

How can boards strengthen governance to accelerate their ESG journeys?

EY Long-Term Value and Corporate Governance Survey

February 2022



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Foreword

We are at a turning point in the sustainability and environmental, social and governance (ESG) agenda.

From the outside-in, we have now reached a stage where investors, regulators, policy-makers, employees, consumers and the public as a whole simply expect a company, its management team and board to be actively addressing ESG priorities and opportunities. The relationship between a company and its employees and stakeholders is being redefined by the sustainability agenda, and their voices need to be heard.

From within the organization, executives are passionate about making a difference to planet and people, and building their companies' resilience, growth prospects and long-term value. In fact, as well as a route to greater risk resilience in the face of increasing disruption, this research shows that executives today believe that ESG is, above all, a major commercial and growth opportunity. For leading companies, it will be a route to innovation across products, services and even business models, allowing them to shape the future of their industries and stay a step ahead of disruption. By deploying an ambitious long-term value approach that proactively addresses ESG factors, a company can outpace its competitors, improve profitability and unlock new sources of value creation.

Robust corporate governance and a central role for boards are critical for getting on the front foot with ESG and achieving the cultural and mindset change needed to drive a sustainability transformation. For executive teams to be proactive and build a winning position while dealing with competing priorities, they need a board that is empowered and has the operating model, data and capabilities it needs to provide strong direction, challenge and support. Without the right governance, there is a danger that a company's ESG approach could be ineffective, fragmented and reactive.

To help guide companies on the next evolution in governance, EY teams has conducted this second edition of its *Long-Term Value and Corporate Governance Survey*, building on our inaugural research in 2021.¹ Drawing on insights from a survey of 200 corporate directors and senior managers from leading European companies – as well as in-depth interviews with business leaders, academics and other experts in this field, including EY own subject matter professionals – we examine three areas:

- ▶ How companies and boards are putting ESG at the heart of their strategy to build risk resilience while also driving new growth opportunities
- ▶ Why success means addressing major external and internal challenges, including economic uncertainty and the need to establish a clear ESG mandate for the board
- ▶ Three priorities for strengthening the governance system to support strategic decision-making on ESG and long-term sustainable growth: the right board operating model, composition and skills; innovative approaches to reward and remuneration; and effective ESG reporting and investor engagement

We look forward to collaborating with CEOs and boards on this critical topic, and our thanks go to the corporate leaders and experts who contributed their thinking to this discussion paper.

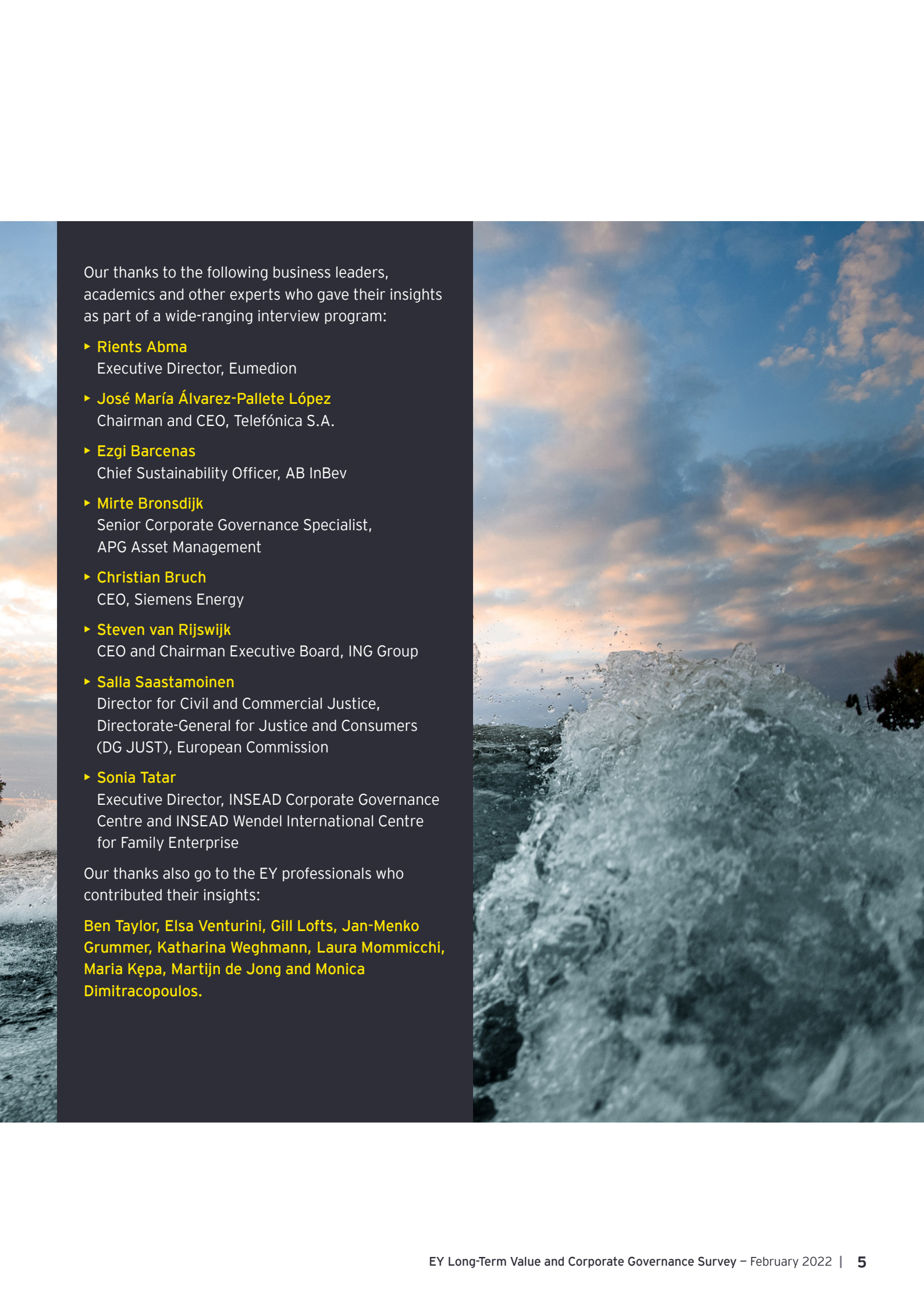


Julie Linn Teigland
EY EMEIA Area
Managing Partner



Andrew Hobbs
EY EMEIA Public
Policy leader

¹ "Will there be a 'next' if corporate governance is focused on the 'now'?", EY Long-Term Value and Corporate Governance Survey, March 2021.



Our thanks to the following business leaders, academics and other experts who gave their insights as part of a wide-ranging interview program:

- ▶ **Rients Abma**
Executive Director, Eumedion
- ▶ **José María Álvarez-Pallete López**
Chairman and CEO, Telefónica S.A.
- ▶ **Ezgi Barcenas**
Chief Sustainability Officer, AB InBev
- ▶ **Mirte Bronsdijk**
Senior Corporate Governance Specialist,
APG Asset Management
- ▶ **Christian Bruch**
CEO, Siemens Energy
- ▶ **Steven van Rijswijk**
CEO and Chairman Executive Board, ING Group
- ▶ **Salla Saastamoinen**
Director for Civil and Commercial Justice,
Directorate-General for Justice and Consumers
(DG JUST), European Commission
- ▶ **Sonia Tatar**
Executive Director, INSEAD Corporate Governance
Centre and INSEAD Wendel International Centre
for Family Enterprise

Our thanks also go to the EY professionals who contributed their insights:

Ben Taylor, Elsa Venturini, Gill Lofts, Jan-Menko Grummer, Katharina Wegmann, Laura Mommicchi, Maria Kępa, Martijn de Jong and Monica Dimitracopoulos.

Executive summary



How can boards strengthen governance to accelerate their ESG journeys?

1

Companies and boards putting ESG at the heart of their strategy can build risk resilience while also driving new growth opportunities

The ESG imperative: today, ESG factors are top of mind for investors, consumers, employees, governments and broader society

84% say the COVID-19 pandemic increased expectations from stakeholders that “our company will drive societal impact, environmental sustainability and inclusive growth”, up from 66% in last year’s survey.

Robust governance is a key success factor in driving long-term, sustainable growth, with encouraging progress made

82% feel they have made significant progress in putting in place the controls and risk management system needed to address material ESG risks.

Opportunity and risk: connecting ESG to strategy is key to creating and protecting sustainable long-term value

The **number one** advantage of incorporating ESG factors into corporate strategy is creating new sustainable products and services to drive revenue growth and meet the needs of ESG-conscious consumers, followed by risk resilience.

2

To succeed and deliver against their ESG agenda while managing significant volatility and uncertainty, boards need to clarify their sustainability mandate

Challenge 1

How to drive long-term value in a volatile and challenging macroeconomic environment

When it comes to generating long-term value, “near-term economic uncertainty” is the **number one** challenge for both companies that are optimistic about their growth prospects over the next 12 months and those who see flatlining or declining growth prospects.

Challenge 2

How to maximize long-term value when the board’s role in ESG is still evolving

The **number one** internal challenge facing companies today when it comes to generating long-term value through a strong ESG proposition is lack of commitment from the board to make decisions that fully integrate ESG factors and create long-term value.

3

Three priorities for strengthening the governance system to support strategic decision-making on ESG and long-term sustainable growth

Priority 1

Board oversight: board operating model, composition and skills

Today, **49%** of boards discuss the ESG agenda and reporting at every meeting, up from 15% two years ago.

Priority 2

Reward and remuneration: creating leadership accountability and organization buy-in

Changing the approach and structure for rewards and incentives, including executive remuneration, is the **number one** priority for governance change over the next two years when it comes to supporting the ESG agenda.

Priority 3

Trust and transparency: effective reporting to steer the business and support investor engagement

83% of respondents said they would like to see reporting of ESG performance measures against a set of globally consistent standards become a mandatory requirement, which is in line with the 89% of investors who said the same in the sixth EY Global Institutional Investor Survey.²

² **Is your ESG data unlocking long-term value?** Sixth Global Institutional Investor Survey, EY, November 2021.

Companies and boards putting ESG at the heart of their strategy can build risk resilience while also driving new growth opportunities



The ESG imperative: today, ESG factors are top of mind for consumers, employees, governments and broader society

Since EY survey last year, focusing on long-term value and the ESG agenda has become even more important. Today, leaders and board members recognize the importance of ESG factors in meeting the changing expectations of corporates:

- ▶ **84%** say the COVID-19 pandemic increased expectations from stakeholders that “our company will drive societal impact, environmental sustainability and inclusive growth”, up from 66% in 2021.
- ▶ **86%** say a focus on ESG and sustainable, inclusive growth has been critical to building trust with their stakeholders in today’s uncertain times, up from 78% in 2021.³

Moreover, a focus on long-term value and ESG is seen as critical to addressing the world’s major challenges and securing the long-term future of the organization through greater resilience:

- ▶ **85%** say driving progress against ESG factors will be critical to post-pandemic recovery and meeting the world’s critical climate change goals.
- ▶ **76%** say addressing major global challenges – such as climate change – will be key to driving and protecting our company’s long-term value.
- ▶ **83%** say companies that maintain their focus on ESG and long-term value will be more resilient in the face of increasing disruption and volatility.

While it is clear from the research that board directors and executive leaders recognize the importance of the ESG agenda to driving long-term value, questions remain about how far these issues have been integrated into the company’s overall strategy and the oversight responsibilities of boards. If the organization’s approach is still at an early stage, there could be a significant gap between sustainability commitments and tangible results and action.

³ 2021 statement: “A focus on sustainable and inclusive growth has been critical to building trust with our stakeholders in today’s uncertain times.”

EY teams’ viewpoint



Gill Lofts, EY Global Financial Services Sustainable Finance Leader, believes that the UN Climate Change Conference in 2021, “COP 26”, had a major impact on the sustainability and ESG agenda in the financial services industry, and we are at a point where companies need to shift from pledges and promises to action and results. “If we look at climate change specifically, COP 26 was a defining moment for financial services and the environmental commitments that they were willing to make,” she says. “We saw many net-zero pledges as well as pledges to transition away from coal and commitments to biodiversity and deforestation preservation. However, it’s now really important that financial services firms take action and that those actions are credible. With COP 27 due to take place this year, there is likely to be significant scrutiny of progress, with the industry needing to be able to demonstrate more details on how they are putting their pledges into action. Targets for green investment, product and service innovation for corporates in transition and credible plans for real economy GHG emissions will all be key.”

There is also the risk that companies will be focused purely on the “now” of ESG rather than also having one eye on the future. The sustainability agenda moves very fast. For example, as well as pressing issues such as climate change, some companies will have to also focus on whether they have a sustainable relationship with nature and are taking account of material natural capital issues, from deforestation to habitat destruction.

It is feasible, as ESG practices mature, that a leading group of companies will emerge that are not only addressing today's sustainability issues but also driving ESG innovation to reshape their industries and to try and seize an unassailable competitive advantage. This means maintaining a focus on the future and defining an ambitious agenda that is grounded in the organization's vision and purpose, which encapsulates their distinct reason for being.

Staying ahead of a fast-moving ESG agenda

The rest of this chapter assesses the progress that companies have made in their sustainable governance agenda and what they are planning to achieve with their efforts. However, before that, it is worth clarifying some key concepts when it comes to ESG:

- ▶ First, ESG is a broad concept, and leaders will still need to decide what themes should be prioritized, what results are being targeted, and the expected time frame. This involves a detailed materiality assessment, and making these fundamental strategic choices is one of the most challenging and time-consuming tasks facing companies today.
- ▶ Second, ESG objectives need to be integrated into the overall strategy of a company, not discussed and executed in isolation. This is to ensure conflicts with other strategic targets – such as financial goals – are identified and considered holistically so that they can be resolved or so that necessary trade-offs are properly understood.

EY teams' viewpoint



Katharina Wegmann, EY Forensic & Integrity Services Partner and specialist in business ethics and organizational culture, believes that much more focus needs to be placed on governance as part of the ESG debate. But this requires a fundamental re-think of a range of areas, from governance operating models to entire value chains, along with the willingness to question long-held assumptions and behaviors. "People sometimes think of governance in terms of their compliance with regulatory standards," she explains. "But that ignores the fact that, today, the expectations placed on companies and how they earn their licence to operate has shifted dramatically. We must aim higher than being compliant. You need to re-examine your fundamental purpose and your willingness to make tough strategic decisions based on that purpose – even if it may hurt in the short-term."

"A governance maturity assessment is a good starting point for that re-think. But you also need to think hard about organizational culture and ethics because when done well, they allow us to navigate in environments of ambiguity and into uncharted territories. We need exploratory conversations, the ability and willingness of leaders to welcome dissent, hear views that counter our own, embrace uncertainty, and seek out diversity of thought and marginalized voices. In the end, we need to challenge the meaning of leadership."



Spotlight on the policy and regulatory agenda

The EU Corporate Sustainability Reporting Directive



There is real impetus behind the reporting regulatory agenda. A number of regions and countries are making significant moves when it comes to mandating ESG disclosures and driving the quality of reporting, including the EU with its Corporate Sustainability Reporting Directive (CSRD). As EY outlined in *How the EU's new corporate sustainability reporting directive will be a game changer*, the CSRD marks a step change in reporting and in the assurance of nonfinancial information.⁴

The CSRD will apply to listed EU companies over a certain scale – such as those that have more than 250 employees and €40 million in net turnover – and requires that they report against mandatory sustainability reporting standards related to environmental matters, social matters and treatment of employees, human rights, anti-corruption and bribery, and diversity on boards. Key proposals also include the following:

- ▶ Double materiality (not only how sustainability issues affect the company but also how the company affects the environment and society)
- ▶ Mandatory third-party assurance of the reporting
- ▶ ESG information to be included in the management report and digitally tagged
- ▶ Companies to report in 2024 for fiscal year 2023, though there is a possibility this will be delayed

Companies, regulators, standard-setters and auditors will all need to devote significant time and resources to prepare for implementation of the directive – within a short timescale of less than two years. There will be certain expectations on businesses such as:

- ▶ Disclosing more sustainability-related information than before about their business models, strategy and supply chains

- ▶ Providing information that investors can compare with peers, with expected capital flow toward companies authentically demonstrating a strong sustainability performance
- ▶ Transforming how businesses approach their own decision-making processes and how they share their stories with their stakeholders

In terms of governance structures, there are also significant implications for audit committees, given their role in overseeing disclosures and regulatory compliance. With audit committees overseeing both nonfinancial and financial data, their oversight role and policies will need to be clearly defined.

As well as the CSRD in Europe, at a global level, the International Financial Reporting Standards (IFRS) Foundation has created a new board – the International Sustainability Standards Boards (ISSB) – which is tasked with creating a single set of standards “to meet investors’ information needs” (see section on “Consistent global reporting standards can be crucial to assessing long-term value and meeting investor needs”).⁵

It is not yet clear what the long-term outcomes of this and other reporting policy initiatives will be. What is evident, however, is that change is coming, and a long-term, multi-stakeholder strategy will require stronger governance and the provision of high-quality information to those charged with governance, as well as stakeholders. Strong governance and internal controls will be key to this journey. They will ensure the integrity of the new metrics and protect against those issues that affect trust and credibility, such as charges of “greenwashing.” For that reason, boards have a key role to play.

⁴ “[How the EU's new sustainability directive will be a game changer](#)”, EY, 28 July 2021.

⁵ “[IFRS Foundation announces International Sustainability Standards Board, consolidation with CDSB and VRF, and publication of prototype disclosure requirements](#)”, IFRS, 3 November 2021.

External viewpoint

Christian Bruch
CEO, Siemens Energy



Siemens Energy is one of the world's leading energy technology companies, employing more than 90,000 people worldwide in more than 90 countries. Its mission is to "support our customers in transitioning to a more sustainable world," with a focus on ESG, innovation and transformation. Julie Linn Teigland – EY EMEIA Area Managing Partner – spoke with Christian Bruch to discuss his perspectives on long-term value and the ESG agenda.

What are some of the goals of your approach to long-term value and the ESG agenda?

One issue with ESG is when organizations become too focused on the environmental perspective. It's very important to remember the social aspect of ESG because, as well as being sustainable, power has to be available and affordable. For society to become interested in sustainability, people need to prosper, and it is important we do not underestimate that social element. When we make important ESG decisions, we need to ask a critical question: how do we maintain a social balance while driving sustainability? Each of the elements of ESG has to play a vital role.

And what are the main challenges you are looking to overcome as you deliver your long-term strategy and sustainability goals?

We – all our people – need to really understand the consequences of the decision to drive a long-term value business. For example, pledging to exit new coal projects: we have people who work in coal-related technologies, and this work is their commitment and a part of their daily lives. For them, it's a tremendous

amount of change. Of course, such tough decisions can create "winners and losers," but it's important that we recognize and manage the social implications of the transformation as well. Another issue is having the right data. If we are making important strategic decisions based on data and planning critical milestones, we need to focus hard on making sure it's reliable and of the right quality.

How is the governance context for your organization changing as a result of this focus on ESG?

ESG is in the focus of our investors, so it's in our focus as well. That's why we have anchored the topic at the highest level. I personally have taken on the role as Chief Sustainability Officer, and our CFO Maria Ferraro also serves as Chief Inclusion & Diversity Officer. We have also established a Sustainability Council to discuss all relevant decisions together with representatives of our businesses. And there too, as in the regions, we have dedicated sustainability business partners. And we have used a dedicated Supervisory Board meeting to conduct a sustainability deep dive, and our chairman is very focused on ESG topics. We also have people



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When we make important ESG decisions, we need to ask a critical question: how do we maintain a social balance while driving sustainability?

on our Supervisory Board from a political background who can look at these issues not only from the industrial perspective but also from a political standpoint, which in the energy industry will always be a relevant element. In the energy business, you're always part of a political or sustainability discussion. If you don't manage that proactively, you could lose your license to operate, because societies won't support your solutions anymore.

How are you looking to change how you engage and communicate with your stakeholders, such as investors, on your sustainability goals and performance measurement?

As a listed company, we put great emphasis on the dialogue with our shareholders, analysts and financial media. We maintain an intensive exchange with them and are present at many public discussions. We give them insights into the fields where we are acting. For example, as part of our investor relations, in 2021, we hosted our first Hydrogen Day. One of the goals was to ensure that investors really understand the complexity of the topic and market with all its challenges. Overall,

in terms of reporting, we intend to create greater transparency and build a strong link between reporting segments and the market drivers.

In general, we are putting a major emphasis on ESG reporting with a report that focuses exclusively on ESG. We have made the Annual Report as concise as possible and we focus everything now on the ESG reporting in alignment with the Supervisory Report.

Regulatory clarity will be critical to building consistency in our measurement and reporting. There's a huge amount of complexity in ESG reporting today, from taxonomy to the range of nonfinancial disclosures. Ultimately, you don't want to report for the sake of reporting, but rather to change something. That all starts with consistency, aligning metrics and building a common understanding. There needs to be more done to consolidate on how you manage and measure ESG performance. After all, leaders need to make critical strategic investment decisions based on these frameworks that can have an impact on people's lives.

Robust governance a key success factor in driving long-term, sustainable growth

Robust governance will be key to meeting changing stakeholders' expectations, building risk resilience and seizing the growth opportunities of the ESG agenda. One example would be the need for strategic decision-making that effectively balances near- and long-term value creation. In this year's survey, over half of respondents – 55% – say that there are significant differences of opinion within their leadership team on how to balance short-term considerations with long-term investments and sustainable growth. While this is slightly down from the 60% who said the same in the 2021 survey, it is still a major issue for the board. If we look at just the board chairs and non-executive board directors in our survey, the number who say there are significant differences of opinion climbs to 68%.

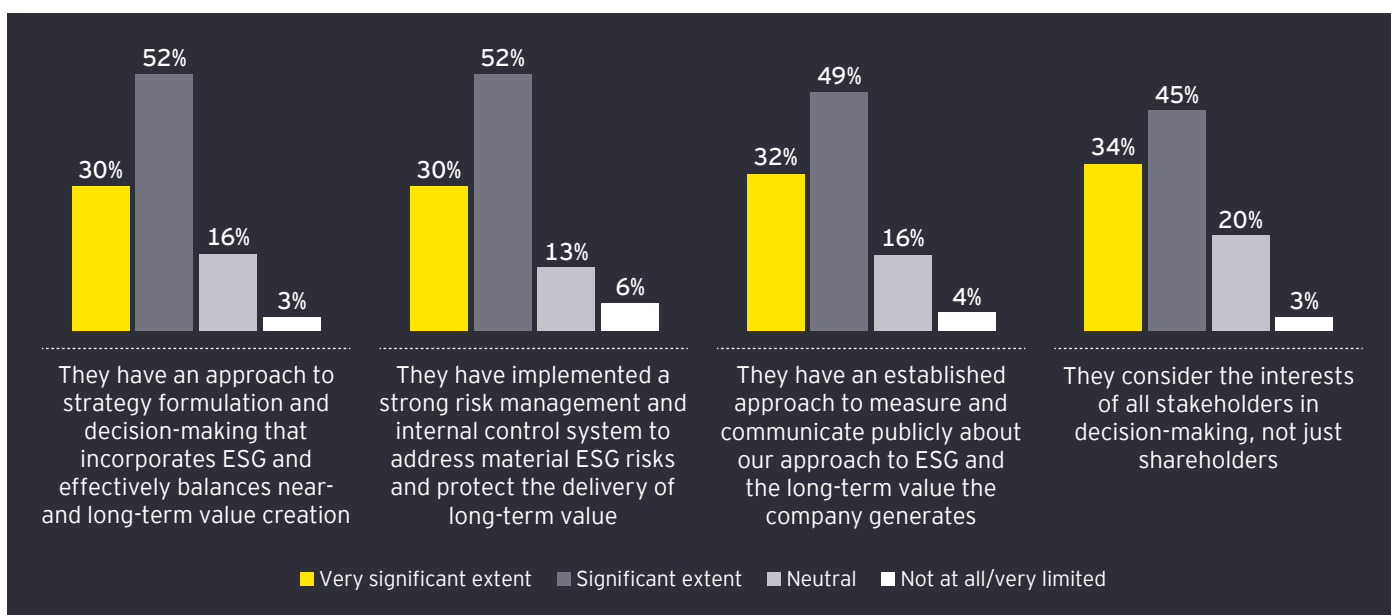
While companies will be at different points in their ESG journey, the survey shows that – overall – boards and CEOs are making encouraging progress in putting in place the governance frameworks needed to drive a long-term, multi-stakeholder orientation. For example, 82% feel they have made progress in putting in place the controls and risk management system needed to address material

ESG risks, including 30% who feel they have made very significant progress (see Figure 1). While this progress is encouraging, not least because it shows that this area is a priority, there will of course be more to do in terms of execution as well as striving for continuous improvement.

Opportunity and risk: connecting ESG to strategy key to creating and protecting sustainable long-term value

The risks related to ESG issues – from the resource dependency and scarcity issues linked to biodiversity loss or the potential disruption from physical environmental issues such as extreme weather events – are some of the most profound and challenging facing today's businesses. Having an internal control and risk management approach that mitigates these issues is key to maintaining performance and securing the long-term future of the organization. But, at the same time, leading companies are also finding new revenue and growth opportunities as markets and the competitive landscape evolve in line with ESG factors. In fact, as Figure 2 shows, driving revenue growth from ESG-conscious consumers is seen as the main advantage of incorporating ESG factors into corporate strategy, even outweighing risk resilience in second place.

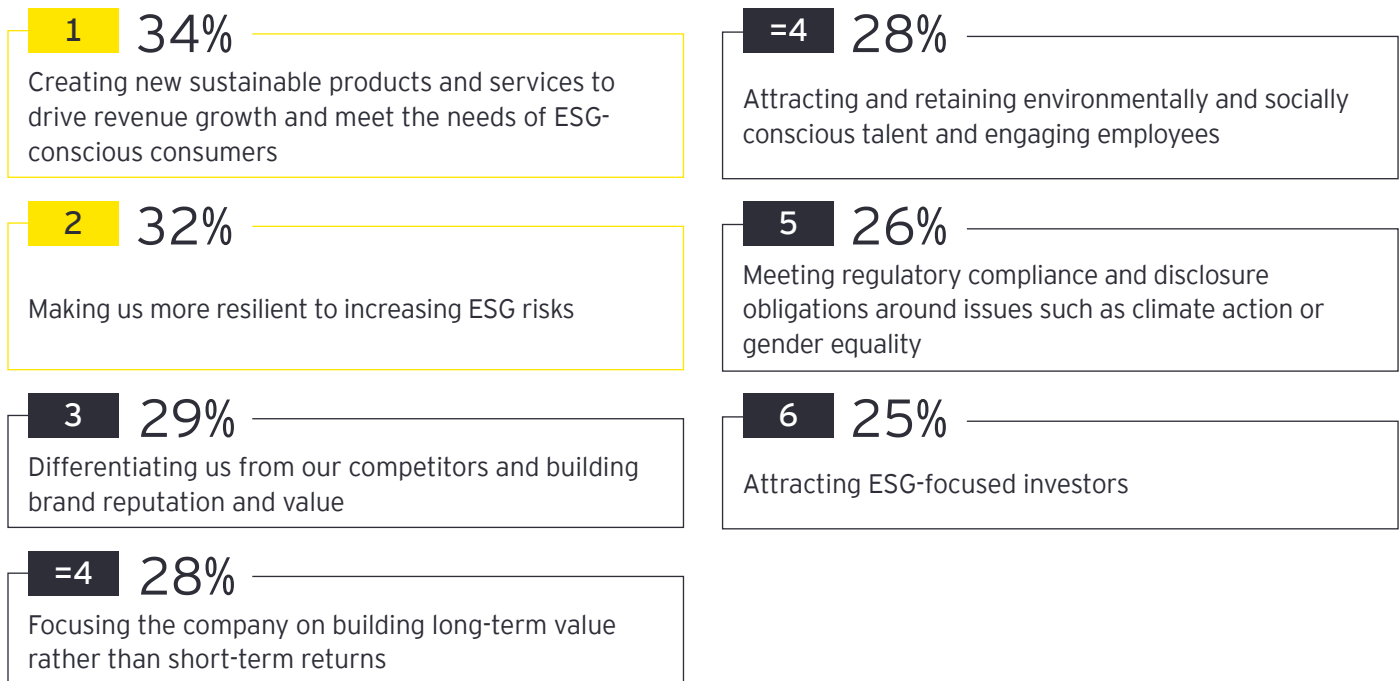
Figure 1: Thinking specifically about the progress your board has made on ESG and long-term value, to what extent have members put these approaches in place?



Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200).

Figure 2: In your view, what are the main advantages of incorporating ESG factors into corporate strategy?

Note: Use of “=” signifies an equal ranking, such as joint 4th.



Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200).

Of course, driving ESG-focused growth is a challenging ambition. It requires executives to take ESG issues into consideration when making strategic decisions, from how capital is allocated to divestment considerations. That requires complex trade-offs to be made between different stakeholders. At the same time, management and boards must think long term but not lose sight of short-term performance.

In the next section, we consider some of the major challenges that companies must address if they are to unlock value by focusing on ESG factors and evolve their governance approach.

Finally, while “attracting ESG-focused investors” falls into sixth place, it is still the main focus of a quarter (25%) of respondents. A few years ago, it was arguably the case that ESG-focused companies might have found it difficult to find investors that understood that ethos and were willing to support that strategic direction. Today, while investors are keen to invest in the ESG agenda, the challenge that leaders face is demonstrating to them that the company is serious and committed to ESG. In particular, giving investors confidence that they will successfully execute and deliver against their commitments.

EY teams' viewpoint



Monica Dimitracopoulos, EY Global Long-Term Value Leader, believes that leaders need to ensure their ESG agenda contributes to long-term value, and this introduces a new level of complexity. “The near-term financial pressures on quarterly earnings have not gone away,” she says. “But this is now coupled with a new set of ESG demands that require long-term investment and planning. Even the most seasoned leaders might struggle to navigate the trade-off decisions associated with meeting quarterly performance expectations and laying the foundations for long-term, sustainable growth. While you may have clarity on the levers needed to drive near-term financial performance, liking pricing changes or cost reductions, the picture is not as clear when it comes to deciding on the long-term investment needed, for example, to optimize your supply chain in a way that identifies and reduces environmental risk. To meet these sorts of demands, CEOs and boards need to have robust data and information to provide input into trade-off decisions, and adapt capital allocation processes to support long-term strategic ESG investments.”

External viewpoint

José María Álvarez-Pallete López

Chairman and CEO, Telefónica S.A.



As Chairman and CEO of this leading telecoms group, José María Álvarez-Pallete López shares his thoughts on the major societal challenges that are driving the ESG agenda, how Telefónica approaches stakeholder engagement, and the governance initiatives it is introducing to drive results.

To what extent do you feel that events of the past 18 months have increased expectations that your organization actively addresses major societal challenges, and how has that affected the importance that ESG factors play in its strategy and approach to long-term value?

2020 will be remembered as the year when our world was rebooted, with no turning back. Living through this era of the pandemic has been like traveling in a time machine: we are now years ahead of where we would have been in terms of the adoption of technology. Today, people do not have a “digital life” on the one hand and an “analogue life” on the other; they have merged into one single existence, and any fear of living in the digital space has vanished. In this context, communications networks are the backbone of society, and our main task is to ensure that both the connectivity and the network function at full capacity in a reliable, stable and secure manner in all the countries where we operate. Our purpose – “we want to make our world more human by connecting lives” – has never made more sense than it does today.

With digitalization, we have an extraordinary opportunity to transform economies and societies. Becoming more digital means becoming more “green” while fostering a fairer transition that leaves no one behind. Our stakeholders recognize us as a force to help mitigate the effects of climate change through more efficient use of energy in our networks, a shift to renewable energy sources and, above all, the potential to decarbonize other sectors through our digital services and know how.

Against that background, ESG factors contribute to our company in three ways: generating growth, enabling efficiencies and driving long-term value. Achieving those goals means addressing both internal and external priorities and challenges. Internally, the challenge is to embed a culture of sustainability in the company. For example, we are putting significant effort into employee training and awareness raising. Externally, the main priority is to accelerate the provision of sustainable products to customers, both B2C and B2B. This depends on promoting more conscious or responsible consumption on a large

⁶ <https://telefonica.com/en/commitment/environment/green-digitalisation/>



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Our purpose – ‘we want to make our world more human by connecting lives’ – has never made more sense than it does today. With digitalization, we have an extraordinary opportunity to transform economies and societies.

scale. We have made significant progress in this area with a number of initiatives, such as the use of Eco Smart labels that visually display the various environmental benefits our services can provide to our B2B clients, from energy savings to reduction of water consumption. This allows customers to make informed purchasing decisions based on sustainability criteria.⁶

Can you tell us about how Telefónica is driving engagement with its key stakeholders, particularly with investors?

We believe we have a good and clear understanding of our stakeholders’ expectations regarding ESG. We were pioneers in asking all our interest groups about the issues they felt Telefónica should be addressing and how they rated our performance. This year, we have taken it a step further, publishing our first approach on double materiality. This framework, supported and encouraged by the EU, incorporates a new dimension: the impact of ESG issues on the company’s value. This gives us a tool that effectively integrates the internal and external views of ESG factors and serves as a base from which to define our priorities and action plans.

Our materiality process is the cornerstone of our approach, but we have also put in place a governance model for sustainability that guarantees that ESG issues are analysed at the highest level with our board of directors.

Overall, we spend more time today interacting with all stakeholders on ESG issues and, with increasing interest from the markets, Telefónica’s management is devoting significant time to investors and analysts, with the number of analysts requesting ESG information growing exponentially in recent years. Furthermore, we continue to improve our sustainability performance and ESG analyst scores. We have recently been upgraded by the relevant analysts – such as MSCI, Sustainalytics and S&P – and are generally considered an industry leader by the investor community. For example, the World Benchmarking Alliance, an investor-backed ranking with AuM of over 7 trillion, considers us as world leader in its Digital Inclusion Benchmark. Our priority is to raise awareness and help investors understand the pivotal role our industry is playing in tackling important societal challenges. The role the telco industry plays

External viewpoint

José María Álvarez-Pallete López

Chairman and CEO, Telefónica S.A.

in decarbonizing other sectors is not yet thoroughly understood by the investment community. Indeed, the telco sector is underweighted versus other sectors such as industrials and utilities. Going forward, the industry should be able to capture a higher presence of ESG-oriented capital, given its enabler role in the energy transition.

Can you tell us about some of the governance changes you have made to drive the ESG agenda and how you are approaching remuneration?

We have already included ESG priorities in remuneration. In fact, we were one of the first Spanish companies to introduce ESG issues into variable remuneration, and all our employees have these criteria in their annual variable remuneration, with a 20% weighting. Our objective of becoming net zero in Scope 1 and 2 emissions by 2025 in our main markets is also one of the long-term, nonfinancial objectives of our board of directors, with a 10% weighting.

We are constantly on the lookout to improve the way we integrate ESG in the management of the company and thereby implement best practices in governance. A good example is the recent reduction of the number of board members to 15, of which 9 are independent, and with women now representing 33% of the board.⁷

We appreciate that our corporate governance model is being reviewed from various angles – by regulators, investors and society at large – so we are listening and integrating those ESG themes that matter to our stakeholders. Our priority is to align ourselves with the new regulation, which requires us to further integrate ESG aspects into the company's risks, products and governance bodies.⁸ For this reason, we are taking several steps. First, we have updated our Responsible Business Principles, which are equivalent to our code of ethics and are the basis of our corporate culture. Second, we have conducted a detailed double materiality exercise. Third, we are revising our risk approach so that we analyze ESG impact across all risks, in addition to financial and operational impacts. We are also taking more account of reputational risk monitoring tools. Finally, we are setting new ESG objectives to address those risks and, above all, seize the opportunities.

All of this is reflected in the company's strategy, in the roles of board committees and in variable compensation.

⁷ <https://telefonica.com/en/communication-room/telefonica-restructures-its-board-and-committees-and-reinforces-its-commitment-to-corporate-governance/>

⁸ Legislative Proposal on Sustainable Corporate Governance, Corporate Sustainability Reporting Directive (CSRD), EU Taxonomy for sustainable activities and EU Mandatory Human Rights Due Diligence Directive.



External viewpoint

Steven van Rijswijk

CEO and Chairman Executive Board, ING Group



ING Group is a global bank with 57,000 employees serving more than 38 million customers, corporate clients and financial institutions in over 40 countries. As CEO and Chairman Executive Board, Steven van Rijswijk shares his thoughts on the importance of sustainability in driving long-term value and effective engagement with stakeholders on ESG priorities.

To what extent do you feel that the challenges of the past 18 months have changed the context for your organization and increased attention on sustainability issues?

The pandemic has acted as a magnifying glass, bringing dilemmas to the surface more clearly. It intensified discussions on long-term value versus short-term gains. But it also increased global inequality further, which fuels societal tensions.

However, the way that governments stepped in with billions of euros to support economies and citizens, as well as the exceptional speed with which vaccines were developed, serve as inspirational examples for how we can pull together and find solutions for global crises.

We are seeing growing expectations from stakeholders in two areas. First, that banks such as ING have a role to play in addressing the world's biggest problems. Second, an increased focus on the actual actions and impact that organizations are having, with accountability taking center stage. This is against the

backdrop of a growing realization that only sustainable growth – growth that creates long-term value for all, including the planet – is future-proof.

Today, what role do ESG factors play in how you deliver on your long-term value commitments and earn the trust of stakeholders?

Sustainability is at the heart of ING's strategy, and it's an integral part of what we do. We have made long-term commitments with clear intermediate goals, such as the Net-Zero Banking Alliance climate commitment to align our lending portfolio with net-zero emissions in 2050. We earn and keep the trust of our stakeholders by showing how we live up to these commitments.

This means really putting in the hard work. First and foremost, it's about putting our financing to work. With regard to climate, this means directing it toward green energy projects and the development of new energy sources, toward helping clients make the low-carbon transition, toward low-carbon technology and away from high-carbon technology.

⁹ PACTA for Banks, an open-source methodology developed together with the 2^o Investing Initiative.

¹⁰ ING is chair of the finance working group of the Net-Zero Steel Initiative.



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Only sustainable growth – growth that creates long-term value for all, including the planet – is future-proof.

It's also about helping the finance industry come together and work in the same direction. For example, we have co-developed a climate methodology for banks⁹ and are currently helping to draft the road map for sectors, such as steel, where there isn't a net-zero climate scenario yet.¹⁰ In practice, this means that we report transparently and comprehensively on our progress while being open about the dilemmas we face.

Do you feel you are now spending more time engaging with stakeholders on these issues than in the past? What are some of the challenges you are tackling?

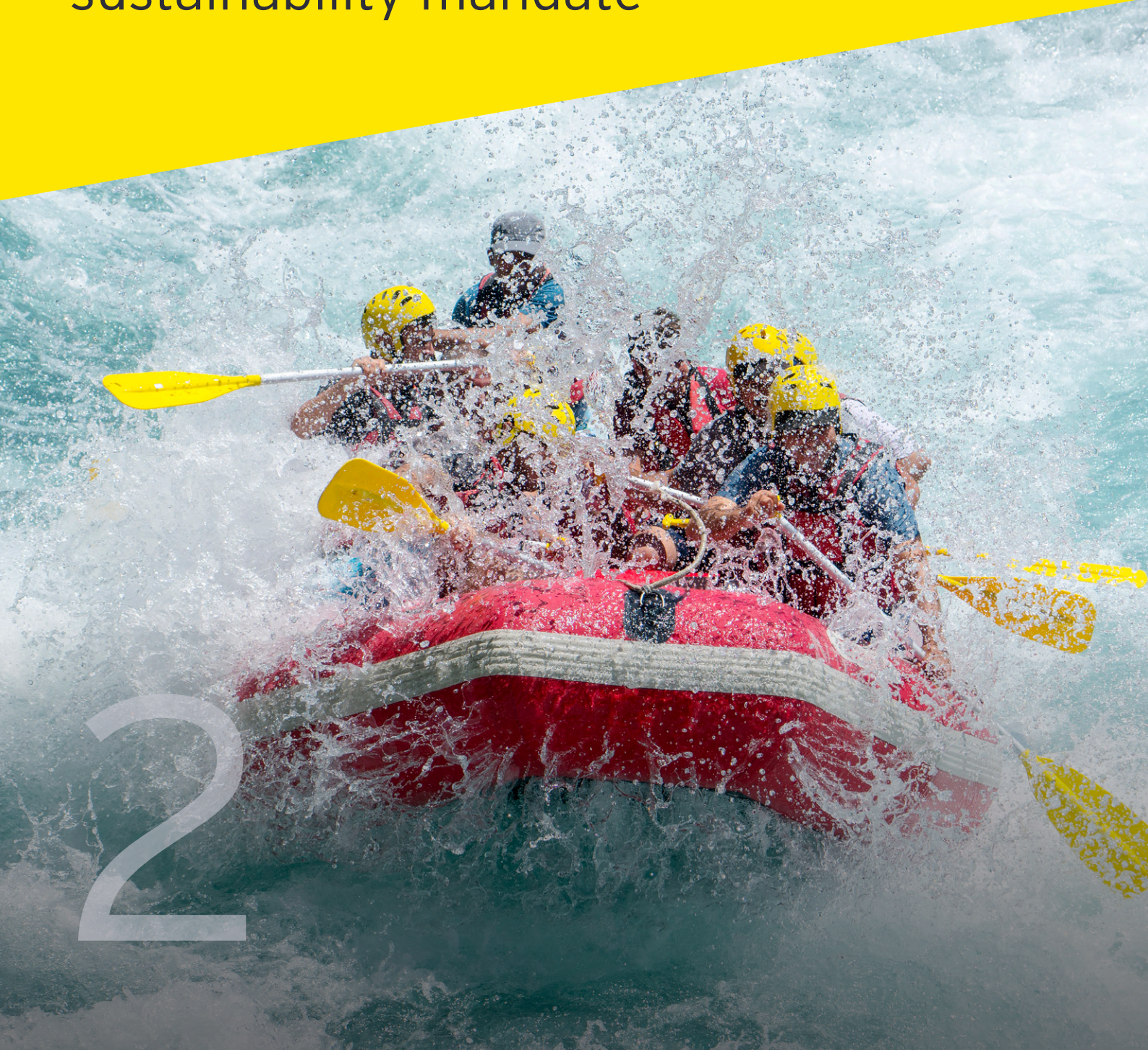
The sustainability and ESG agenda has brought us closer to stakeholders than in the past. We are in regular dialogue with our stakeholders, from customers and investors to employees and local communities. We discuss their expectations, needs and demands regularly at a board and also supervisory board level. We are an active member of platforms such as the United Nations Environment Programme Finance

Initiative (UNEP FI) and industry associations, which provide us with additional insights, and we work with academics and other experts to really get to the heart of the matter on certain topics.

With investors in particular, one challenge is that the acronym “ESG” encompasses a broad and constantly widening range of topics. We have observed that each investor has a unique viewpoint on which specific ESG priorities are at the heart of their firm's strategies and investment policies. Another is the increasing request for data and metrics, which is sometimes challenging, as standalone figures don't necessarily illustrate the whole picture and can get in the way of a more nuanced reality. We prioritize engagement to foster a mutual understanding of investors' expectations and to illustrate how we are addressing the ESG topics that are most applicable to our company. Through dialogue, we can deepen investors' knowledge on our ESG journey while also learning from them.

To succeed and deliver against their ESG agenda while managing significant volatility and uncertainty, boards need to clarify their sustainability mandate

2



While encouraging progress has been made in how leaders and boards govern their organization’s approach to long-term value and ESG factors, significant internal and external challenges stand in the way of delivering on an ambitious ESG agenda. In particular, survey respondents point to two issues:

- ▶ Externally, they are concerned about near-term economic uncertainty, no doubt reflecting in part, the continued market disruption caused by COVID-19 variants.
- ▶ Internally, they are concerned about whether boards have established a clear mandate for integrating ESG factors into major strategic decision-making. This, of course, is also a critical requirement for addressing the external challenge of increasing volatility. The ability to respond quickly and effectively to volatility and disruption – and set a new direction for sustainable growth – requires decisive, integrated leadership that focuses on long-term business resilience and not just immediate short-term crisis response.

Challenge 1

How to drive long-term value in a volatile and challenging macroeconomic environment

As leaders and boards look to make the long-term decisions needed to manage major risks and seize ESG growth opportunities, they are faced with significant uncertainty in their domestic and global markets. And this is not just an issue for companies that see a challenged future for their company. In fact, as Figure 3 shows, near-term economic uncertainty is the primary challenge for both companies that are optimistic about their growth prospects and those that are more concerned.

The uncertainty caused by a range of issues – from disruption caused by COVID-19 variants, to supply chain interference due to extreme weather events – is a top-of-mind issue for all executives and boards seeking to make long-term investments and decisions. While companies that are less bullish about growth are more likely to be concerned (47%), it is still a priority for those who are more optimistic about growth prospects (38%). While the less optimistic may be concerned about the impact

of economic volatility and whether they can withstand the turbulence, the more optimistic may be focused on this issue as they look to not only build resilience into their operations and culture but also accelerate through market turbulence and seize a competitive advantage.

Figure 3: Which of the following external factors have the greatest impact on your ability to generate long-term value through a strong ESG proposition?

	High-growth companies	Flatlining or declining companies
Near-term economic uncertainty	38%	47%
Lack of standard metrics and reporting for ESG and nonfinancial (i.e., sustainability) information	37%	26%
Limited access to capital	36%	26%
Short-term earnings pressure from investors	35%	38%
Customer demands	32%	26%
Directors’ duties and other aspects of company law	28%	38%
Regulatory requirements for publicly listed companies	27%	41%
Competitive pressure	26%	24%

Note: “high-growth companies” are those in the research sample that see 10% or more growth in their revenues over the next 12 months; the other group see their revenues as either flat or declining.

Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200).

Economic uncertainty is driven by a range of concerns, such as geopolitical instability, inflation and talent shortages. It is also likely that COVID-19 will continue to make its presence felt in the long term, as we learn to live with its “long tail” effects. Overall, the impact of the pandemic – and the clearer understanding it has given us of the devastating impact of “grey swan” events – have raised concerns about the challenges of delivering long-term value when there is so much uncertainty about the future economy and potential disruption (in this instance, “grey swan events” means events that are possible even if they are not considered probable).

Challenge 2

How to maximize long-term value when the board’s role in ESG is still evolving

To unlock the value of a company’s ESG agenda, a clear-sighted focus on the long term is critical. Boards play an essential role in aligning ESG initiatives with the strategic direction of the company, ensuring it is focused on material topics (both risks and opportunities), establishing targets and accountability, and assessing the company’s performance at a company-wide level. While ESG implementation will be devolved to individual business units, boards play a central role in establishing a clear strategic direction, focusing on the long term, and developing a plan to avoid fragmentation and duplication.

However, the research finds that the board’s role in ESG strategy is still evolving and that there is a need to strengthen that role to ensure ESG offers a competitive advantage and not just compliance. As Figure 4 shows, the major internal challenge facing companies today when it comes to generating long-term value through a strong ESG proposition is lack of commitment from the board to make decisions that fully integrate ESG factors and create long-term value. Today, 43% of respondents identify this as a significant challenge, up from 28% in 2021.

Navigating a complex regulatory environment

As well as uncertainty about the macroeconomic environment, companies also have to navigate a world in which policy-makers are making significant changes. If we look across the whole survey sample, the regulatory requirements facing companies is seen as the major external challenge, up from least important in 2021. This perhaps reflects the challenge of navigating an increasingly complex web of market regulations and frameworks, with developments under consideration including new EU ESG disclosure rules, compulsory disclosure of climate risk and EU standards for the green bond market.

This seems to reflect a recognition from both leaders and board members that there is still more to do to make ESG a systematic part of how governance functions: in particular, the need to embed ESG into strategic decision-making around risks and opportunities, and to ensure that, as well as short-term performance, the organization is making the long-term capital investments required to drive progress and balance financial performance with the nonfinancial impacts of ESG. In the next chapter, we assess some of the key priorities that boards need to consider if they are to make this critical next stage of the board’s evolution a reality.

Figure 4: Which of the following internal factors have the greatest impact on your ability to generate long-term value through a strong ESG proposition?*

Note: Use of “=” signifies an equal ranking, such as joint 4th

	2022 survey	Ranking in 2021 survey
Lack of commitment from the board to make decisions that fully integrate ESG factors and create long-term value	43%	=4 (28%)
Lack of internal processes or metrics to measure the nonfinancial drivers of long-term value, such as human capital	41%	=2 (31%)
Limited board diversity or knowledge in key areas	37%	=3 (29%)
Siloed or inflexible organizational structure	34%	5 (25%)
CEO and executive compensation are tied to short-term performance	33%	1 (36%)
Misaligned business strategy and/or growth targets	29%	=3 (29%)
Limited near-term liquidity	24%	=2 (31%)
Misaligned organizational culture and behaviors	21%	=4 (28%)

*2021 question: “Which of the following internal factors have the greatest impact on your ability to generate long-term value?”

Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200) – EY Long-Term Value and Corporate Governance Survey, March 2021 (total respondents: 100)



External viewpoint

Ezgi Barcenas

Chief Sustainability Officer, AB InBev



AB InBev is the world's largest brewer, with a diverse portfolio of well over 500 beer brands, including global brands such as Budweiser, Corona and Stella Artois.¹¹ Julie Linn Teigland – EY EMEA Area Managing Partner – spoke to Ezgi Barcenas to understand her perspectives on integrating the ESG agenda into strategy and corporate governance.

Can you tell us about how AB InBev is aligning the ESG and sustainability agenda with its purpose and strategy?

We have recently launched a new purpose, We Dream Big to Create a Future with More Cheers, which builds on our legacy and reflects our culture of dreaming big. To us, “a future with more cheers” means shared prosperity for our communities, for the planet and for our company. To accelerate the sustainability agenda, a leader needs to have double vision: you must see the world as it is today – with all its realities – but also imagine what it could look like and have the belief system that a better world is possible. Setting this purpose of dreaming big not only orients us into the long term but also enables and empowers our teams to think that a better future is possible – and together, we can be part of creating something bigger than the company.

Thinking about your stakeholders, where are you seeing increasing expectations around the ESG and sustainability agenda?

We are seeing signals of change. We're seeing growing interest and expectations from the investor community, but also from our own colleagues. We live in a world now where employees expect more decisive action on sustainability from the companies they work for. The same goes for consumers and communities. Accordingly, we're enhancing our transparency and disclosure but also creating space to listen to stakeholder expectations. This new form of collective learning for sustainability allows us to stay innovative in a rapidly changing world.

And what role does the board play in the ESG agenda?

Governance is key. As the company's ultimate decision-making body, the AB InBev Board has oversight of all ESG responsibilities, including approval of ESG

¹¹ <https://ab-inbev.com/faq/>

¹² <https://ab-inbev.com/investors/corporate-governance/our-board/>

¹³ https://ab-inbev.com/assets/presentations/ABI_Investor%20Seminar_ESG_FINAL.pdf



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To accelerate the sustainability agenda, a leader needs to have double vision: you must see the world as it is today – with all its realities – but also imagine what it could look like and have the belief system that a better world is possible.

strategies and review of ESG performance. Depending on the matter, we engage with the full Board or a specific committee. Our Board is composed of independent directors as well as representatives of family shareholders and restricted shareholders.¹² This gives us a broad and diverse set of perspectives and experiences.

What has been really empowering for me as the CSO is the care and interest our Board takes in how we define and communicate our long-term value approach. As we define and communicate long-term vision with top-down support, we are able to build a sustainable business for the long term while delivering short-term objectives. The Board also stretches our thinking when they bring questions that help us rethink what the future can be and how we can innovate further.

How are you thinking about communicating your long-term value and sustainability agenda to key stakeholders and setting out a distinctive narrative?

In developing a 10-year plan, we evolved our ESG strategy to fulfil our purpose and enable our commercial vision. And we were able to authentically refine our narrative by leaning into our category and operating model. We have sharpened our focus on eight ESG strategic priorities: Smart Drinking & Moderation, Climate, Water Stewardship, Sustainable Agriculture, Circular Packaging, Ethics & Transparency, Entrepreneurship and Diversity & Inclusion. And in doing so, we have identified how these priorities culminate in three cross-cutting themes – inclusive, natural and local – that encapsulate who we are and how we will create shared prosperity.¹³

Salla Saastamoinen

Director for Civil and Commercial Justice, Directorate-General for Justice and Consumers (DG JUST), European Commission



Salla Saastamoinen has extensive experience in a wide range of policy areas, including civil procedural law, private international law, contract law and company law. Speaking in an individual capacity to Andrew Hobbs (EY EMEA Public Policy Leader), she shared her personal perspectives on the regulatory environment when it comes to sustainable corporate governance.

Any views and opinions in this interview are personal and belong solely to the speaker and should not be associated with her professional capacity or the institutions she is associated with.

Could you share your personal perspective on how the Commission is looking to ensure that corporate governance can effectively support sustainability objectives?

The pandemic made it very clear that resilience is critical, and resilience means sustainability and a long-term view on risk. The work of the company's board members is very important here and it's very much a corporate governance issue. A second point is the importance of Commission and EU policy on sustainability or green transition. This policy must influence not only the public actors who lead on regulation; it's also an important question for companies and those who lead them. "How do we deliver transition in our company?" is the basis of transition thinking.

In Europe, the aim is for European companies to be leading at the front line when it comes to sustainability. It is part of our industrial and commercial thinking that sustainability is beneficial and profitable in the long-term for European companies that benefit from transition. It's then down to the company's board and its management to look at these areas.

This is not the first time that Europe has looked to align societal goals with companies and their corporate governance. Take diversity, for example. Existing directives have looked at the diversity of company boards and how their composition should better reflect society.

¹⁴ Questions and Answers: Corporate Sustainability Reporting Directive proposal: https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_1806

¹⁵ Shareholders' rights directive Q&A: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_17_592.



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“The aim is for European companies to be leading at the front line when it comes to sustainability.”

What impact do you see the EU's Corporate Sustainability Reporting Directive having on the ESG agenda and corporate governance?¹⁴

We had focused on the disclosure of nonfinancial and diversity information by companies. This Directive takes things one step further, looking at how sustainability issues and risks affect the company and any adverse effects on areas such as the environment or human rights. It essentially aims to create a level playing field and also legal clarity for all companies. The aim is to have a harmonized approach, where member states are aiming for similar goals, provisions and principles.

In your own view, what are some of the key issues in ensuring that companies and boards interact and fully engage with shareholders?

The Shareholder Rights Directive was intended to strengthen the position of shareholders and allow them to be more active on issues like remuneration and risk, including sustainability risks.¹⁵ When we talk about societal demands, shareholders actually mirror those societal demands. Good participation and engagement are essential. Looking forward, digitization will likely shape engagement. The COVID-19 pandemic has certainly highlighted the potential impact of digitization on corporate governance, such as “digital” AGMs for example. But, of course, you need to ensure that the approach is resilient.

Three priorities for strengthening the governance system to support strategic decision-making on ESG and long-term sustainable growth

3



Given the importance of ESG issues to long-term value creation, and the profound challenges that companies face in achieving their goals, how can board directors and CEOs think differently about their governance approach and then deliver the necessary changes? There are three critical areas that require action:

- ▶ The board operating model, as well as composition and skills
- ▶ Reward programs, including remuneration and incentive plans
- ▶ Effective reporting to steer the business and support investor engagement

We now consider these topics in turn and outline specific recommendations for moving forward.

Board oversight: board operating model, composition and skills

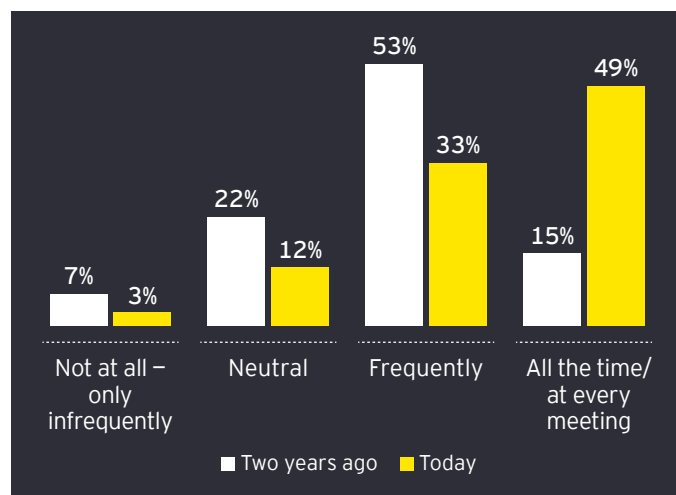
There are three critical issues when it comes to effective board oversight – the operating model, composition and skills.

Operating model

The move to a sustainable economy raises questions about whether some boards need to rethink their core operating model. This is about analysing the governance structure in its current form and assessing any concerns, such as lack of clarity on which leaders are actually responsible for sustainability, then identifying leading practices as to how governance should be structured to drive sustainability outcomes. At the same time, as companies continue to respond to immediate ESG expectations and opportunities, this assessment looks at the governance model needed to deliver a fundamental rethink of business models and strategy.

Part of this will be about understanding whether board operating models offer the agility to respond to a fast-changing sustainability landscape. Do they have the credible, forward-looking data they need and

Figure 5: Comparing two years ago with today, how frequently does your board discuss ESG strategy and reporting?



Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200) – EY Long-Term Value and Corporate Governance Survey, March 2021 (total respondents: 100)

the digital tools to analyse its implications? Are they devoting enough time to the ESG agenda, given the many demands on their time? On this latter question, as Figure 5 shows, the amount of time that boards devote to ESG topics has increased significantly. Two years ago, for example, only 15% used to discuss the ESG agenda and reporting at every meeting. Today, 49% do so, with another 33% discussing these issues frequently.

While the frequency of ESG discussion is encouraging, greater innovation may be needed to respond with the required agility to ESG issues, given how quickly and constantly the market and regulatory picture is changing. Boards may want to consider the timing and mode of meetings, and work with key leaders – such as chief sustainability officers, CFOs or chief value officers (finance leaders with a focus on the integration of financial and ESG value) and chief risk officers – to formalize processes and controls, standardize data collection and put in place data-driven early warning systems that provide forward-looking and agile insight into emerging trends and developments.

There is also the critical issue of the right structures for effective ESG oversight by the board. In short, should companies have a dedicated sustainability committee or make ESG the responsibility of the overall board? In the recommendations below, we outline how the CEO and directors can think about these issues and arrive at a structure that is right for the organization, its ESG maturity and market demands.

Board composition

A critical priority in terms of composition is diversity. Diversity of skills, experience, outlook and culture – encouraged by a focus on areas such as diversity of gender, race or age – leads to different ideas and thinking. This, in turn, is critical to the “combinative” thinking needed to find innovative solutions to complex ESG issues. Diversity has been shown to result in better problem-solving and decisions, helping ensure that assumptions and entrenched beliefs are challenged, and different perspectives are aired.

Skills

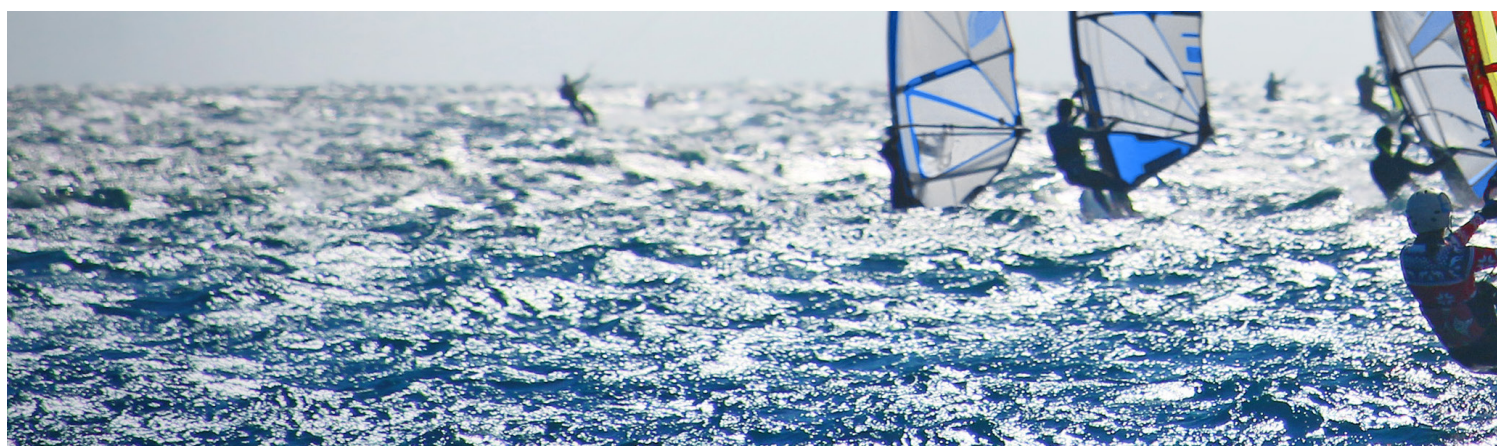
As well as diversity of skills, building the board’s specific ESG knowledge is critical if it is to ask the right questions and challenge management on sustainability topics in the short and long term. As well as including sustainability skills as criteria when assessing new candidates for supervisory boards, other interventions can help existing board members build their ESG expertise. One example would be putting in place advisory groups for the board, perhaps including academics or scientists that have a particular understanding of environmental or social issues (see “Audit committees and ESG governance”).

Audit committees and ESG governance

At a recent meeting of Tapestry Networks’ European Audit Committee Leadership Network – which focused on ESG governance – many members agreed that audit committees will need to upskill, with some saying that they are already conducting ESG training with internal and external experts.¹⁶ It was also suggested that nonfinancial expertise would be an increasing requirement, given that corporate reporting is moving to an “enhanced” approach where ESG disclosures and traditional financial reporting are more closely integrated and aligned, and where financial expertise alone would no longer suffice for effective oversight.

For some companies, the sustainability skills question could extend to selecting board members with expertise and capabilities. For example, energy companies might look for directors who bring a specific track record and expertise in climate change and energy transition. Others, however, will rely on the fact that directors bring core skills to the table, such as the ability to offer a strategic challenge or to absorb and analyse large amounts of complex information. In turn, these directors can build the necessary ESG understanding through access to outside expertise.

¹⁶ **ESG Governance**; European Audit Committee Leadership Network, January 2022; Tapestry Networks. The network is sponsored by EY.



Key recommendations

Putting in place the right board operating model, composition and skills



Boards and leaders can take a number of steps to build effective board oversight through the right operating model, composition and skills.

Operating model and committee structure

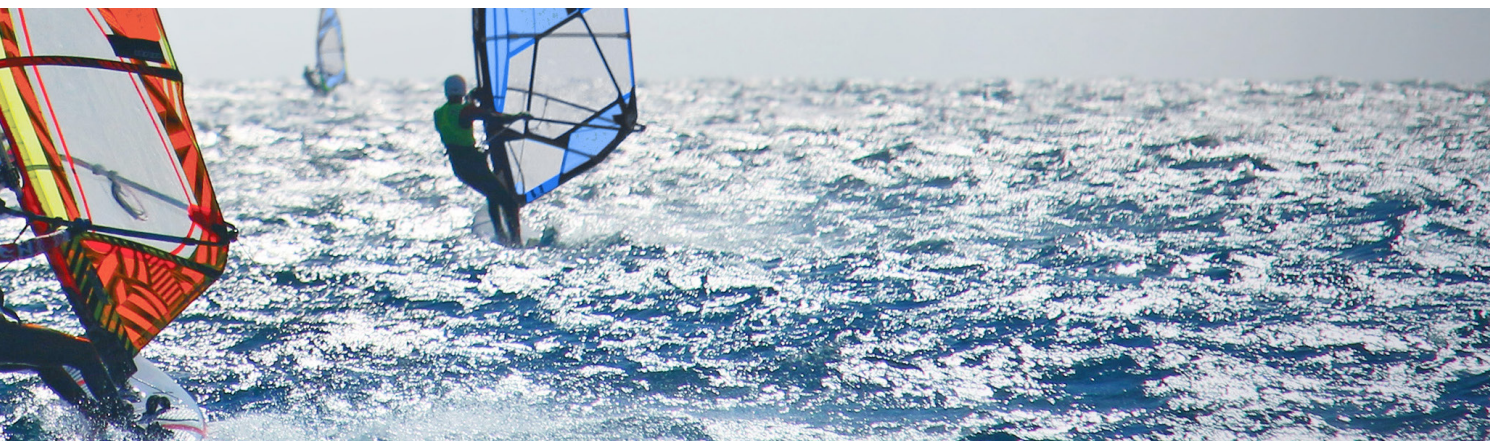
The right structure in terms of board oversight is a complex issue. Many companies will assign responsibility to a committee – either a dedicated sustainability committee or an existing one, such as the audit committee. The other approach is to give ESG responsibility to the board as a whole. There are important success factors when it comes to these respective choices. If an existing committee is chosen, companies will need to ensure that the oversight is not weighted toward the particular interests of that committee, such as an overemphasis on risk at the expense of opportunity. There also needs to be regular CEO involvement.

And, of course, there are wider success factors too. A committee will need sufficient support from the business to discharge its duties, interact with others where remits overlap (e.g., with a risk committee) and have enough time for the board-level discussion required to ensure adequate integration with strategy.

Composition and skills

As discussed earlier, diversity of perspectives is critical to finding innovative answers to complex ESG issues. However, in terms of the specific ESG knowledge that is required, a number of steps can be used to build expertise in different sustainability domains:

- ▶ Based on the organization's strategy – and its ESG priorities – assess the skills needed to deliver and whether today's board – as well as critical senior executives – possess those skills currently; then put in place a specific plan to address critical gaps and regularly assess the picture
- ▶ Revisit the board's approach to learning and development, putting in place programs to build understanding of the key trends and considerations for a sustainable business (this should include understanding of major ESG risks as well as opportunities)
- ▶ Provide exposure to expertise – as well as new perspectives – by considering introducing external advisory boards, including scientific and academic expertise



External viewpoint

Mirte Bronsdijk

Senior Corporate Governance Specialist, APG Asset Management



APG Asset Management is one of the world's largest pension investors, managing assets of approximately 627 billion euros for pension funds with 4.7 million participants.¹⁷ Andrew Hobbs (EY EMEA Public Policy Leader) and Martijn de Jong (a corporate governance specialist, Ernst & Young Accountants LLP) spoke to Mirte Bronsdijk to understand her perspectives on the importance of ESG and corporate governance in the context of creating sustainable investment returns.

Can you tell us about some of the key drivers that are shaping today's ESG and sustainability agenda?

COP 26 certainly galvanised companies and everyone into action. There's a much stronger focus on setting net-zero commitments, but also on the credibility of those commitments, whether they are made by companies or investors. Essentially, we have arrived at the next stage of ESG scrutiny, where stakeholders want to understand how organizations are going to actually achieve the sustainability commitments they have made. From an investor's perspective, there is increasing focus by regulators on understanding risk exposures, and if we are going to meet that expectation, we need credible data from the entities that we invest in.

From an investor's perspective, what implications do these developments and other sustainability issues have on governance and the role of boards?

There is increasing expectations about representation of sustainability expertise on the board. This reflects the general expectation of investors that a board will reflect experience and expertise that are relevant to

the strategy that the company is communicating. Is the board fit for purpose when it comes to helping the company move forward in executing its strategy? Are the people on the board still the right people for that pursuit of strategy execution?

Part of that is about diversity, but boards also have to think of other ways to integrate sustainability expertise in their leadership. While we would not set the expectation that there has to be a board member that is a sustainability expert, we do expect the issue to have been thought through. We need to be clear that there is sufficient understanding and expertise on the ESG agenda within the management team and board.

What implications do an increasing focus on ESG have for the board operating model?

We definitely see an increase in the number of companies that have set up separate committees for sustainability-related topics. Some boards put together a committee that includes a representative from each committee – from audit to remuneration – to ensure it's an integrated view. But it still feels like there is more to do in terms of really overseeing how the sustainability

¹⁷ As at end-November 2021. See: <https://apg.nl/en/about-apg/asset-management/>

¹⁸ **Targeted consultation on the establishment of a European single access point (ESAP) for financial and nonfinancial information publicly disclosed by companies**, European Commission.



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We have arrived at the next stage of ESG scrutiny, where stakeholders want to understand how organizations are going to actually achieve the sustainability commitments they have made.

strategy of the company is implemented throughout the enterprise. To address this, a key approach is a materiality assessment, as this gives the board a better understanding of what it is that shareholders and stakeholders expect from them and what ESG areas the strategy should be prioritizing.

And what are your expectations when it comes to the transparency and credibility of companies' ESG reporting and the challenges you see in terms of providing trusted data?

In terms of reporting, there is a lot of demand on corporates for sustainability data, given the regulatory environment. One issue that has been raised is companies receiving multiple Excel-spreadsheet-based requests for ESG information from data providers. But those requests don't necessarily always align with the company's strategy and where its focus is in terms of the ESG agenda. Companies have to struggle to balance reporting on the ESG issues that matter to them while meeting requests that they monitor and measure all sorts of data that may not necessarily be their area of focus.

We are cautiously hopeful that a potential European database for sustainability information could help here, potentially providing a single source of truth where every company can upload their data based on agreed formulas for how to calculate that data. A European database that is of high quality and reliability could be really helpful for both investors as well as companies.¹⁸

Finally, can you tell us about some of the key issues that companies need to think about when looking at alignment of executive compensation with ESG targets?

We have many conversations with companies about embedding ESG performance metrics in their remuneration policies, and there are some who are in fact very well advanced in this area. Our focus though is on how credible the approach is: we expect companies to select ESG metrics in their remuneration schemes that are measurable and auditable and aligned with financial targets. We want companies to be very transparent about what they are measuring, what management is incentivized to do, what the target setting is, and then how they have performed against those targets.

Commitment, accountability and alignment: leveraging reward programs, including remuneration and incentive plans

There has been heightened investor focus on how companies operationalize their ESG goals across their organizations over the last 24 months. Key investor focus areas include the identification, measurement and assessment of ESG performance metrics to foster accountability and create long-term value. A strategic lever that can be used to enhance leadership accountability on sustainability is executive remuneration and incentive plans. Survey respondents recognize this focus on accountability: 75% say there is more focus

today on the personal responsibility and accountability of board directors and management teams for whether a company is making progress against ESG goals.

The research asked respondents to think about the governance changes needed to support their approach to ESG and long-term value, and then identify the major changes they have made over the last two years to reinforce accountability and what the priorities will be for the future. As Figure 6 shows, remuneration will be the main focus over the next two years. Two years ago, it was the lowest level priority. This perhaps reinforces how focus has shifted to tangible action and results, given that making the link to remuneration proactively incentivizes ESG-aligned decisions.

Figure 6: The major governance changes that companies are prioritizing over the next two years to support their approach to ESG and long-term value

Question: what are the major governance changes your company has made to support its approach to ESG and long-term value over the last two years, and what are the major priorities for the next two years?



Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200).

Of course, while the goal is clear, the design and implementation of ESG-focused remuneration schemes is more complex and challenging. Each company's ESG journey and priorities are unique to it, reflecting a combination of factors such as corporate strategy, geographical footprint, local law and regulatory requirements. As such, a one-size-fits-all approach is not

appropriate, and it should not be assumed that a program that worked well for one organization will be equally successful for another. While alignment of ESG and executive remuneration is a key tactic, it is not a panacea that will solve every sustainability issue, and there are many nuances that demand specific consideration and evaluation if approaches are to be effective.

Key issues that need to be considered include the following:

- ▶ Before compensation schemes are defined, organizations need to align on the right metrics and KPIs, time horizons, and monitoring and governance structures, which can be challenging to define and assess. Companies need to evaluate their strategy and determine which metrics are most relevant to them, while ensuring that focus is given to all three pillars of E, S and G. This will vary by sector, based on different industries' unique sustainability profiles. Such metrics must be reliable if they are to influence executive remuneration; therefore, robust processes and controls will be required, including board committee oversight. At the same time, a degree of flexibility will be required, given that sustainability is a fluid and fast-changing landscape. Companies need to assess whether they have the data, technology and processes in place to accurately report to boards on progress against ESG KPIs.
- ▶ There is the question of how much is results- and output-based, and what scale is appropriate. For example, just rewarding a CEO on output could ignore the stellar work they have done in changing processes or culture to achieve a goal, such as driving diversity. Also, when it comes to results, there needs to be clarity on how the scale runs from "acceptable achievement against results" to "high performance," so that meaningful progress is also assessed and rewarded.
- ▶ There is the question of materiality, or how much compensation to tie to ESG measures. If companies are going to change executive behaviour and drive long-term performance, they need to ensure that a meaningful portion of pay is at stake. Based on their experience, EY remuneration professionals believe that companies must identify a material level of pay to be connected with ESG goals and objectives, with clear performance targets to make a meaningful impact.

Key recommendations

Designing remuneration schemes to incentivize a focus on long-term value and the achievement of ESG goals



Boards can consider the following guidance as a starting point to evaluate what is right for their company:

- ▶ Align metrics with the company's ESG strategy
- ▶ Determine what metrics, and in what percentages, make sense in the short and long term, benchmarking by sector, position and characteristics of the metrics – i.e., measurable, understandable, etc. (benchmarking will also be important so that boards can show that what they propose is in line with the company's peer group)
- ▶ Build transparency and effective communication to markets, shareholders and employees (if the ESG goals that leaders are tasked with achieving are too vague, it will be impossible for stakeholders – such as investors – to hold remuneration committees to account)
- ▶ Examine the wider rollout of ESG-focused reward programs within their company (while executive remuneration is a focus of governance and board oversight, building a sustainability culture across the enterprise – and mobilizing staff behind the ESG approach – can also involve introducing ESG priorities into broader total reward programs, e.g., "green reward" programs that incentive wider groups of employees to embrace sustainable behaviors)

External viewpoint

Sonia Tatar

Executive Director, INSEAD Corporate Governance Centre and INSEAD Wendel International Centre for Family Enterprise



Andrew Hobbs (EY EMEA Public Policy Leader) and Martijn de Jong (a corporate governance specialist, Ernst & Young Accountants LLP) spoke to Sonia Tatar to understand her perspectives on the impact of ESG factors on long-term strategy and governance.

What are some of the factors that organizations should be thinking about when it comes to generating long-term value through a strong ESG proposition?

It all depends on the maturity of the organization when it comes to ESG and also the readiness and willingness of the organization to commit. Given the dynamic and complex nature of ESG, which involves rapidly moving targets linked to the 17 UN Sustainable Development Goals (SDGs), organizations need to consider the larger multiplex ecosystem. Many factors come into play, intertwining the purpose of the organization, its people and its stakeholders.

The first priority is for board members to embrace the culture and mindset for driving ESG – understanding its complexity and acting like activists themselves. They need a strategic perspective that addresses the “why, what, how, and who” in the development of an ESG roadmap. The “how”, for example, is about areas ranging from capital allocation to change management.

Part of the answer will also come from diversity of thinking and perspectives. The younger generation has ESG embedded in their thinking and doing, while the older is perhaps more in “catch up” mode. As well

as insights from more formal advisory boards, they can learn from more informal “shadow boards” where younger voices can offer a fresh outlook on ESG issues.

What are some of the key priorities in ensuring that boards have a clear understanding of stakeholders’ ESG expectations, from investors to customers?

Stakeholder engagement is part of the new capitalism model and it is something that boards need to embrace fully. At a high level, this means actively listening, being responsive, inclusive, and working alongside the different stakeholders to find solutions that create shared value for the organization, people and the planet at large. This, however, might not necessarily translate to satisfying all stakeholders at once. The process is evolutionary, which is why monitoring and tracking progress is important.

More than ever, boards need to spend more time on engagement with stakeholders. This begins with identifying their key stakeholders and their expectations, and then engaging in open dialogue to shape priorities. As well as a continuous and clear communication strategy, an effective feedback loop is also important, particularly for learning and adaptation as circumstances demand.



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The first priority is for board members to embrace the culture and mindset for driving ESG — understanding its complexity and acting like activists themselves.

What do you feel are the main priorities for organizations when it comes to ensuring their governance and approach to ESG are aligned?

First, the governance structure and support systems. This is about who is accountable and responsible in the management team for overseeing and ensuring effective execution across the organization. This implies establishing the resources needed, support systems, capital allocation, and business model innovation. The sustainability committee, for example, can play a key role, from providing a structure for the board to truly implement and embed ESG in the organization to ensuring the right and relevant questions are asked to align governance around ESG priorities. Second, clear objectives, with measurable and transparent KPIs that set out the key milestones to achieve and specific metrics to monitor impact. Third, putting in place an incentive mechanism, with compensation and reward that are tied to executives' performance against ESG targets. Finally, articulating the behavioural norms and cultural values that will foster an inclusive approach to ESG.

Finally, how can boards build the skills and expertise that will be needed for playing their part in a sustainable future?

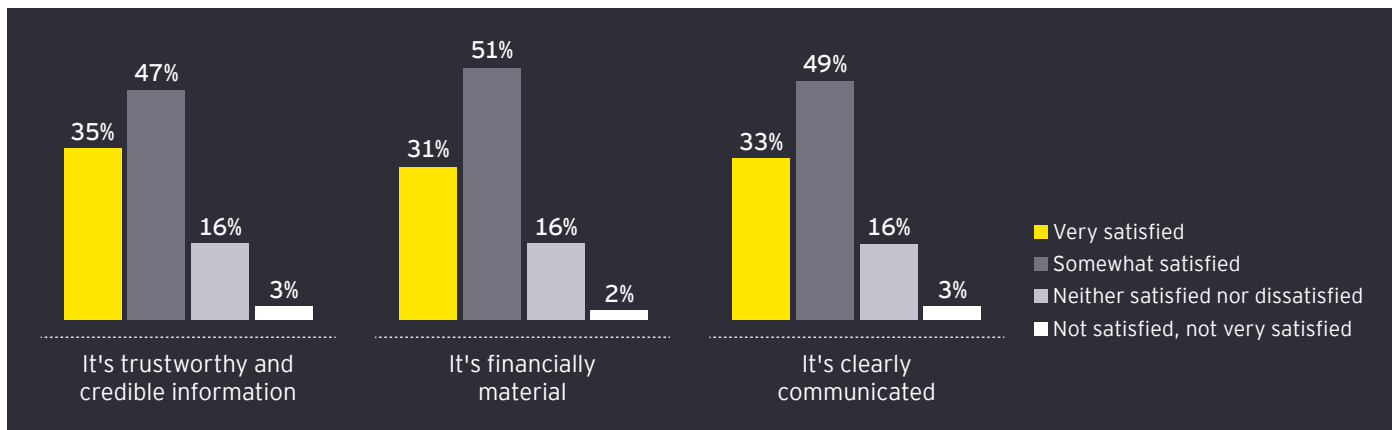
Boards recognize the importance of ESG. However, like others across many organisations, they are

still grappling with the knowledge needed to play a strategic role in overseeing an effective ESG execution. To bridge the knowledge gap, board members can undertake training. They can commit to organizing regular sessions for the board with leading experts, and benchmark themselves with other companies in their transformation journey towards a sustainable business.

Integrating ESG as a criterion in the selection process for the next nominations in the boardroom is a good start in building the required expertise. Setting up an ESG committee and organizational structure would certainly help the board keep abreast with the latest trends and regulations and allow directors to learn in a systematic way. Let me point out, however, that this ESG committee cannot function as a standalone entity. Instead, it needs to be a coalition and collaboration with the Risk, Audit, and Financial Committees to ensure alignment and integration, as ESG has implications for all.

Board members are not expected to be experts in every subject matter. However, fostering a learning attitude on new topics and emerging trends has become an imperative. With growing complexity and demands on their fiduciary duty, upskilling has become a competitive advantage they can bring to the boardroom. Staying agile and open to reinvent themselves is vital.

Figure 7: How satisfied, if at all, are you with the ESG reporting that you produce and share with stakeholders today?



Source: EY Long-Term Value and Corporate Governance Survey, February 2022 (total respondents: 200).

Trust and transparency: effective reporting to steer the business and support investor engagement

Today, corporate reporting is increasingly expected to include enhanced and material ESG disclosures alongside other information to show how a company is driving value for all stakeholders. There is increased pressure on corporates and their leaders to improve their ESG reporting – from equity investors, insurers, lenders, bondholders and asset managers, as well as customers. All these stakeholders want more detail on ESG factors to assess the full impact of their decisions.

CEOs and boards need to move quickly to meet stakeholders' expectations and articulate a unique narrative on how they create long-term value. In the latest EY Global Corporate Reporting Survey, 74% of more than 1,000 CFOs and finance leaders surveyed said that they had seen an acceleration in the past 12 months

in the transition from traditional financial reporting to an enhanced reporting model that encompasses financial and ESG reporting.¹⁹

In this Long-Term Value and Corporate Governance Survey, as Figure 7 shows, around a third of companies are very satisfied that the ESG disclosures they share with stakeholders are completely trustworthy (35%), material (31%) and clearly communicated (33%).

While this shows encouraging progress, other EY research has shown there is a gap between how useful companies believe their ESG reporting to be compared with the views of investors who use it in their decision-making. The Sixth EY Global Institutional Investor Survey found that 50% of investors felt that the usefulness and effectiveness of corporates' ESG disclosures were compromised by a lack of focus on the material issues that really matter.²⁰ However, the EY Global Corporate Reporting Survey found that only 38% of finance leaders at corporates were concerned this was an issue.

¹⁹ "The CFO Imperative: How do you transform data into insight?", EY Eighth Global Corporate Reporting Survey, December 2021.

²⁰ "Is your ESG data unlocking long-term value?", EY Sixth Global Institutional Investor Survey, November 2021.



EY teams' viewpoint



To provide investors and other stakeholders with ESG disclosures that are credible and trusted, **Ben Taylor, EY Global Strategy and Markets Leader, Climate Change and Sustainability Services**, believes leaders must ensure their reporting is “assurable, verifiable and on demand.” “In terms of the assurability of ESG disclosures, this is about having an end-to-end process where you know where the data is coming from and you have all the accountabilities mapped out,” he says. “This is a hard piece of the puzzle, because ESG data comes from across the enterprise, from operational arms such as manufacturing to HR systems. Investors are also often looking for disclosures to be independently verified. The on-demand piece is critical, because investors will want information on progress against ESG goals more speedily than the usual quarterly cycle offers, and they want to see ESG reporting that is integrated with financial reporting, not siloed.”

“The credibility and quality of ESG reporting is particularly important because, realistically, there is a degree of scepticism about some organizations’ green and sustainability claims, so one bad number can reinforce people’s view that the reporting cannot be fully trusted. Advanced technologies, including AI, will be crucial here, as they can be used to orchestrate what is very complicated and federated work to secure the data, and can then be used to analyse it and spot anomalies and risks.”

Consistent global reporting standards can be crucial to assessing long-term value and meeting investor needs

Board members and leaders are clear about the importance of globally consistent standards to improving the quality and transparency of corporates’ ESG reporting:

- ▶ 83% said they would like to see reporting of ESG performance measures against a set of globally consistent standards become a mandatory requirement.
- ▶ This is in line with investor sentiment – in the Sixth EY Global Institutional Investor Survey, 89% said the same.²¹

At COP26, the International Financial Reporting Standards (IFRS) Foundation announced the creation of a new board – the International Sustainability Standards Boards (ISSB) – which is tasked with creating a single set of standards “to meet investors’ information needs.”²² As EY outlines in *What to watch as global sustainability reporting standards take shape*, this could be a significant development in the transition toward a sustainable economy, but there may be a number of issues for the ongoing policy agenda.²³

Leaders also need to consider the specific implications for their own organization and its long-term value narrative. While it is clearly critical to have a global baseline for sustainability reporting, some companies could find that an agreed standard will not always capture their ESG approach and activities, raising the risk that stakeholders such as investors are not given a clear picture when making their assessment. As well as global standards, companies also need to ensure they have the ESG reporting in place to tell their sustainability story in the right context.

²¹ “[Is your ESG data unlocking long-term value?](#)”, EY Sixth Global Institutional Investor Survey, November 2021.

²² “[IFRS Foundation announces International Sustainability Standards Board, consolidation with CDSB and VRF, and publication of prototype disclosure requirements](#)”, IFRS, 3 November 2021.

²³ “[What to watch as global ESG reporting standards take shape](#)”, EY, 11 November 2021.

External viewpoint

Rients Abma

Executive Director, Eumedion



Eumedion, which is based in the Netherlands, represents the interests of institutional investors in the field of corporate governance and sustainability. Andrew Hobbs (EY EMEA Public Policy Leader) and Martijn de Jong (a corporate governance specialist, Ernst & Young Accountants LLP) spoke to Rients Abma to understand his perspectives on corporate governance and the sustainability and ESG agenda.

Can you tell us about some of the major sustainability goals that corporates and institutional investors are focused on?

Overall, ESG is high on the agenda, but there's a particular focus on climate. Even for companies where their impact on climate change is quite small, they are showing how they can contribute to fighting it as a global challenge. Many companies are now working on setting specific net-zero commitments, including short-, medium- and long-term targets, and we also see a move toward external verification of these plans by, in particular, the science-based targets initiative. This progress on climate action is a positive development, but, of course, there is also a lot more to do on other topics, such as fighting biodiversity loss, circularity, human rights due diligence, diversity policies and aligning executive remuneration with long-term sustainability objectives. On these themes, many companies still have a long way to go.

What are some of the key success factors in your view when it comes to putting in place the governance frameworks to drive sustainability?

Effective sustainability governance starts with diversity in the leadership teams – from management to the board of directors. Many investors believe that a more diverse board will lead to better decision-making. It also sets an example for the outside world, with a

diversified board helping to attract talented employees. The younger generation, in particular, considers diversity an important factor when they are considering who to work for. This is particularly important in an environment where there is a war for talent. Showing progress on these topics is part of being a good corporate citizen, which is very important today in attracting the best people to the company.

What are some of the key issues that Eumedion focuses on when it comes to board composition and capabilities for the sustainability and ESG agenda?

In terms of boards having the right skills and competencies, it is difficult for investors to know whether a candidate's "sustainability DNA" has been considered when selecting new executives: in particular, the CEO. Companies are also not elaborating on the specific factors used to select a specific board member for appointment at the annual general meeting (AGM). We also find that sustainability credentials are not often considered when selecting a director and a member of the nomination and selection committee. I think companies should improve their reporting on those aspects because investors, as well as employees, expect the sustainability profile or "DNA" of the person to be considered during selection. Companies could be more open about that and the critical criteria that were used when nominating a new CEO for election by the AGM.



Effective sustainability governance starts with diversity in the leadership teams — from management to the board of directors.

When it comes to understanding of ESG issues, more companies could establish a sustainability council, including people from outside the company. They can reflect on the company strategy and how sustainability has been embedded into the strategy as part of the continuing stakeholder dialogue. This gives it a more formal place in the governance structure of a company and allows outside views to be included.

And what is your view on how responsibility for ESG should be handled within the board operating model?

I think the committee structure for sustainability and ESG will depend on what stage of the journey the company is at. Those who are not front-runners with respect to sustainability, and still have lots to do, might like to put focus and attention on the topic by establishing a separate sustainability committee within the board of directors. But for companies that already have a long tradition of incorporating sustainability factors into strategy and risk management, you would trust that the overall board will ensure that ESG factors are considered in strategic decision-making.

Recently, we have received more invitations from members of the supervisory board – in particular, the chairman – to discuss sustainability issues. Today, supervisory boards are becoming more and more active and involved in this subject and are actively seeking information from institutional investors on what they see and assess when it comes to the sustainability

performance of the company. I think that is a very good sign and, hopefully, a trend that will continue in the coming years.

Finally, what are some of the key issues that investors are focused on in terms of corporates' ESG disclosures and getting transparency into their sustainability performance?

Many companies are now reporting in a more process-oriented manner on issues such as long-term value creation, culture, diversity, risk management and executive remuneration. It is important that companies streamline this ESG information together with financial disclosures and publish them at the same time, but many companies are still wrestling with the information systems needed to do this. Because of the regulatory obligations for institutional investors today, it is important that these data are public and robust enough to be taken into account in the investment decision-making process. It is important that boards initiate a dialogue with institutional investors on this theme.

At the same time, it is also important to provide contextual information about the dilemmas and challenges that the management and the board of directors faced when reaching their conclusions. We are looking for better and informative reporting on how important decisions have been reached within the board, explaining the dilemmas and challenges it faced when reviewing the company strategy and business model.

Key recommendations

Enhanced reporting and closing the investor reporting disconnect



Boards and leaders can take a number of steps to move to an enhanced reporting model, where investors and other stakeholders are provided with consistent and credible ESG disclosures on material issues alongside the financial reporting that companies traditionally disclose:

- ▶ **Better understand the climate risk disclosure element of ESG reporting.** Companies around the world are undoubtedly making progress on climate risk disclosure, spurred by growing demand from investors, regulators and the public. But there is growing pressure for them to do more. Companies should look carefully at the broad risks and opportunities that climate change presents to their business and their industries, undertaking robust climate risk scenario analysis. A number of steps are important to achieving this, including connecting financial reporting with climate risks and embedding it into existing risk frameworks, rather than treating climate as a separate issue. Second, improve climate risk and opportunity disclosures now, rather than waiting for mandatory reporting standards to be introduced. And, while climate risk is an immediate priority, companies also need to consider other ESG risks, be it new areas of the “E” pillar, such as biodiversity; “S” areas such as the treatment of employees and customers; or “G” issues such as ethical risks. Having trusted data – and the sophisticated technology and analytics tools to deliver credible insights – will be critical. Without those capabilities, trusted and credible tracking of financial and ESG performance is impossible.
- ▶ **Deepen engagement with investors and understand how new ESG disclosure requirements could differentiate the organization from competitors.** EY research has shown that

investors view a company’s ESG performance as pivotal in their investment decisions.²⁴ As well as the existing ESG information that companies provide, issuers should understand what kind of new information investors are demanding, and how well prepared they are to access and disclose the relevant data.

- ▶ **Make strategic use of the finance functions to help inject rigor into ESG reporting and align financial and nonfinancial reporting.** Boards and management teams should clarify the role of the finance function in ESG reporting. A clear role for the CFO and the finance team can bring value in a range of areas. First, aligning ESG reporting and financial reporting to build better understanding of how sustainability issues affect operating and financial performance. Second, bringing finance’s understanding of data controls and processes to bear on ESG reporting, with the aim of moving ESG disclosures to “investment grade” quality and credibility standards. Finally, there is a key role for internal control and risk management systems as a robust basis for the integrity of the reporting, while also contributing to a greater nexus between sustainability and financial information. Without the discipline of controls, it will be difficult for users of ESG reporting to be completely confident in the disclosures offered. While many companies will have controls in place for financial information, with robust and documented underlying processes – and a clear view of management sign-off required – that is much rarer in the nonfinancial ESG space. Putting in place a robust controls framework – drawing on best practices from the financial reporting domain – will be critical.

²⁴ “[Is your ESG data unlocking long-term value?](#)”, EY Sixth Global Institutional Investor Survey, November 2021.



Looking ahead

It would be difficult to overstate the level of stakeholder interest in company ESG practices and performance. The topic has largely dominated much of the discourse around corporate governance in the past 12 months, with near-continuous market-driven and regulatory developments accelerating the pace of change and shaping stakeholder expectations. Given the level of attention this topic has received and the numerous implications for companies, we would point to two issues that leaders and stakeholders can focus on in the years ahead.

First, an ESG agenda that is capable of unlocking long-term value needs to be tied not only to business strategy but also to governance. Unless it is at the heart of governance, the chances of long-term success will be undermined.

Second, there needs to be a spirit of collaboration among market participants as this significant sustainability transformation takes place and best practices emerge. This is about participants giving feedback that is constructive and ensuring their response is proportionate should new reporting standards create a different picture of a company's ESG opportunities and risks than had previously been thought. Actively communicating about the journey you are on – and being transparent about the next steps you are planning to take – will support collaboration. It recognizes that nobody expects companies to have all the right answers straight away and that progress, rather than perfection, should be the focus.

We put forward this report in that constructive spirit, and hope it shows how boards can put in place the right information, skills, operating model and reporting to carve out a proactive sustainability agenda and really deliver on the company's ESG commitments.





About the survey

Two hundred corporate directors and senior managers were surveyed in November 2021 to understand their progress and challenges help in driving long-term value and the implications for corporate governance. Twenty percent were chairmen or non-executive directors of the board, 20% were CEOs and the remainder were drawn from across the C-suite. Half of respondents' organizations have revenues in excess of €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.

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EY contacts

Andrew Hobbs

Partner, EMEIA Public
Policy Leader
+44 7958 252679
ahobbs@uk.ey.com

Sarah Alspach

EY EMEIA Brand, Marketing &
Communications Lead
+44 20 7806 9706
salspach@uk.ey.com

Marie-Armelle Bénito

EY EMEIA Brand, Marketing &
Communication
+33 1 55 61 35 45
marie.armelle.benito@fr.ey.com