How to make the transition to governance for good

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Boards and organizations must reframe their roles and the measure of value as societies demand greater responsibility for sustainability.

In brief

- More traditional strategies that only focus on financial performance have become increasingly risky.
- Consequently, organizations must rethink their corporate purpose and strategy as well as understanding of long-term value.
- Sustainability must be a key part of the board agenda for effective governance and long-term value creation.

Globally, stakeholder capitalism – the idea that businesses have a responsibility that extends beyond their shareholders – has gathered significant momentum in the last few years. Consequently, boards and management teams have been prompted to rethink the role of their organizations in terms of who they serve, what contributions they can make to society and what constitutes long-term value.

More traditional strategies that narrowly focus on financial output have become increasingly risky. Long-term value is not just about immediate financial returns. It's asking what will drive or destroy value for the business in the next era. Organizations will need to look at value from three pillars, namely customer value, including customer satisfaction, trust and loyalty; people value, comprising engagement, employee loyalty, diversity and inclusiveness, health and wellness; and societal value, encompassing sustainability, total economic impact, carbon footprint and ethics.

With the increasing emphasis on long-term value, governance for good, or a strong focus on ethical, responsible and sustainable decision-making, must be at the heart of corporate governance.

Imperatives for board leadership

How can boards better lead their organizations on a path toward creating long-term value?

It first starts with defining and embedding the organization's purpose. Purpose is the organization's north star – the reason for which it exists. Once this purpose is defined, it should underpin all decision-making. The board will need to define what stakeholder capitalism means to the organization and formalize it through the corporate purpose and strategy.

Second, organizations should adopt a discipline in integrating environmental, social and governance (ESG) considerations into the board agenda. To that end, some companies have a dedicated sustainability committee, while others assign the responsibility to an existing committee, such as the risk or audit committee. Depending on the complexities of the business, an agile board operating model – not a one-size-fits-all one – is essential.

It's not just about having the right board structure. Effective governance also means devoting sufficient time to sustainability matters. In the *EY Europe Long-Term Value and Corporate Governance Survey* released in March 2023, 200 European corporate directors and senior leaders surveyed were split into two groups: "experts" and "beginners", depending on how they scored on sustainability governance. The survey found that a vast majority of the "experts" were effective at managing the board agenda so that long-term ESG risks and opportunities *were always discussed* in addition to near-term business issues. In contrast, only half of the "beginners" did the same.

Boards also need the right competencies and awareness of the key trends in ESG issues. This means it is important to include sustainability skills as criteria when assessing new board candidates or consider setting up external advisory boards that include scientific and academic expertise.

> Having the right board structure and sustainability skills as well as devoting adequate time to sustainability matters are key ingredients of effective governance.

Third, diversity in the composition of the board and senior management is important. Effective governance requires being intentional about bringing new perspectives to the table. The more diverse your board composition is, the better you can identify, anticipate and manage the universe of risks, including ESG ones.

Fourth, organizations should be authentic with material and credible disclosures. Leading companies not only embed ESG into their strategy, but also put ESG-linked KPIs in place to manage the business. These companies know what ESG factors are material to their business and therefore what needs to be measured. With such clarity, they also better navigate evolving ESG regulations.

What's crucial in the reporting is authenticity. Authenticity is not just about sharing targets and successes, but also about the challenges and difficulties encountered along the way. Greenwashing or greenwishing will only create more reputational and confidence issues.

Finally, governance will not be complete without accountability. Making a real impact requires a shift in mindset and actions. To incentivize the management to work toward long-term value creation, the board should consider how to link sustainability to executive remuneration. Making such a move is a bold step. The key is for boards and remuneration committees to be pragmatic and agile when setting such sustainability-based KPIs, which will continue to evolve as the business evolves.

Good for the planet, society and business

The emphasis on ESG in governance is not just a feel-good philosophy; it also makes good business sense. For example, **EY research** found that companies that took the boldest steps in climate action were 2.4 times more likely than their peers to report significantly higher-than-expected financial value as a result of their climate initiatives. They also achieved higher emissions reductions.

This dispels the myth that there is an insurmountable trade-off between financial and nonfinancial impacts. While priorities may need to shift, what's good for the planet and society can be good for business too.

It is fair to say that governance for good can be an ambitious goal. There will be tough calls to be made, cynics to be convinced, and obstacles and risks to overcome. Yet, the results will be immensely rewarding: resilient organizations that can better weather challenges; stronger relationships with employees, customers and communities; and sustainable value for the long term.

After all, will there be a "next" if governance only focuses on the "now"?

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Summary

As stakeholder capitalism gathers momentum, a strong focus on ethical, responsible and sustainable decision-making is integral to corporate governance and long-term value creation. The board must define stakeholder capitalism for the organization, with it being a key part of the corporate purpose and strategy.

Integrating environmental, social and governance considerations into the board agenda, focusing adequately on sustainability matters, and diversity in board composition that also includes members with sustainability skills are crucial for effective governance. Other key actions include being authentic with material and credible disclosures as well as linking sustainability to executive remuneration for accountability.■

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