How can boards convert sustainability from a wish to a winning reality?

EY Europe Long-Term Value and Corporate Governance Survey

Fourth edition: March 2024

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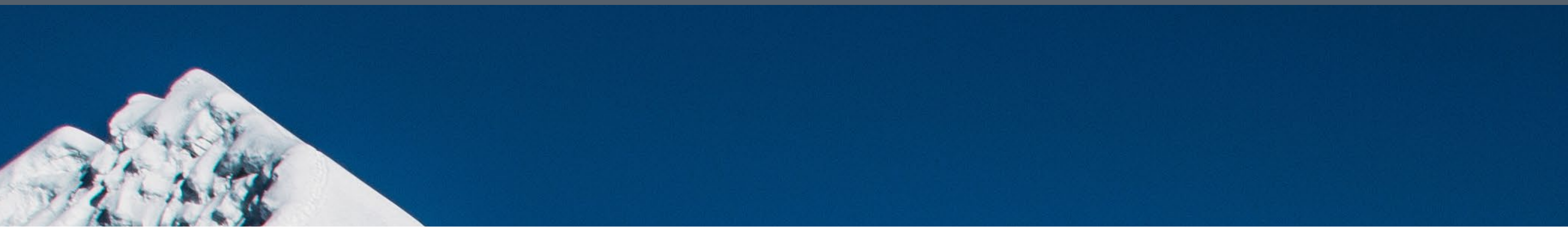

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- **Christian Heller**, CEO, Value Balancing Alliance
- **Paul Lee**, Head of Stewardship and Sustainable Investment Strategy, Redington
- **Christina Shim**, Global Head of IBM Sustainability Software
- **Robin Stalker**, former CFO at adidas AG, and a supervisory board member at a number of companies

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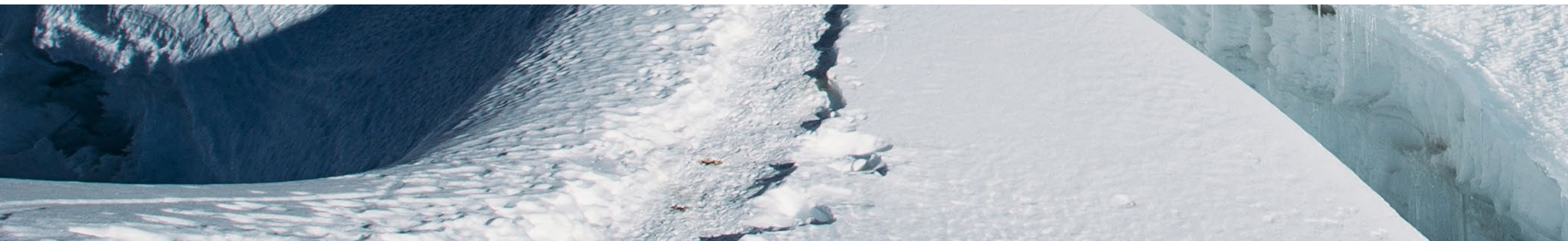
Defining sustainability and ESG

Sustainability is the practice of operating a business in a way that meets the economic, social and environmental needs of the present without compromising the ability of future generations to meet their own needs — measuring success in terms of the "triple bottom line" of profit, people and planet. **ESG** is a framework — often used as risk assessment in the investment industry — that provides a more quantitative, granular assessment of a company's risks and opportunities, using benchmarks and metrics to build an understanding of environmental and social issues ("E" and "S"), as well as the corporate governance practices ("G") that ensure it is run in the best interests of all stakeholders.



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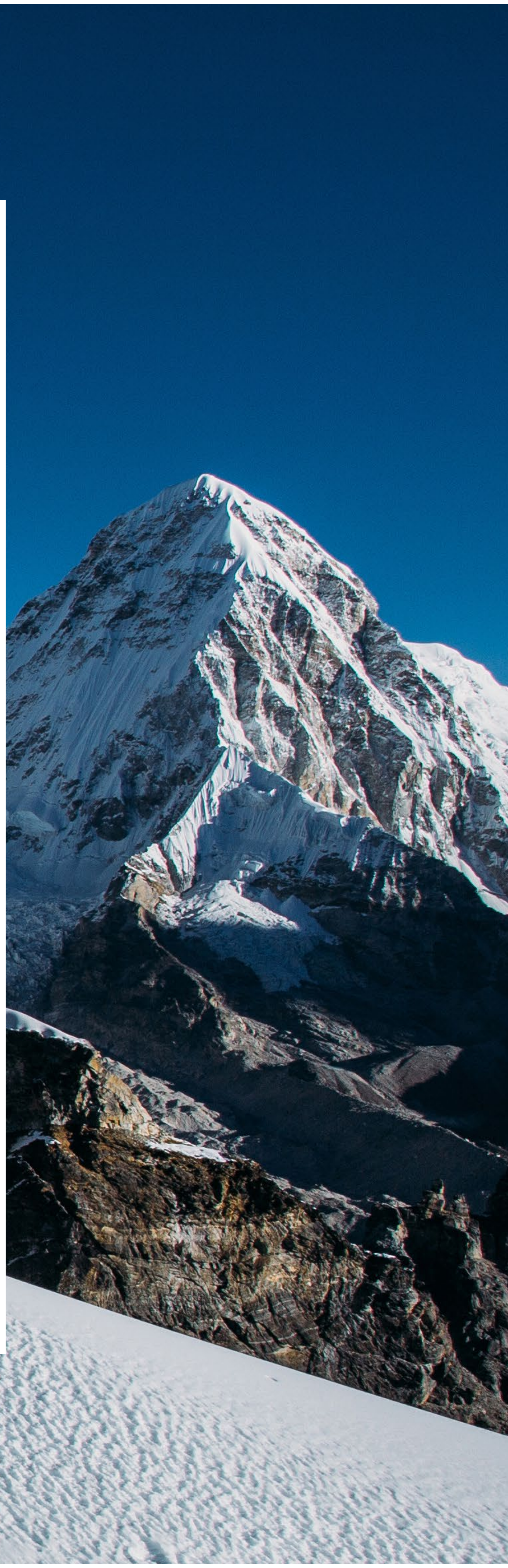


Foreword

Focusing on sustainability in today's operating environment is clearly challenging. Company leaders are having to contend with significant geopolitical turbulence, macro-economic uncertainty, and considerable pressure on supply chains. There are worrying signs that commitment to sustainability is cooling at a time when global warming is still unchecked.

If businesses do not move fast enough, policymakers are increasingly likely to intervene, implementing more stringent measures to manage the implications of resource scarcity and limiting companies' potential for future innovation in the process.[1] This is a plausible scenario if we do not better progress. For example, the WEF's Global Risks Report 2024 explains how environmental risks could hit the point of no return.

This new EY research suggests that boards need to respond by leaning in — emboldening management to embed sustainability as a business imperative and rationalizing investment decision-making so that capital allocations flow to projects that make a difference, boost financial performance, and deliver on their promises.

The fourth annual edition of our EY Europe Long-Term Value and Corporate Governance Survey examines the role of governance in sustainable business model innovation. While our 2023 research program focused on the most effective models and practices of effective sustainability governance, this year we look at how boards can challenge their companies to embrace sustainability as a true business imperative and utilize policy and technology developments to accelerate progress.

[1] ***Global Risks Report 2024***, WEF, 10 January 2024.

Julie Linn Teigland
EY EMEIA Area
Managing Partner

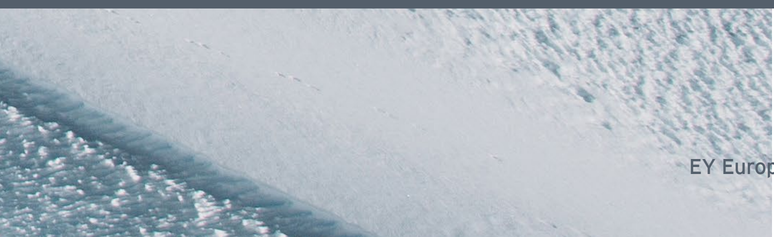
Andrew Hobbs
EY EMEIA Center for Board
Matters Leader, EY Global

Drawing on the views of 200 directors, CEOs and C-suite leaders, we found a group with more advanced governance (the "Leaders") that are better placed to challenge management thinking, scrutinize capital allocation, and insist on greater ambition. Compared to the "Followers", the Leaders have a clearer strategic view of how sustainability can achieve their value-creating objectives; tend to go beyond compliance with sustainability regulations; and are better placed to seize AI's potential to accelerate sustainability.

Based on that analysis, this report explores three key areas where boards can get on the front foot and accelerate progress:

1. Boards need to challenge management to embed sustainability into the business strategy, demanding an ambitious strategic vision from the CEO and senior management teams and critically scrutinizing supporting business cases.
2. Boards should insist on a more ambitious, strategic approach to the policy and regulatory agenda to move beyond compliance and pinpoint where the company can find a strategic advantage over the competition.
3. Boards need to exploit AI's sustainability potential. While the subject of artificial intelligence (AI) is ubiquitous today, there is a significant link between AI, sustainability and governance that needs to be explored. Responsible governance allows the organization to balance the sustainability opportunity while managing AI's environmental, societal and ethical challenges.

Effective boards do not just have a view on possible alternative futures for their organizations. They must also play an active role to encourage management to do what is right for the long-term health of the business in the face of challenge. Sustainable business models are, quite simply, good business. We hope this report plays a role in galvanizing action on sustainability, and our thanks go to the leaders who contributed their thinking to it.



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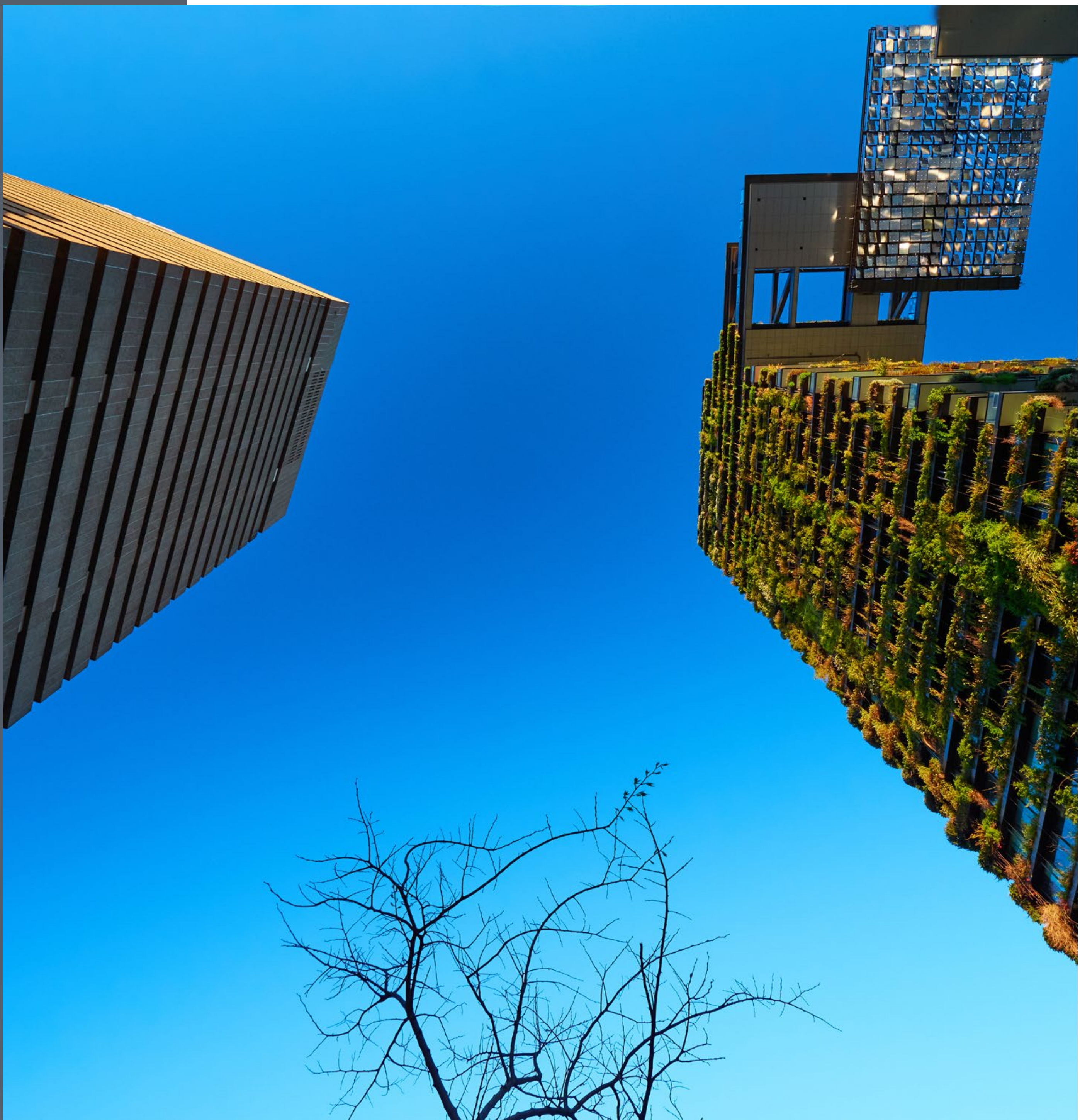
The sustainable business imperative



There are concerns that sustainability momentum is slowing as companies confront significant challenges, from geopolitical volatility to macroeconomic uncertainty. Data from the **2023 EY Sustainable Value Study** found that the median target year for achieving climate ambitions is now 2050, compared with 2036 in the previous year's study.[2]

Boards play a key role in maintaining focus on sustainability as a strategic imperative in the face of challenge – reimagining the business for a sustainable future. EY research shows that investors expect sustainability to be an imperative – EY Center for Board Matters analysis found that investors see "climate change and environmental stewardship" as one of the top two board priorities in 2024, selected by 56% of investors.[3]

However, this new research – drawing on the views of 200 directors, CEOs and C-suite leaders – suggests that companies in Europe are not driving sustainability as a source of differentiation and growth. In other words, they are not pursuing game-changing opportunities that focus on new sustainability ventures and products or services.

The research asked respondents to nominate their top value driver when it came to their sustainability agenda. As Figure 1 shows, while companies are pursuing legitimate sources of value – such as employee and customer loyalty – the Leaders are less inhibited and are aiming, first and foremost, for business model innovation and the growth agenda. This signals a bolder ambition to reimagine their business model to turn sustainability into a core business advantage.

The fact that companies overall are not aiming for bolder business model reinvention could reflect the difficult strategic choices that need to be made. Companies will need to understand the limits of their current business models as well as the precise long-term opportunity offered by new markets. Trade-offs will need to be made when it comes to allocating capital – shifting allocations from traditional business lines to new sustainability ventures.

The value case for sustainability: metrics

As well as making decisive choices about their sustainability ambition, companies will need to show how their initiatives link to value creation and financial performance. However, the research found that companies do not appear to have a robust business case showing and quantifying how investing capital and resources in a priority, such as net zero, will unlock value.

Figure 1: What are your main objectives when it comes to driving value from your sustainability agenda?

Overall results

1 **Boosting customer loyalty and our price premium (selected by 19% of respondents as their first and foremost objective)**

2 Creating positive impact on the valuation of the business (17%)

3 Building employee loyalty and engagement (16%)

Leaders

1 **Driving growth strategy, including new products and services, business models and market expansion (20%)**

=2 Identifying unique advantages over our competition (18%)

=2 Targeting opportunities for cost efficiencies and optimization (18%)

[2] "As global headwinds slow momentum, how can we accelerate climate action?," *EY 2023 Sustainable Value Study (Second Annual Study)*, EY, 21 November 2023.

[3] "What directors need to know about the 2024 proxy season," EY, 6 February 2024.

- Less than a quarter of survey respondents (24%) say they are "completely satisfied" that they have a clear strategic view, backed by credible analysis, of how tackling their material ESG priorities will achieve their value-creating objectives.
- Moreover, non-executive directors and chairs are particularly skeptical about the business rationale – only 8% are "completely satisfied" – indicating a significant strategic data and information gap at the board level.

The Leaders in the survey are confronting this issue. They prioritize robust sustainability metrics that show financial impact and are much more likely to have complete confidence in the metrics that support decision-making by the board.

There needs to be a more robust articulation of long-term value potential, backed by a credible business case, to build support for sustainability investments that would increase market share, reduce cost of capital, boost net promoter scores, and increase employee engagement and productivity.

Those who resist the development of sustainability value frameworks and metrics tend to say it is too complex to do or point to a lack of data. However, all those hurdles can be overcome, if boards set the expectation that it can and must be done. Boards play a critical role in shifting thinking and some of the misconceptions that are still attached to putting long-term value frameworks in place.

Being able to articulate the business case credibly and persuasively for sustainability offers several advantages:

- Helping balance long-term goals with the need to satisfy short-term performance expectations. In the research, 60% of respondents say "there are significant differences of opinion within our leadership team on how to balance short-term considerations with long-term investments and sustainable growth."
- Ensuring management teams feel accountable for achieving long-term goals in the same way they need to hit their shorter-term financial performance targets.
- Making a persuasive "case for change" to galvanize people behind the complex enterprise transformation required. As we examine below, there are question marks over whether companies can deliver the complex transformation required to achieve their sustainability commitments, including uniting and mobilizing employees behind the vision.

Figure 2: **How confident are you about the metrics you have in place today to quantify and communicate how ESG investments can protect and grow financial and operating performance?**

Percentage of respondents who are "completely confident" about the metrics they have in place today.

Note: excludes those who responded "not confident" or "somewhat confident."
Source: *EY Europe Long-Term Value and Corporate Governance Survey*, March 2024 (total respondents: 200).

External viewpoint

In conversation with

Robin Stalker

Robin Stalker, former CFO at adidas AG, is a supervisory board member at a number of companies.

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Leadership must understand that sustainability is a business imperative and critical to stakeholders. For one CEO I know, expectations to focus on sustainability came not only from investors, customers and clients — it also came from his children around the breakfast table, who wanted to know what his company was doing.

To reach a truly sustainable business model, how demanding of executives do boards need to be, particularly to produce robust business cases for major sustainability investments?

I think the issue is that not everyone on a board will have the same view about balancing the longer term with immediate returns. Some sustainability decisions that need to be made now are not going to deliver returns, such as profitability or a lower cost of capital, immediately. As a result, some of these critical decisions risk not being made because they do not meet an immediate short-term ROI hurdle.

So, you need to be looking at the business case over a long-term timeframe. To do this, a board will likely need to ask for new metrics to critique a decision – the point being that you cannot always solve 21st-century issues with traditional tools and accounting techniques. Boards will also need to ensure that executive bonus schemes reflect not just short-term financial results but also long-term sustainability targets.

How effective will the EU’s Corporate Sustainability Reporting Directive (CSRD) be at transparently demonstrating a company’s sustainability performance?

The CSRD is addressing an issue that the business community has simply failed to deal with: giving investors credible, comparable sustainability disclosures that they can critique and use to make strategic choices. Boards play a critical role in tying reporting to the material information that investors and other stakeholders need to make decisions, and therefore positioning it as more than a compliance exercise.

While the CSRD may not be perfect, the fact remains that we need this information, and we need it now. But I do think it’s important to see this not just as “reporting.” You also need to see it as putting together information that will allow a company to make better decisions. So, this information is good for our stakeholders, but should also be seen as necessary for the company making better decisions for the long term.

Sustainability transformation: Nonexecutives are more doubtful about workforce engagement and culture

"Sustainability transformation" is particularly challenging. The enterprise's goal of driving a more sustainable future will often draw on "transformation" programs taking place within multiple functions. Decarbonization, for example, can cut across disparate decarbonization initiatives in supply chain, people and operations.

The research finds that the nonexecutive directors and chairs in the survey are not in alignment with executive C-suite leaders[4] when it comes to transformation capability. Nonexecutives are less confident in the ability of the organization to drive sustainability transformation, particularly when it comes to bringing people along on the journey:

Defined values and culture that reflects sustainability transformation priorities

63% of C-suite executives believe they have a highly effective approach when it comes to values and culture, but this drops to 40% for nonexecutives and chairs.

Robust program of employee training, including upskilling or e-skilling, to align the workforce and culture behind sustainability goals

60% of C-suite executives believe they have a highly effective approach when it comes to training, but this drops to 43% for nonexecutives and chairs.

This could, of course, be an awareness issue and reflect that executives will tend to have more direct interaction with employees than nonexecutives. However, the fact remains that boards play a critical role in ensuring that the workforce is truly engaged in the sustainability transformation. This suggests that boards need more information and insight on workforce readiness, and the ability of the business to embed sustainability into behaviors and culture.

Transformations will not succeed without engaged people. According to research by the **EY organization and the University of Oxford's Saïd Business School**, organizations that put humans at the center of their transformation efforts are 2.6 times more likely to be successful than those that do not. Boards can focus on people being genuinely engaged with sustainability by ensuring the company has a robust approach across three areas:

1. Understanding and strengthening sentiment (e.g., how employees feel about the sustainability ambition)
2. Involving people in shaping solutions (e.g., identifying change agents and internal champions)
3. Sustaining and reinforcing impact and contribution (e.g., providing spaces for people to collaborate and share success stories)

[4] Note: This refers to senior executives who responded to the survey, such as chief sustainability officers, chief operating officers, and CFOs, but does not include the CEO.

External viewpoint

In conversation with

Christian Heller

Christian Heller is CEO of the Value Balancing Alliance, which is creating a global impact measurement and valuation standard to translate environmental and social impacts into comparable financial data.

> “
> Our overall vision is to devise a totally standardized sustainability statement in monetary figures.

What are some of the key success factors for companies to effectively measure, manage and disclose their environmental and social impacts and, at the same time, secure a return?

If you look at many sustainability or long-term value reports today, the fact remains that you will struggle to understand where the company is heading in terms of performance and then compare them with other organizations. But there are two promising developments that can address this issue. First, the movement around integrated profit and loss (P&L) accounts or impact statements. Secondly, how you integrate environmental or societal effects into the financial statements, such as balance sheet or P&L – a direct integration. I would expect to see legislation and policy emerge around this soon.

This does raise questions about data and capabilities. Lack of data will be a significant issue as long as data systems sit in silos like finance, HR and so on – so IT solutions that integrate this will be key. In terms of capabilities, while there has been progress in involving CFOs and finance, there's still further to go in building an integrated approach. This is where you also involve the CEO for strategy and investor relations professionals to cover off communications to financial markets.

How important is it that companies measure and communicate environmental and social impacts using financial language that the market understands and is willing to reward?

Today, companies that are integrating sustainability into their business models are not being adequately rewarded for their efforts, either by capital markets or by customers and clients.

There are a range of detailed objectives, regulations and reporting standards – SDGs, TNFD, CSRD and so on – but our overall goal needs to be to reduce sustainability KPIs to a language that everyone in the business community understands: money. This drives a change in attitude. The board and other decision-makers, like investors, won't truly care unless you talk their language. If you turn up with monetary figures, then people get that their business model may be at risk unless they do something.

Our overall vision is to devise a totally standardized sustainability statement in monetary figures. The work of policymakers and regulators is important in terms of improving the processes and data behind sustainability KPIs, but the business community and financial markets cannot wait for the regulators to address the issue – we need to come up with active solutions now.

Key actions

To fulfil their responsibilities, boards need to embolden their management teams. This active stance from the board will reinforce a company culture where sustainability is seen as mission critical. Here, the leadership team of CEO and board are united behind the sustainability mission rather than leaving it to a sole executive – such as a chief sustainability officer – to champion, important though the role of CSO is (see "The chief sustainability officer: Boards need to ensure they have the right person for the job").

Key questions for boards

Strategic vision and sustainability integration

- How can we actively revise our business strategy to incorporate sustainability at its core? How have the core components of the business model been assessed from a sustainability perspective?
- What specific steps can we take to ensure our leadership visibly champions and drives our sustainability ambitions?
- What more could we do in our engagement efforts and sustainability narrative to bring funders and investors closer to our sustainability vision and journey, so they are more engaged, enthused and bought-in?
- What new approaches can we adopt to ensure a better balance in our focus on both immediate and long-term sustainable growth?
- How do we know that management understands the universe of initiatives created under a sustainability umbrella? How can we tell which ones are part of a coherent approach to building a more sustainable business model as opposed to those with value limited to positive perception only?

Sustainable value metrics

- How can we define sector-specific sustainability metrics that link to value drivers such as market share, consumer uptake and reduced cost of capital?
- What skills and capabilities do we need to develop such metrics and monitor them over time?
- How can we use such metrics in alignment with our reporting and a sharpened investor narrative?

The board's role in sustainability culture and transformation

- How can we cultivate a company-wide culture where sustainability is a fundamental value?
- How can we move beyond compliance to embed sustainability deeply into our company's creation of value?

> “There can be a need for a dedicated chief sustainability officer to ensure that consistent sustainability KPIs are pushed down to the management teams making day-to-day decisions. This then provides transparency for the executives on progress. But while there are certain tasks that can be assigned like this, it’s not something at the board level that can be ‘delegated’ to one group — sustainability needs to be business as usual and integrated into the strategy.

Robin Stalker
Former CFO at adidas AG, Supervisory board member at a number of companies

The chief sustainability officer: Boards need to ensure they have the right person for the job

When the chief digital officer position first emerged on a wave of technology innovation, it was argued that the end goal of the incumbent should be to make their role effectively redundant – to embed technology so deeply into the strategy that “digital” effectively became business as usual.

Similarly, sustainability is not something that can be “assigned” to an individual: For it to be embedded in the strategy of a company, it needs to be everybody’s business. Rather than a CSO being seen as someone who carries the sustainability torch for the rest of the organization, there is recognition that the CEO and board must also see sustainability as mission critical to the company’s future.

That is not to say that, with the right remit and capabilities, a CSO cannot be an integral part of the governance picture when it comes to sustainability issues such as net zero. As part of the **EY Sustainable Value Study**, our analysis of corporate data from Forbes’ The Global 500[5] indicates that organizations with a CSO are more committed to sustainability, have more ambitious emission reduction targets (54% vs. 44% of organizations without a CSO) and have reduced their emissions 3.6% over three years (vs. a 5% increase in companies without a CSO).[6]

However, a CSO who can drive such results – and can play their part in challenging the CEO, board and management – needs to have the right background and capabilities. In the same way that the remit of the CFO has changed over recent years, the CSO role has also become more strategic. CSOs need to be able to identify the sustainability issues that have a substantial impact on an organization’s financial performance and risk profile. This requires someone with the right operational background, including commercial, operations, finance and business transformation experience.

For boards, this means asking if they have the right CSO for today’s needs and whether the remit is best fulfilled by a discrete CSO role or, potentially, rolling the responsibilities into an existing role: either CEO or a C-suite position such as finance chief or COO.

[5] Fortune Global 500: fortune.com/ranking/global500/.

[6] “As global headwinds slow momentum, how can we accelerate climate action?,” *EY 2023 Sustainable Value Study (Second Annual Study)*, EY, 21 November 2023.

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A bold approach to sustainability policy and regulations

Boards — particularly those of multinationals — face a highly complex and fast-changing policy and regulatory environment. They may be operating across regions where political and policy support for sustainability varies significantly, which means compliance requirements will differ between jurisdictions — as can the politics. Particularly in the latter situation, boards would do well to focus the company on the delivery of value via an integrated strategy that uses financial language as far as possible, where sustainability factors are the means to the delivery of that value and not the end itself.

When a policy or regulatory directive is introduced, companies face a choice: Respond with a bold approach that looks to unlock the strategic advantage of a regulatory directive or take a less responsive approach that aims for compliance and not much more. A bolder approach offers several advantages:

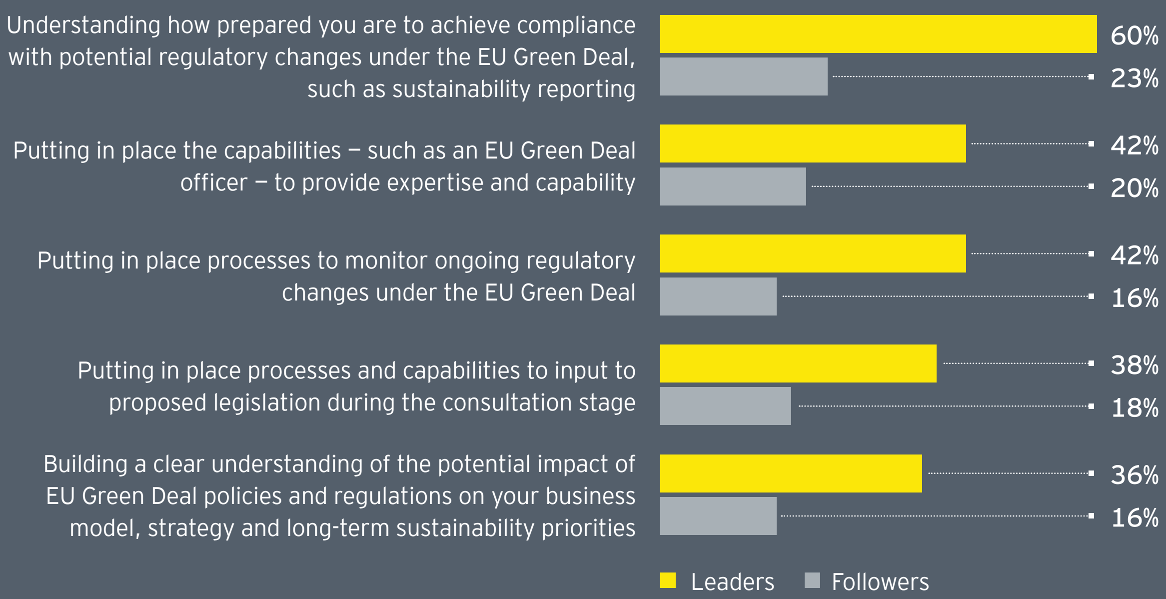
- It allows an organization to look at the investment required to achieve compliance and understand where it can build on that investment to unlock an advantage and drive innovation.
- In the short term, it can streamline the organization's response to regulations, as boards will be clear about what really matters within a directive. And, in the long term, boards need to be thinking about the business implications if climate change is insufficiently checked, including increased intervention by policy makers.

As an example, the research finds that Leaders are taking a more proactive approach to the European Green Deal and are more likely to be pursuing a bold approach in response to the CSRD and the Corporate Sustainability Due Diligence Directive (CSDDD).

Those taking a bolder approach to policy will have assessed their current strategy against the funding and incentives that are available. They will have put in place the capabilities they need — including, potentially, a "Green Deal Officer" — and have team members that offer public sector experience and understanding of the laws, language, culture and stakeholder frameworks that govern public-sector decision-making. Leaning into sustainability policy enables companies to respond to a fast-changing policy and regulatory environment.

Figure 3: Given the focus of the EU on the Green Deal and the greening of the European economy, how far progressed are you when it comes to the following actions?

Percentage of respondents who have completed the following actions.



Source: *EY Europe Long-Term Value and Corporate Governance Survey*, March 2024 (total respondents: 200).

In conversation with

Raija-Leena Hankonen-Nybom

Raija-Leena Hankonen-Nybom is a Board Member and Chair of the Audit Committee at Cargotec Oyj, Danske Bank A/S, Metsä Board Plc and Posti Group Oyj.

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It’s important that boards include a ‘sustainability ambassador’ — someone who ensures that sustainability is on the agenda even when there are significant challenges facing the company, like geopolitical risk or economic uncertainty.

Sustainable finance is key to ensuring that capital flows to environmental priorities. What are some of the success factors – and challenges – for an effective approach to sustainable finance between banks and clients?

Bank executives need close dialogue and cooperation with customers to understand their sustainability agenda, the effectiveness of their transition plans, and their risks. You therefore need the right capabilities and knowledge within the bank to assess this. This extends to advising customers on sustainability and ensuring they are aware of both the current situation and developments in the future.

But it may not be a surprise to people that the biggest challenge for banks is the complexity of securing high-quality sustainability data from across the customer base and value chain to measure and report on their sustainability impacts.

What impact do you think the CSRD will have when it comes to supporting transparency and creating high-quality sustainability data and reporting?

The CSRD is important, but my concern is that it is too technical and detail focused. The end goal should be that the most important, material information is reported to the market. It may improve as we go forward, but my concern is that it means we focus on the details rather than the overall sustainability objectives. Of course, you must start somewhere, but I wish we’d started at a higher level.

How can boards ensure their organizations are on the front foot with sustainability and that it is driven as a strategic imperative?

The chair’s role is important here because boards must confront many topics, and it’s down to the chair how much emphasis is given to sustainability. It’s also important that boards include a “sustainability ambassador” – someone who ensures that sustainability is on the agenda even when there are significant challenges facing the company, like geopolitical risk or economic uncertainty. This person makes sure that sustainability is not forgotten and that the board provides consistent oversight even when there are other external challenges that need to be dealt with.

Similarly, bold organizations rethink their approach to sustainability reporting. They develop a coherent and compelling long-term value narrative that utilizes 'investor-grade' nonfinancial data and disclosures. They are reshaping their controls, assurance processes, and technologies for an enhanced approach to reporting. They will have defined a central role for the CFO in sustainability reporting and appointed roles such as 'ESG Controller'.

The European Green Deal: incentives and subsidies

The European Green Deal, aimed at making Member States climate-neutral by 2050, is a comprehensive green fiscal policy initiative embracing grants, tax exemptions, loans and financial instruments. Overall, Leaders are taking a more proactive approach to the Green Deal, as Figure 3 shows, and are further ahead in a number of areas.

Leaders are also more likely to feel they have built an understanding of how to access any funding and incentives available under the Green Deal (40% of Leaders feel they have completed this step versus 23% of Followers). However, Leaders do not outpace the field when it comes to understanding how to access funding and incentives; at 40%, the figure is consistent with the overall results.

That organizations are not fully engaging with the European Green Deal could reflect wider uncertainty about engaging with broad policy initiatives. As well as understanding the specifics of incentives and access to public funds, leveraging the Green Deal also requires the experience and knowledge to successfully navigate the particular dynamics and political sensitivities of the public sector.

However, leaders with careers spent in the private sector do not always have a complete understanding of the politicized nature of public service delivery, the specific policy and legislative restrictions that govern how decisions are made, and the stakeholders that influence how decisions are reached. Given that Europe's policy and regulatory initiatives are likely to grow because of societal and economic challenges, boards will need to consider how the organization builds that capability and what it means for the composition and skills of board members themselves.

This means finding ways to build directors' understanding of the way the public sector operates and potentially bringing public-sector experience onto the board, with due consideration to any conflict-of-interest issues.

"

The business community has perhaps sat back a little over the past five to 10 years, waiting for the regulator to come up with an answer to transparency into sustainability performance, but I think we need to come up with solutions ourselves if we are going to make sustainability data and reporting meaningful for both the preparers and the users of disclosures.

Christian Heller

CEO of the Value Balancing Alliance

CSRD and CSDDD: A bold approach can drive climate transition and unlock value

The fifth annual **EY Climate Risk Barometer** found that while companies are investing more time and energy into the quality of their climate disclosures, only 53% provide a coherent plan for achieving transition.[7] However, EU regulations on corporates' sustainability reporting are intended to drive change in how businesses conduct themselves:

- The EU's CSRD states that all listed companies in the EU (and all large companies operating in the EU) will need to disclose a transition plan aligned to 1.5 degrees Celsius warming in their annual report. Or, if they do not, they will need to explain the absence and whether they intend to adopt a plan in the future.
- The CSDDD requires companies to adopt a climate transition plan and put it into effect.

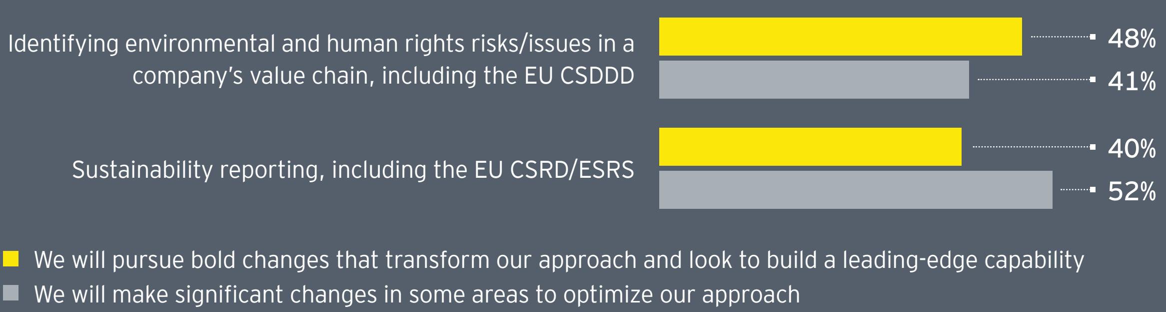
As Figure 4 shows, almost all organizations are making changes in response to the CSRD and CSDDD – either an approach that looks to optimize their capability or a bold program of transformation required to deliver a leading-edge approach (by "bold," we mean companies that look to fundamentally transform their approach: re-engineering data processes and controls, introducing new technologies, and putting in place new skills and capabilities). Investing in new technologies to manage and analyze nonfinancial and sustainability data has a wider benefit as well: better data for reporting disclosures also creates better data-driven insight for strategic decision-making. These investments should be seen as part of the wider digital transformation agenda rather than just a discrete solution in one area.

Encouragingly, the number of companies taking a transformative approach to the CSDDD (48%) exceeds those who are aiming for a less ambitious approach focused on optimization (41%). At the same time, 40% plan to transform their approach to sustainability reporting in response to the CSRD and the need to report under the European Sustainability Reporting Standards (ESRS).

The research shows that Leaders are more likely to be taking a bold approach to the CSRD (51% vs. 27% of Followers) – showing an even greater willingness to undertake a more fundamental transformation of reporting. This will need investment in advanced technologies and process re-engineering to address data challenges. Changes to operating models – including the use of managed services providers to meet sustainability reporting requirements – will also be a factor.

These bolder companies, which are looking to achieve more than compliance, can realize significant value. They will be better placed to turn their climate ambition into action, reduce the risk of greenwashing and improve their access to sources of green finance. At the same time, more ambitious companies will be better placed to provide a compelling story to investors and financial markets about how sustainability will deliver economic value, creating a positive impact on the valuation of the business.

Figure 4: How would you describe the changes you will be pursuing in response to the following areas of regulatory scrutiny?



Note: excludes those who responded, "We will make some adjustments to our approach in order to achieve compliance."
Source: *EY Europe Long-Term Value and Corporate Governance Survey*, March 2024 (total respondents: 200).

[7] "How will understanding climate risk move you from ambition to action?," *Global Climate Risk Barometer 2023*, EY, 27 November 2023.

External viewpoint

In conversation with

Paul Lee

Paul Lee is Head of Stewardship and Sustainable Investment Strategy at Redington, an investment consultancy for pension funds, wealth managers and institutional investors.

> “Institutional investors will say the Corporate Sustainability Reporting Directive is needed to ensure they can then fulfil their own obligations under the Sustainable Finance Disclosure Regulation. But I believe both need re-engineering to make them less mechanistic and more useful and informative.

Do you feel enough is being done to drive the sustainability agenda as a business imperative, and what role should boards be playing to maintain focus and momentum?

It does feel that more immediate issues – like geopolitical volatility and macroeconomic challenges – are perhaps forcing themselves up the agenda at the expense of sustainability. In this situation, it's essential that boards impose themselves more actively. As the long-term stewards of the organization, their role is to not be swept up by immediate concerns. Boards maintain that discipline of thinking about what the future holds and ensuring that long-term priorities – like sustainability – are not neglected because of immediate challenges.

What are some of the key success factors for effective investor stewardship and meaningful engagement between asset managers and investee companies?

Dialogue is key, and this can often be simple, open questions, like “how are your people?” That's the sort of dialogue that investors should be having with companies to get under the skin of whether the leaders they are speaking with have a real feel for their major sustainability challenges and the likelihood of the company successfully addressing those challenges. For some investors, I feel there's too much emphasis on getting through the items on their agenda rather than seeing the interaction as a chance for conversation and dialogue between human beings. Equally, from the corporate side, there's a need to bring funders and investors closer to your sustainability vision and journey, and get them engaged, enthused and bought-in.

There are also aspects of board reporting that are frustrating for investors. An example would be board evaluations. Investors are told that an evaluation took place, certain issues were found and that they have been addressed. But they don't give you an insight into what those findings were and what's being changed as a result. Disclosure is only valuable if it gives that sort of richness of insight.

Key actions

The policy and regulatory agenda when it comes to sustainability is complex – both in terms of the breadth of regulations and the fact that different directives come into play at different times. This creates its own pressure and perhaps explains why there is a temptation to take a reactive approach.

However, boards need to ensure the company's approach is not too narrow and leverages the policy and regulatory agenda to accelerate sustainability transformation, drive performance and improve reporting transparency.

Key questions for boards

Policy and the European Green Deal

- How has management reviewed the company's strategic choices by reference to availability of the different grants, tax exemptions, loans and financial instruments that are part of the European Green Deal?
- How have we modeled cost scenarios with (and without) available government incentives and funds? Do we understand how incentives affect asset allocation, product development and overall strategic planning?
- In a similar way, how are we developing a "universal" understanding of the wider green policy environment: for example, the Inflation Reduction Act in North America and its implications for our strategic choices?
- How can we build our leadership's capabilities in effective public sector interaction, and what are the implications for board composition and capabilities?

A proactive regulatory agenda

- How can we systematically identify and exploit strategic opportunities presented by sustainability regulation?
- Have we put in place the processes and resources to continually monitor and analyze policy and regulatory developments?
- What concrete actions can we undertake proactively and positively to shape and adapt to policy and regulatory change? How are we engaging with industry groups and trade associations to develop a collective response to such developments?

Biodiversity: further to go in understanding the opportunity in nature

In last year's report, we looked at how boards will need to increasingly focus on how a company measures and mitigates its impact on biodiversity. This year, we take a more detailed look at how prepared businesses are when it comes to understanding their biodiversity risks and opportunities, building internal accountability and disclosing their actions.

The ESRS, adopted by the European Commission in July 2023, include disclosures under ESRS 4 Biodiversity and ecosystems, and the Taskforce on Nature-related Financial Disclosures (TNFD) released its recommendations for Nature-Related Risk Management and Disclosure in September 2023.[8]

This research shows that, while encouraging progress is being made, there is still further to go in building a leading approach to understanding nature impact. For example, 52% of respondents say they have made some progress in identifying business areas that are most affected by, and have an impact on, nature, but only 38% have a comprehensive approach in place.

The Leaders are much further ahead than Followers across these areas. However, just 27% of Leaders say they have a leading capability established when it comes to "understanding the opportunity for our organization of making a positive nature impact or mitigating nature-related risks." This is less than the average across the 200 respondents and perhaps indicates that there is further to go in building the business rationale for nature, supported by credible metrics.

[8] "EFRAG and TNFD sign a cooperation agreement to further advance Nature-related Reporting," TNFD, 21 December 2023.

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AI's sustainability potential and responsible technology governance

While the subject of AI is ubiquitous today, there is a significant link between AI, sustainability and governance that needs to be explored. AI has significant potential to create positive sustainability outcomes and accelerate a company's sustainability transformation. But, as we show below, it is also a technology where the opportunities must be balanced against the challenges. As a result, it provides added complexity for leadership teams that are looking to embed sustainability into their strategy. For example, while it is inevitable that AI will change the world of work, there are two paths the technology can take:

- One focuses on *taking* over the tasks that people do (automating tasks – such as data collection or compliance – which could lead to a decline in employment).
- The other focuses on *augmenting* what people do (focusing on AI's potential to create new tasks and arming people with better tools to do their jobs).

Below, for illustration, we highlight just a few examples of some of the tensions that need to be managed:

	Opportunity	Challenge
Environmental	**Climate change insights:** AI can analyze vast data sets to provide insights into climate change, helping in predictive modeling and informing better environmental policies.	**Energy consumption:** Advanced AI systems, especially large data centers and servers required for machine learning (ML) tasks, can consume significant amounts of energy, contributing to higher carbon footprints.
Social	**Job creation and skills development:** AI can create new jobs in AI development, maintenance and oversight, and the need for AI literacy and data skills can encourage investments in education and training, promoting skill development.	**Workforce displacement:** AI can automate routine tasks, potentially displacing workers in certain roles.
Governance	**More effective risk and compliance:** AI can be used to proactively identify emerging risk issues and help identify control failures.	**Regulatory compliance:** Companies must ensure that their use of AI complies with all relevant laws and regulations, including those related to data protection, privacy, employment and consumer protection.

The same dynamic plays out in the environmental space. AI can analyze vast datasets to provide insights into climate change, helping in predictive modeling and informing better environmental policies. But advanced AI systems, especially large data centers and servers required for machine learning tasks, also consume significant amounts of energy, contributing to higher carbon footprints.

The research shows that leaders recognize the difficult balancing act that must be struck when it comes to reconciling the business opportunity of generative AI (GenAI) with environmental, societal and ethical challenges:

61% say

"AI offers a significant opportunity for driving long-term value, from creating new business models and revenue streams to transforming how work is done."

64% say

"The key challenge of GenAI is driving transformation and growth while ensuring ethical and societal implications do not undermine confidence in our organization."

Companies could lose the confidence of customers and the public if they do not manage those implications properly. Close to half of the respondents to the 2024 Edelman Trust Barometer (43%) said they would reject AI-enabled solutions, avoiding products and services that incorporate it, if they believe innovation is being managed poorly.[9]

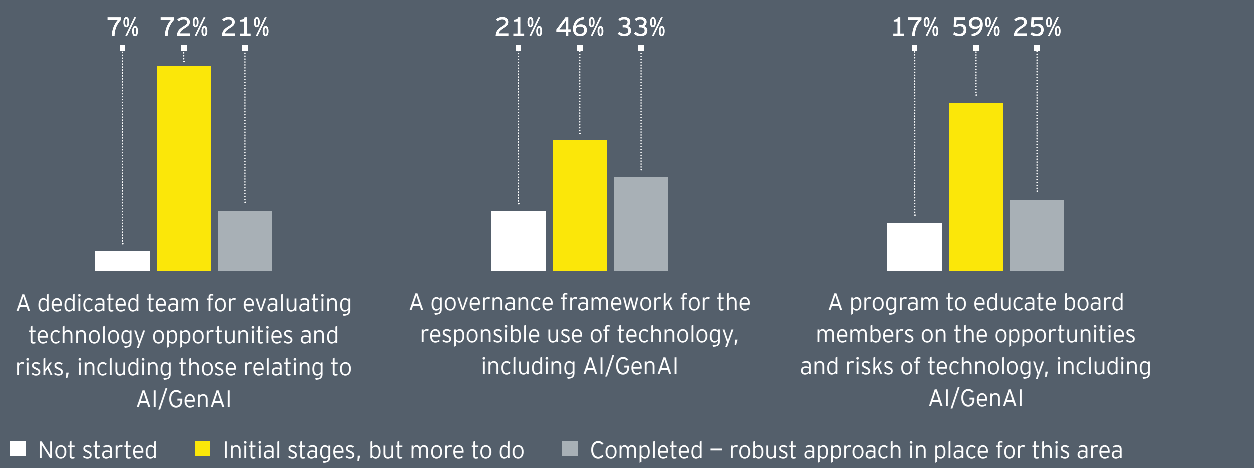
Effective and responsible technology governance is key to balancing opportunity and risk

Building stakeholders' confidence in AI as a driver of sustainable transformation requires effective and responsible technology governance. However, given that AI regulations – such as the EU AI Act – are still at an early stage, there is less guidance to offer boards a direction on their oversight of AI. This raises the risk that too many are taking a reactive approach as they wait for more detailed regulatory and policy guidance.

Today, most organizations have made progress in putting in place technology governance for AI. However, while many have made initial progress, there are not many who are a step ahead and have a robust approach already in place.

Leaders are more likely to be a step ahead, including having a program in place to educate board members on the opportunities and risks of GenAI (33% vs. 9% for Followers). Overall, however, this raises questions about whether enough is being done in terms of education and understanding: 63% of respondents say that "because GenAI is such a rapid, disruptive technology, it is challenging for boards to keep pace with developments."

Figure 5: Today, how far have you progressed in developing the following aspects of technology governance?



Note: excludes those who responded "not confident" or "somewhat confident."
Source: *EY Europe Long-Term Value and Corporate Governance Survey*, March 2024 (total respondents: 200).

[9] "**Innovation: The Trust Test for Business**," Richard Edelman, 14 January 2024.

External viewpoint

In conversation with

Annet Aris

Annet Aris is a supervisory board member at ASML, Jungheinrich and Randstad; and Senior Affiliate Professor of Strategy at INSEAD.

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Boards are asking whether management is thinking about the social implications of GenAI — the implications for the workforce and the steps needed to handle AI’s impact, such as re-skilling.

What role should the board be playing in overseeing the implementation and management of GenAI?

The key is striking the right balance. Companies need to innovate and experiment, but boards need to ensure that all risks are understood and covered adequately. While these are “classic” risks that have been debated for past technologies, like biases and the quality of data inputs, generative AI intensifies them. The board ensures the right questions are asked and how they can be mitigated.

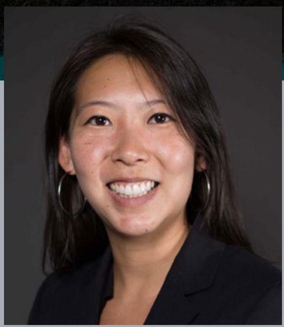
Boards also need to consider the impact on the workforce. There are certain jobs that are prone to be taken over – so these people will need the skills to do something else. At the same time, people will need the skills to use these technologies – the capability to write a prompt but also the skills to verify the outcome.

How can boards ensure they have the expertise and understanding needed to fulfil their oversight role effectively when it comes to AI and GenAI?

In terms of board composition and profile, the debate comes down to specialists vs. generalists. In theory, the board could be entirely made up of deep specialists in areas like AI or geopolitics. However, in my own experience of these debates, the view has swung more toward people who first and foremost have a broad, generalist profile, but perhaps have experience in sustainability or digital technologies.

Presentations and sessions from external leaders on topics like AI are important for building understanding. At the same time, external members of a committee – people who are not members of the board or supervisory board – can provide ongoing input. In one of my technology committees, we have three or four external members who provide expertise and are in place for two or three years. Then, we reassess the expertise we will need going forward into the future.

External viewpoint



In conversation with

Christina Shim

Christina Shim is Global Head of IBM Sustainability Software

> “It’s important to understand that we have options to leverage the power of AI to accelerate sustainability, and to do so with a lower intensity of energy and water use.

How important is it that boards ensure that the views of stakeholders — such as customers — are considered when developing their approach to AI governance?

AI won’t achieve its amazing potential without the trust of all relevant stakeholders, including customers. CEOs and boards need to be talking to their stakeholders and prioritizing how they think about AI governance. IBM, for example, has an AI Ethics Board that I sit on. It’s made up of a diverse set of delegates from across the company: business-facing people, developers and representatives from corporate functions, including government and regulatory affairs. This cross-section means we have many different perspectives that allow us to have robust conversations as we look at the entire lifecycle. As a result, our recommendations to the leadership team reflect a variety of perspectives.

Dialogue with government and regulators is key too. When it comes to policy around the responsible use of AI, we need a regulation approach that is risk based. In other words, rather than try to regulate the technology itself, you focus on high-risk use cases and applications. This risk-based AI governance approach is based on five pillars: accountability, transparency, privacy, explainability and fairness.

How can companies utilize AI’s ability to drive progress on sustainability without a high environmental cost?

Nearly 40% of business leaders are already using AI for their sustainability agenda, and another 40% plan to soon. This appetite for AI reflects how powerful these tools can be when it comes to climate risk mitigation and adaptation. And it’s important to understand that we have options to leverage the power of AI to accelerate sustainability, and to do so with a lower intensity of energy and water use. Those two goals are not mutually exclusive. You can reconcile these two needs by making considered choices about where data processing is conducted, the efficiency of supporting infrastructure, and utilizing foundational models rather than having to train AI from scratch, which is energy intensive. The more we understand this, the more we can benefit from the positive impact that AI can have on the sustainability agenda.

Key actions

AI raises a host of governance issues, from regulatory compliance to accountability. Companies must ensure that their use of AI complies with all relevant laws and regulations, such as those related to data protection, privacy, employment and consumer protection. While developments in AI, particularly GenAI, are moving extremely quickly, it is important that a company continues to evolve its technology governance in parallel. A proactive approach offers significant advantages when it comes to unlocking value. It allows you to proactively identify high-value areas for AI deployment and effectively scale learnings and best practices discovered in early pilots.

Key questions for boards

AI's sustainability potential

- What specific governance practices should we establish to responsibly harness AI for sustainability?
- How can we implement AI solutions that align with our sustainability objectives while mitigating associated risks?
- How can we take a people-centered approach to AI — demonstrating the benefits for people and managing societal risks and concerns?

AI strategy and governance

- What is our organization's AI strategy and how does this align with the overall business strategy and objectives?
- Do we recognize our company's place in the AI value chain and understand our obligations under legislation such as the EU AI Act?
- Do we have visibility of AI being deployed across the organization, including AI that may impact internal controls and reporting to stakeholders?
- How are we identifying and addressing potential risks associated with the use of AI, including those under regulatory scrutiny, such as privacy-, security- and reporting-related risks?
- Have we assessed how privacy and cybersecurity approaches need to be updated to reflect the latest AI developments, and whether cybersecurity oversight needs to change?

Looking forward

The pursuit of sustainability is transforming our socioeconomic paradigm, raising new risks and bringing new sources of value. Developments in AI offer significant potential to accelerate sustainable outcomes, and encouraging progress is being made in certain areas, with a significant surge in renewable energy capacity in 2023.[10] However, urgent action is still needed to address systemic planet and people challenges. Boards have a critical role to play in pushing executives to identify opportunities for growth and value creation — driving a bold program of sustainability transformation.

[10] "Renewable energy surge of 50% driven by China, IEA says," *Financial Times*, 11 January 2024.

Methodology

About the survey

Two hundred corporate directors and senior managers were surveyed in November and December 2023. Twenty percent of respondents were chairs or nonexecutive directors of the board, 20% were CEOs and the remainder were drawn from across the C-suite. Half of respondents' organizations have revenues of more than €1 billion a year, with the other half between €100 million and €999 million. Respondents were split across 15 European countries and 25 industry segments.

Leaders vs. Followers

To identify the Leaders and Followers, we assessed how effective their governance was in three key areas: challenging management on its sustainability plans; exercising board oversight on execution and progress against sustainability pledges; and engaging with shareholders about sustainability plans and action.

The Leaders are 45 respondents who have an "extremely effective" sustainability governance capability in two or more of those areas. The Followers are 44 respondents who are not extremely effective in any of these three core categories.

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