Research participants

European and North American audit committee chairs and members who participated in the research through one-to-one or small group teleconference discussions during October 2007 included:

- Mr Denny Beresford, Audit Committee Chair, Kimberly Clark
- Mr John Clendenin, Audit Committee Chair, The Home Depot
- Mr Tom de Swaan, Audit Committee Chair, Royal Ahold and GlaxoSmithKline
- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Professor Guido Ferrarini, Audit Committee Member, Atlantia
- Mr Gene Fife, Audit Committee Chair, Caterpillar
- Mr Dick Harrington, Audit Committee Chair, Xerox
- Mr Roland Hernandez, Audit Committee Chair, Wal-Mart
- Mr Phil Hodgkinson, Audit Committee Chair, BT Group
- Mr Laban Jackson, Audit Committee Chair, JPMorgan Chase
- Dr DeAnne Julius, Audit Committee Chair, Roche Holding
- Ms Marie Knowles, Audit Committee Chair, McKesson
- Mr Daniel Lebègue, Audit Committee Chair, SCOR and Technip
- Mr Oscar Munoz, Audit Committee Chair, Continental Airlines
- Mr Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Ms Pam Patsley, Audit Committee Chair, Texas Instruments
- Sir Ian Prosser, Audit Committee Chair, BP
- Mrs Judy Richards Hope, Audit Committee Chair, Union Pacific
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, Areva
- Dr Klaus Schlede, Audit Committee Chair, Deutsche Telecom and Lufthansa
- Mr Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services
- Mr Sandy Warner, Audit Committee Chair, General Electric Company
- Mr Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company