THE CONFERENCE BOARD

The Roles of the Board in the Era of ESG and Stakeholder Capitalism: Supplement 4

Improving Board Evaluations of Corporate, Management, and Its Own Performance in the Era of ESG and Stakeholder Capitalism

In partnership with: MORROW SODALI

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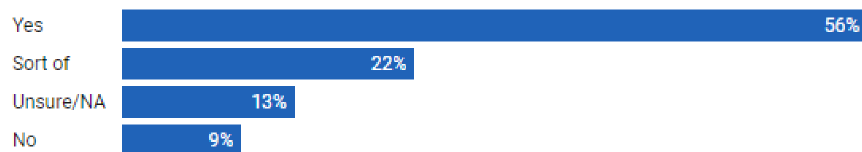
The intensified focus on ESG and stakeholder capitalism should not only be reflected in the board's responsibilities, but also echoed in its processes for evaluating the *company's*, *senior management's*, and the *board's* own performance. Currently, these evaluation processes tend to be discrete and somewhat disconnected. It's especially important that the board's assessment of senior management's performance and its own performance tie back to the evaluation of the company's performance.

Evaluating the *Company's* ESG Performance

While most boards evaluate their company's ESG performance, poll participants find their assessment somewhat rudimentary. While a majority of respondents indicate that their board evaluates—at least to some extent—their company's ESG performance, almost half (48 percent) believe their board is only doing an *OK* job. Another 21 percent say their board is doing a *good* job and only 7 percent think their board is doing an *excellent* job.

Most boards evaluate company ESG performance annually

Q: Does your board evaluate your company's ESG performance on at least an annual basis?

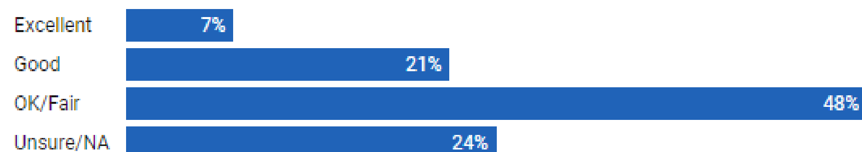


In-meeting poll question - 32 respondents

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group - Session 4 •

Only 28% of boards do a good or better job of evaluating company ESG performance

Q: How good of a job does your board do in evaluating your company's ESG performance on at least an annual basis?



In-meeting poll question - 29 respondents

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group - Session 4 •

To be sure, the assessment of the company's ESG performance will depend on the maturity of the overall ESG program and the company's position on each issue. Indeed, there will be a different degree of evaluation, depending on how deeply ESG is embedded in the company: from compliance with the law, to risk and cost reduction, to reputation protection, to leadership.

Other factors for companies and boards to consider with respect to a company's ESG performance include:

- **The company's ESG performance evaluation needs to be built into the overall business evaluation.** An assessment of the firm's ESG performance will likely be ineffective if it is conducted in a silo with the board focusing on just a few narrowly defined ESG measures. Just as ESG needs to be integrated into business strategy and operations to augment impact, so should ESG performance be measured as part of a more holistic review of the company's overall performance.
- **While boards should look at ESG as part of the company's business, evaluating ESG performance is not as straightforward as evaluating financial performance.** Assessing ESG performance isn't as simple as looking at a few well-established financial metrics such as total shareholder return or earnings per share. But even in the absence of universal (or even generally accepted) ESG metrics to assess *substantive* performance, boards need to address *process* matters. These may require a somewhat different mindset, with the board asking questions such as: What does ESG/sustainability mean for the company? How are we integrating sustainability into the business to reduce risks and take advantage of opportunities? How are we organizing to successfully execute our sustainability strategy? How are we setting goals? How are we communicating our sustainability story? And how are we dealing with reporting frameworks, rating agencies, and regulators?
- **Companies already have a meaningful level of information about ESG performance that simply hasn't been shared with the board yet as part of an annual review process.** Companies may have already been tracking performance on certain ESG topics that are integral to their business strategy or company culture (e.g., employee health & safety; pollution; diversity, equity & inclusion). While it may take time to develop other relevant ESG measures of performance (e.g., percentage of revenue derived from, or spend on, sustainability-linked products and services), companies can start now by incorporating existing measures in their year-end (or even quarterly) assessments of corporate performance.
- **Companies should determine their own approach to evaluating their ESG performance to avoid being pulled in various directions**. Companies are facing numerous ESG (disclosure) regulations—both in the US and beyond—as well as myriad expectations from investors, rating agencies, and other stakeholders. If they simply measure their performance in response to investors (who may be focused too much on risk and not enough on strategic opportunities) or regulations (which are different depending on the region), the assessment might become fragmented and misshapen. By taking a business-oriented, tailored approach—similar to what they already do when it comes to risk management—companies are more likely to look at ESG performance in an integrated way.

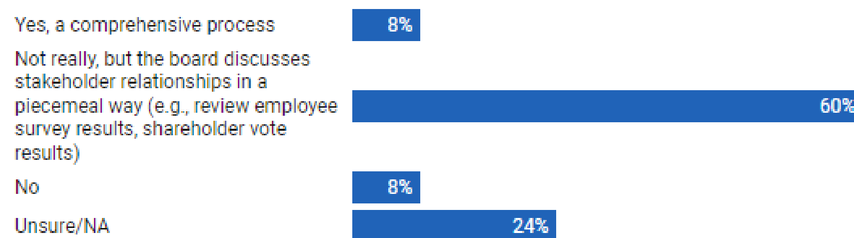
- **There should be some level of alignment between the board's assessment and investors' assessment of the company's ESG performance—but this can be difficult to achieve.** Both boards and investors evaluate the company's performance in ESG, which is why boards will want to ensure there's alignment between how they themselves assess the company and how investors go about this. But there are currently disconnects. First, rather than taking a holistic view, investors tend to look at companies' ESG performance generically and—either driven by their own agenda or constrained by a lack of resources—often focus on a narrow set of metrics without considering the company's unique circumstances or ESG priorities. Second, the way investors are structured (with a portfolio side focused on financial results and a stewardship side focused on ESG) is sending mixed signals to companies about where investors' priorities lie.

Evaluating the *Company's* Stakeholder Relationships

Boards are evaluating the company's relationship with its stakeholders in a somewhat ad hoc manner, according to poll participants: a majority of respondents (60 percent) indicate that their board doesn't have a comprehensive process in place to evaluate the company's relationships with stakeholders but rather discusses stakeholder relationships in a piecemeal way. (For example, the compensation committee might be looking at employee satisfaction and the nominating/governance committee might be looking at shareholder voting results.)

Boards do not consistently evaluate stakeholder relationships

Q: Does your board have a process in place to evaluate the company's relationships with stakeholders?



In-meeting poll question - 25 respondents

Source: The Roles of the Board in the Era of ESG and Stakeholder Capitalism Working Group - Session 4 •

Boards can evaluate the company's relationships with stakeholders in various ways. For example, they can look at the *quality of the relationship* with each stakeholder group (that is, investors, employees, consumers, business partners, regulators, etc.); whether the company is serving its stakeholders' *interests*; and/or if it is meeting its stakeholders' *expectations*.

But with different stakeholders having divergent interests and expectations, it's nearly impossible to employ a unified stakeholder strategy, which is why each stakeholder group will require its own approach. Generally speaking, companies and boards will want to:

- **Consider the state of their relationship with *every stakeholder group*** and ensure there's a constructive, two-way dialogue with each of them. This allows companies to

understand what's important to their different stakeholders as well as where they can have the biggest impact.

- **Serve the interests of *most stakeholder groups*,** as this is at the heart of the shift toward multistakeholder capitalism, in which companies are placing a higher priority on serving the long-term welfare of constituents beyond their shareholders. However, the extent to which a company can serve the interests of stakeholders will vary over time, based on the issue and on the company's circumstances. Further, serving interests is not particularly relevant when it comes to regulators, as companies typically are less concerned with serving their regulators' interests.
- **Meet the expectations of *some stakeholder groups*** and educate others. While it's vital for companies to meet the expectations of their regulators and investors, it's likely impossible to meet (or be guided by) the expectations of *all* their stakeholders, including employees and customers with widely ranging views. To increase their stakeholders' (especially employees') understanding and acceptance of the firm's positions, including on ESG, companies will want to educate their stakeholders about the company's business model and the intersection between the firm's business success and sustainability.

It's important to note, however, that maintaining fruitful stakeholder relationships is a two-way street and takes some effort on the part of the company's stakeholders as well. For example, as companies mature in their approach to and assessment of ESG, so should investors evolve in order for the dialogue on these complex and nuanced issues to remain constructive. This might require additional resources and a change in mindset (e.g., investors should not regard ESG solely as an area of risk but also opportunity, and they shouldn't focus on generic metrics but take a tailored approach when assessing each company on ESG).

Evaluating *Senior Management's* ESG Performance and Stakeholder Relationships

Boards and compensation committees typically assess management's performance in the context of executive compensation, where they look at a predefined set of (predominantly financial and operational) goals. Yet, when it comes to promotion/development practices and succession planning, they tend to evaluate executives more comprehensively and look at how individual executives are carrying out their full breadth of responsibilities as well as how they are doing in their relationships with stakeholders, which brings into play the executive's "soft skills" such as agility, authenticity, and ability to listen.

Some additional considerations for boards as they evaluate senior management's ESG performance and stakeholder relationships:

- **Boards should take a holistic look at executive performance without trying to "redo" the CEO's performance evaluations of executives.** It's unrealistic to think that the board or compensation committee conducts a comprehensive review of each executive every year. However, it should have some visibility into how the CEO evaluates each executive (including their ESG performance and relationships with stakeholders), and the CEO should bring to the board's attention anything notable, especially as it concerns risks and opportunities for the company.

- **CEOs and boards will want to consider whether, how, and at what cadence to solicit input from across the C-suite on an individual executive's performance.** Compensation committees don't typically include, either in person or by proxy, the nonfinancial side of the house (e.g., human resources, government relations, corporate citizenship/community relations, marketing, and investor relations) when discussing executive performance. However, these functions represent the views of the company's stakeholders (e.g., employees, regulators, communities, consumers, and shareholders). CEOs and boards may want to consider how those departments' perspectives can be brought to bear in periodic, if not annual, evaluations of management's performance.

Evaluating the *Board's* ESG Performance and Stakeholder Relationships

Boards don't need a separate questionnaire on how they are fulfilling their roles with respect to ESG and stakeholder views, but they should consider building these topics into the traditional board and committee self-evaluations. For this to be successful, it needs to be practical. For example, boards can incorporate the notion of ESG and stakeholder interests into existing questions on board composition, leadership, and capabilities, and include oversight of ESG into questions on board committee structure and board meetings.

There are, however, a few broader questions on ESG and stakeholder views that boards might want to add to existing evaluations, including whether:

- The board has a good understanding of—and consensus on—the ESG issues that matter most and how to balance various stakeholder views;
- The corporate governance policy appropriately reflects the board's responsibilities with respect to ESG issues and stakeholder interests; and
- The board is effectively taking relevant ESG issues and stakeholder interests into account in its discussions and decisions.

Additional points for boards to keep in mind:

- **The evaluation of the board's ESG performance and stakeholder relationships will likely evolve over time.** Indeed, as a company's ESG program matures, so will the board's role with respect to ESG. Initially, the board may want to assess whether ESG responsibilities are allocated adequately among the full board and its committees. Later, this may shift to building—and evaluating—the board's understanding of key ESG issues and stakeholder views.
- **A deeper and more advanced evaluation of the board's ESG performance and stakeholder relationships may result in an increased gap between what the board knows and what is disclosed.** Given the sensitive nature of these performance evaluations, boards need to be mindful about how transparent they want to be in their public disclosures in this area—whether it's in written materials or in engagement calls with investors.

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