ESG GUIDELINES FOR BALTIC BOARDS – WHAT, WHY, AND HOW

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“ESG is a core strategic issue for companies now and in the future. Baltic Institute of Corporate Governance and EY have produced an excellent practical tool for Boards to deepen their knowledge of ESG issues and how to benefit from new ideas and drive innovation. All directors should peruse the guidelines and find food for thought to help them in their difficult work on company Boards.”

Leena Linnainmaa,
Chair of the Board, European Confederation of Directors Associations (ecoDa)

“The ESG domain is rapidly maturing, and it is becoming imperative for the companies to integrate these factors in their risk assessments, business models and strategies. The ESG guidelines developed by the Baltic Institute of Corporate Governance and EY will help Boards to get equipped with the latest understanding of the ESG concept and best practices, so that they can provide effective guidance and direction to the executive management of the Baltic companies in this important journey.”

Arminta Saladžienė,
Vice President, European Markets, Nasdaq

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INTRODUCTION

Today, both society as a whole and people individually are demanding greater responsibility from the companies they work for, buy from, invest in, or live near to. Organizations that anchor their strategies in the creation of long-term value for their stakeholders are best positioned to demonstrate and measure the value they create, as well as benefit from it. One of the key tools to support this strategic transition is understanding of environmental, social, and governance (ESG) factors – a set of focus areas and metrics utilized globally by investors, regulators, and standard setters to measure the ESG performance of companies and funds.

Leadership in taking an integrated approach to sustainability and considering the impacts of a wide range of ESG issues should come from the non-executive Boards (hereinafter – Boards), as they are in charge of company strategy.

This guide aims to provide an understanding of what ESG is, why it is important, and to serve as a practical guide for how Boards should act on the integration of the ESG concept into business strategy and practices.

1. WHAT IS ESG?

The lens of ESG factors is often used interchangeably with the lens of sustainability. The latter is a wider concept defined by companies in a variety of ways, with some focusing narrowly on the sense of environmental ("green") sustainability (e.g., decarbonization) and others focusing broadly on ESG issues, including the integration of financial aspect (FESG).

ESG is a specific set of focus areas and metrics driven by objective realities, market demand, and/or societal views. It is the most commonly used framework globally for assessing the sustainability-related performance of an enterprise. The financial aspect is often added since it is important to properly measure the related costs and business opportunities. This aspect also helps enterprises to rethink how they use ESG to inform strategic choices, drive innovation, and to articulate how they are creating long-term value[1].

Overall, long-term value can only be created by considering a broad list of issues under each of the ESG factors:

ENVIRONMENTAL	SOCIAL	GOVERNANCE
Climate risk and mitigation	Diversity and inclusion	Board diversity, quality, effectiveness and accountability
Greenhouse gas emissions	Pay equity	Risk and opportunity management
Energy efficiency	Skills for the future	Capital allocation
Water consumption	Dignity and equity	Compensation polices
Pollution and waste	Human capital	Transparency in shareholder and stakeholder communications
Natural resource scarcity	Innovation of better products and services	Succession planning
Sustainable materials sourcing	Changing social views on data privacy	Shareholder rights
Clean energy and technologies	Health and well-being	
Product stewardship	Employment and wealth generation	
Biodiversity	Community impact	
	Ethical behavior	

1 Steve Varley and Steven Lewis, "How to realize the full potential of ESG+," EY, accessed 30 June 2022.

The environmental (E) factors tackle climate change and scarcity of natural resources, which put a strain on societies as well as on businesses specifically by impacting the supply chain, asset valuations, and access to capital. The social (S) factors address inequality and exclusion problems that negatively affect the well-being of talents and community. Finally, the governance (G) factors promote Board effectiveness, enterprise risk management, and transparency towards the stakeholders, etc. Non-compliance with ESG considerations weakens the organization's position in the market.

There are several global and multilateral initiatives and regulations connected to ESG and aiming to encourage actions towards a sustainable future and business operations for companies and even nations. For instance, the **UN Global Compact**[2] and **Sustainable Development Goals**[3] (SDGs) urge to focus on ending poverty, fighting injustice and inequality, and tackling climate change. The **Paris Agreement**[4] and **Glasgow Climate Pact**[5] incentivise the reduction of carbon emissions by requiring businesses to report their efforts towards climate change mitigation. The increasing ESG-related regulations in the European Union (EU) aim to develop more responsible approaches to business. For example, the **Corporate Sustainability Reporting Directive** (CSRD), coming into force in early 2024, will require companies to publish regular reports on sustainability. Therefore, only companies embracing ESG considerations will gain an advantage in creating long-term value for a broad set of stakeholders.

2. WHY ESG IS IMPORTANT

Multiple forces are driving demand for businesses to redefine their purpose and deliver long-term value across stakeholders. As a key tool in this process, understanding of ESG factors is important for the company not only in terms of threats or trends among customers or society, but also because of the tangible and intangible opportunities it can bring.

ESG-related threats and trends companies should consider include:

- Changing demographics with related political and socio-economic pressures.
- Risks related to climate change.
- Rapidly evolving and more demanding regulatory requirements.
- Decreased trust and greater scrutiny in the age of social media.
- Increased business complexity, technological advancements, and competition in a time of disruption.
- Decreased ability to attract and retain capital.
- Changing decision criteria and preferences of consumers.
- Rising employee mobility, flexibility, and expectations amidst growing skill gaps.

Some of the benefits of integrating ESG into a company's activities are:

- Enhancing brand loyalty, reputation, and public image among consumers, employees, and investors, who are increasingly environmentally and socially conscious.
- Easier attraction, retention, and uplift in productivity of employees with matching social and environmental values.
- Improved co-operation with investors, better access to financial and other resources.
- Capturing a larger market share and addressing unmet needs of stakeholders through product, service, and process innovation with sustainability attributes.
- Benefit from green tax incentives, if complying with requirements/regulations.

(See Annex 3 for more examples.)

2 "The Ten Principles of the UN Global Compact," United Nations, accessed 13 May 2022.
3 "The 17 Goals," United Nations, accessed 13 May 2022.
4 "Paris Agreement," United Nations, 2015.
5 "Glasgow Climate Pact," United Nations, 2021.

These tangible and intangible aspects and tendencies create a strategic imperative for business leaders to act responsibly and identify opportunities, address the challenges in the market. Motivation for change usually originates from different factors – threats, opportunities and, possibly most importantly, the company's purpose and values – all having an influence on future ESG-related achievements of the organization.

The following sub-chapters will cover topics that are considered the key drivers of the shift towards a more sustainable business, including employees, consumers, investors, broader society, regulators, and the company's maturity in terms of ESG-related issues.

2.1. PURPOSE-DRIVEN SUSTAINABLE TRANSFORMATION

Aside from the company mission, vision, and values, progressive businesses increasingly tend to define company purpose. While mission defines what the organisation does and for whom, purpose is a level above and provides the reason it exists at all. Such companies hold a belief that capital and talent will shift from organizations that only create value for their shareholders to those that create and protect long-term value across a broad group of stakeholders, including employees, consumers, suppliers, government, communities, investors, and shareholders. This means a fundamental shift from a financially driven business strategy to one guided by purpose and a broader definition of value. Therefore, enterprises that authentically link their approach to long-term value with a meaningful purpose are best positioned to demonstrate and measure the value (monetary and non-monetary) they create, benefitting from it as well.

2.2. COMPETITION FOR TALENT

The shift of values among the younger generation creates new demands for employers of future talents. Employees want to work for companies that do good for society and have a strong sense of purpose, which also boosts employee engagement and determines a three times higher likelihood of staying at the company, according to statistics[6]. The younger generation of employees are keener for ESG to gain exposure and shape the strategy by actually playing a part in its execution[7]. For companies without a determined strategic approach to ESG and without a plan to incentivise the workforce to advance social and environmental issues, it might become a challenge to attract and even retain the talent in the market.

2.3. COMPETITION FOR CUSTOMERS

Demand for more sustainable products and services is growing steadily and is expected to increase at a higher pace in the following years due to customer awareness of ESG issues. Their rising sustainability expectations stretch beyond the brand and encompass how a company behaves[8]. While generational attitudes towards sustainability differ, consumers are willing to promote sustainability. Gen Z and Millennials are very likely to favour sustainable lifestyle choices and share with their peers information about products that are good for the planet[9]. Failure to capture and react to such trends will have a negative influence on business performance or reputation.

2.4. EXPECTATIONS OF FINANCE PROVIDERS AND INVESTORS

ESG information has already shifted from "nice-to-have" to critical for private and institutional investors in their decision-making process[10]. Institutional investors view the integration of material ESG

6 "What Employees Really Want At Work", Forbes, July 2018.
7 Jamila Abston, partner in EY Business Consulting, Ryan Bohn, senior manager in EY Consulting, Stef Coleman, partner in EY People Advisory Services, interviewed by Shefali Jethmalani, ESG – a new opportunity for engaging talent, 10 December 2021.
8 Kristina Rogers, Andrew Cosgrove, and Jon Copestake, "The CEO Imperative: Make Sustainability Accessible to the Consumer," EY, accessed 13 May 2022.
9 Kristina Rogers, Andrew Cosgrove, and Jon Copestake, "The CEO Imperative: Make Sustainability Accessible to the Consumer," EY, accessed 13 May 2022.
10 Matthew Bell, "Why ESG performance is growing in importance for investors," EY, accessed 13 May 2022

opportunities into company strategy as one of the key factors towards its success[11]. They want reassurance on brand value protection and, globally, on the resilience of business models. Thus, companies that set an agenda for climate-resilient growth will likely be seen as more attractive prospects by investors and will be eligible to benefit from green taxes and incentives.

2.5. EXPECTATIONS OF SOCIETY

For business reputation and public image, it is critical for the company's standard business practices to be accepted by its various stakeholders and the public. For example, climate action failure and biodiversity loss are among the most severe risks on a global scale over the next 10 years, according to the Global Risks Perception Survey[12]. A company's ignorance of such societal and environmental issues and inaction to implement more sustainable business practices can not only cost a fortune but also jeopardize its license to operate. To strengthen its social license to do business, a company should assess how its strategy is delivering long-term value for the multiple stakeholders that the company's activities depend on.

2.6. REGULATORY REQUIREMENTS

The latest development of regulations introduces new sustainability-related risks and opportunities for businesses to manage. The **European Green Deal**[13] has committed to transform the EU into a resource-efficient and the first climate-neutral continent by 2050. Successful transformation would result in net-zero emissions, economic growth decoupled from resource exploitation, and a sustainable lifestyle. To reach these goals, there are a few key trends in regulation:

- Reporting and transparency to enhance investment and stakeholder decision-making. Here the **Corporate Sustainability Reporting Directive**[14] (CSRD) has a direct impact on existing and future reporting requirements, putting companies under pressure to become more sustainable.
- Regulations on products and services for consumer protection and conduct-related matters, including greenwashing. These questions are covered under the **EU Taxonomy**[15], which establishes an EU-wide classification system, providing firms and investors with a common framework for identifying environmentally sustainable activities. It is an important enabler to scale up sustainable investment and implement the European Green Deal, accompanied by others, such as the **Sustainable Finance Disclosure Regulation**[16] (SFDR).

These strategic documents and regulations are on the way to being incorporated into the national regulatory frameworks of the EU Member States. Thus, businesses should be already prepared for the implications of the changing regulatory landscape and stronger momentum on the convergence of sustainability standards. For Boards, it is critical to consider adaptation to these requirements as an important part of the company's agenda, since a lack of risk-based ESG management and disclosure can lead to reduction of business value or even challenges in business survival long-term.

11 "2021 Proxy Season Preview," EY, January 2021.
12 "The Global Risks Report 2022, 17th Edition", World Economic Forum, 2022.
13 "A European Green Deal," European Commission, accessed 13 May 2022.
14 Financial Stability, Financial Services and Capital Markets Union, "Sustainable finance package", European Commission, accessed 13 May 2022.
15 "EU taxonomy for sustainable activities," European Commission, accessed 13 May 2022.
16 "Sustainability-related disclosure in the financial services sector," European Commission, accessed 13 May 2022.

3. KEY AREAS OF ENGAGEMENT WITH ESG FOR BOARDS

Even though companies face an increasing variety of ESG related issues, good understating of ESG risks and benefits as well as their integration into a company's business model and strategy are not common. Boards should ensure that ESG related competencies are strong at both Board (revision of Board composition could be an option) and management levels.

Being in charge of the company's strategic direction, Boards should lead and strongly contribute to the creation of long-term value by integrating ESG into the strategic and operational activities of the company, as helping deliver value back to a wide circle of stakeholders, not only shareholders, helps ensure the health and prosperity of the company.

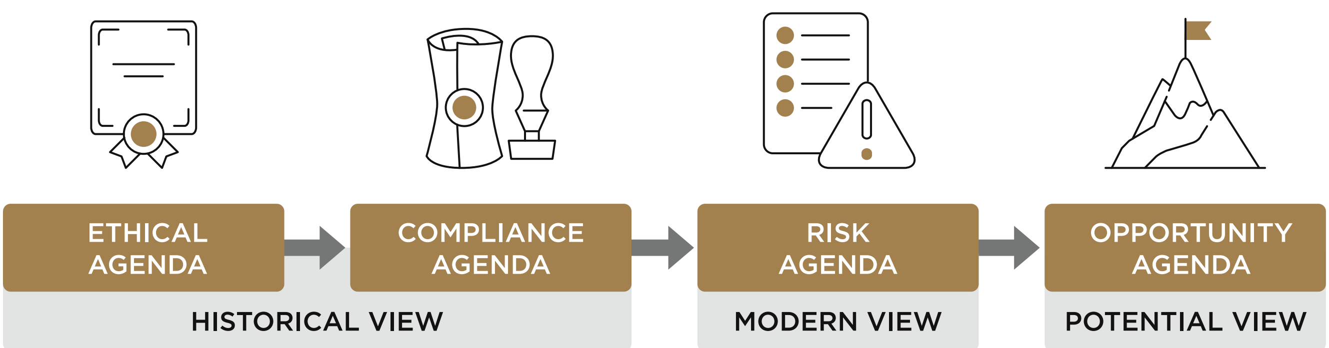
The shift to more sustainable business practices will require a significant involvement by the Boards in many areas, while the following can be considered the key ones:

- Boards can help their companies reassess both their purpose and operational practices in light of the ESG changes taking place in different business fields such as product innovation, shifting the company's culture, understanding of sustainability, and more.
- Boards should oversee the integration of ESG considerations into company business strategy and monitor progress and performance over time.
- Growing recognition of stakeholder interests means that Boards may also need to play a more active role in overseeing stakeholder engagement and ensure such interests are appropriately accounted for in key business decisions for the benefit of the organisation.
- It is critical to oversee transparency and accuracy of reporting on business sustainability and any related communication to all interested stakeholders as well as the general public.
- Finally, the Board and management should decide the scope of any assurance conducted by third-party service providers, and how to ensure that internal reporting processes yield accurate and verifiable data[17].

This guide aims to assist the Boards in this transition and helps consider all relevant topics in the following sub-chapters.

3.1. ESG MATURITY MODEL

Discussions around the concept of sustainability historically focused on ethics or compliance and have evolved to mainly focus on business risks. While each executive role sees sustainability through a different lens, it is usually focused primarily on the material risk agenda. However, a rising number of companies now look at sustainability as an opportunity for business[18].



17 David M. Silk, Sabastian V. Niles, et al., "ESG and Sustainability: Key Considerations for 2021," Harvard Law School Forum on Corporate Governance, January 2021.
18 "Sustainable Futures: Building Resilient Businesses, Emerging Trends." Source Global Research, June 2020.

Thus, some companies may move beyond tolerating minimum performance against consensus ESG benchmarks and accelerate to best-in-class ESG policies[19], identifying propositions with unique worth and doing things differently. To start any change, Boards must acknowledge a spectrum of ESG maturity levels, understand where their company stands, and what level it wants to reach in the long-term.

MATURITY

LEADING	Drive distinctive long-term value creation and promote broad industry focus	*Businesses creating new markets and behaviors through iniciatives, actions and alignment around shared purpose*
STRATEGIC	Integrate long-term value into core business strategy and operations	*Businesses anchoring their strategy to a clear and compelling purpose, with a focus on deliverting long-term value across stakeholders*
MATURING	Meet stakeholder expectations by piloting innovative initiatives and products	*Businesses designing and implementing ESG strategies to meet expectations of key stakeholders*
COMPLIANT	Adopt a policy-based, compliance approach as a cost of doing business	*Businesses integrating minimal ESG requirements and intangible value focus in order to meet regulatory demands*
DEFENSIVE	Deny existence of problematic practices, or responsibility for addressing them	*Businesses continuing harmful practices and refusing to take part in any compensating measures*

Boards can rely on the following five steps as guidance to monitor and support integration of ESG into business practices:

DISCOVER – start with a foundational analysis of ESG related impacts and dependencies in the company's activities to have a base for actions and decision-making.

NAVIGATE – define their vision for sustainability and gather stakeholder support and feedback for further changes and implementation of initiatives.

ACTIVATE – incentivise the workforce on all levels to execute the ESG-based strategy.

MEASURE – understand the performance outcomes for compliance requirements, future reinvestment decisions as well as ESG-related external and internal communication.

INNOVATE – initiate improvements or create new products/services and business models based on the strategic ESG-related objectives and goals.

Each of the steps is clearly defined in further sub-chapters, emphasizing the key objectives and role of the Board.

19 Steve Varley and Steven Lewis, "How to realize the full potential of ESG+," EY, accessed 13 May 2022.

3.2. CLOSING THE GAP IN UNDERSTANDING OF ESG RELATED ISSUES

Before starting any strategic discussion or action on ESG issues, Board members and top management should be introduced to the ESG concept as well as related standards, regulations, and trends in the relevant industry. The sustainability language has gone mainstream in recent years and every employee needs to have at least a general understanding. Also, this is an important signal for businesses to upskill their leaders and workforce to equip themselves for navigating the sustainability agenda[20].

3.3. ESG MATURITY ASSESSMENT

One of the first steps toward sustainability is to understand the level of a company's maturity in the ESG area. Companies should consider the level of integration of ESG factors into the business, based on the implemented ESG initiatives and procedures. Having this information, the Board, together with management, should discuss current and wanted future states of business in the following areas:

- Leadership and strategy. Relevant aspects:
    - Company's strategy, objectives, and related targets.
    - Leadership from top management and Board on ESG-related questions, including:
        - Showing willingness to make ESG-related changes.
        - Setting direction towards sustainability.
        - Orienting towards ESG-related KPIs.
- Stakeholder engagement. Relevant aspects:
    - Inclusiveness of stakeholders through recording feedback; management practices for proactive stakeholder engagement[21].
- Governance and reporting. Relevant aspects:
    - Governance structure, responsibilities, and accountability procedures for ESG factors as well as management of related improvements.
    - Company's compliance with legal and regulatory requirements.
    - Defined reporting practices and principles on ESG factors, including external and internal communication.
- Materiality. Relevant aspects:
    - Identified and assessed actual and potential impacts in the organization's context.
    - Most significant impacts are prioritized for reporting as material topics.
- Risk governance. Relevant aspects:
    - Defined procedures of identification, management, mitigation, and monitoring of ESG-related risks.
- Value chain. Relevant aspects:
    - Strategic partnerships are established with relevant stakeholders in alignment with material ESG areas.
    - Integration of risk considerations into the procurement function as well as sustainability performance assessment of suppliers' practices.
    - Practices of assessing the impact of a company throughout the whole product or service life-cycle.

20 Steve Varley, "COP26: five actions for business", EY, November 2021.
21 GRI, "GRI 1: Foundation 2021", 2022.

• Culture and capability. Relevant aspects:

- Awareness of ESG topics and internal engagement initiatives. Prioritisation of decision making related to ESG incentives.
- Available internal competencies, information resources for implementing sustainability-related goals.

• Policies and systems. Relevant aspects:

- Defined and regularly monitored policies and management systems related to ESG (e.g., stakeholder management policy, occupational health and safety policy, risk management policy, etc.) that are aligned with industry standards.

Based on the results of the assessment, a company can decide on the maturity level it will aim to reach as the strategic long-term state, by referring to the ESG maturity model in sub-chapter 3.1.

3.4. IMPACTS AND DEPENDENCIES IN THE BUSINESS MODEL

Leaders must delve deep into the business model of the company, e.g., gain a detailed understanding of where their carbon emissions come from and establish a target reduction plan to meet the requirements defined in the national regulations and relevant international standards. Based on the leading practices, such company plans include a short-term target of 3–5 years or a medium-term target of 8–10 years as well as a framework to obtain accreditation by the Science Based Targets Initiative (SBTI) across all three scopes[22]. Social and governance factors are also important when understanding the business model and taking action on potential issues. Therefore, while overseeing the sustainability assessment of a company's business model, consider all value dimensions (e.g., activities, partners, whole of extended value chain, methods, technologies, and sales channels, among others). Also, a company should review its business model when reviewing strategy and align both in light of ESG dimensions. One of the approaches for management is to use the Business Model Canvas[23], among other alternative concepts, and to look at each of the business model's building blocks through the ESG perspective.

3.5. ESG RISKS AND OPPORTUNITIES

3.5.1. IDENTIFICATION OF ESG RISKS AND OPPORTUNITIES, INDUCING MATERIALITY ANALYSIS

The impact of companies' activities on ESG can be not only environmentally but also financially material. This can be seen in the case of disruptions from physical environmental issues, such as extreme weather events affecting operations and revenue streams, to the scarcity of funding and resources. Therefore, it is important to identify the most material ESG-related risks and opportunities for business operations. Companies usually determine the most material issues and opportunities by the following approaches, known as the double materiality concept, detailed below:

- Identify a sub-set of sustainability topics that are material for enterprise value creation, recognising that some of that performance may already be reflected in the annual financial accounts. This information is usually used for economic decision-making by different stakeholders such as institutional providers of financial capital.
- A broader approach, where topics are material because the enterprise has a significant impact on the economy, environment, and people, and the importance of these topics to its stakeholders. The resulting information is often referred to as "sustainability reporting," serving a broad range of users[24].

The approach should be selected based on the sustainability maturity level of the company. Overall, the acquired understanding will help define strategic objectives, prioritise areas for innovation, investment, and other decisions.

22 Steve Varley, "COP26: five actions for business", EY, November 2021.
23 The model was invented by Alex Osterwalder and elaborated in a book called Business Model Generation, co-authored with Yves Pigneur.
24 Impact Management Project, World Economic Forum and Deloitte, "Statement of Intent to Work Together Towards Comprehensive Corporate Reporting", September 2020.

A summary of the practical key aspects to be taken into account during the assessment is provided below:

- Sector standards for assessing opportunities and risks should be used to understand the organisation's context, topics, and impacts.
- Engagement with a company's most important stakeholders and relevant experts is recommended to gain clarity on the actual and potential impacts (materiality) of the enterprise's activity and their significance. This is a critical step, as it helps filter the excessive number of ESG topics into a more manageable set upon which to focus[25].
- After determining the material topics, the company should prioritise the most impactful ones, including the indicators to monitor and report on.

3.5.2. RISK MANAGEMENT AND MITIGATION

The defined ESG-related risks and opportunities need to be properly managed. While opportunities could be approached as an area for new revenue and growth by innovating business models, products, or services (see sub-chapter 3.15), the defined most material risks should be mitigated. Having an internal control and enterprise risk management (ERM) approach that mitigates ESG risks is key to maintaining the performance of the enterprise and securing its long-term value. Companies ease accelerating ESG risks by integrating them consistently through existing ERM systems and procedures, or by establishing new ones. This can help risk management and sustainability practitioners navigate these risks[26] within the organisation.

Finally, the Board should oversee that the risk management function has the following aspects:

- Ownership of risk management exists at the top levels of the organisation.
- Responsible employees have the required skills and expertise to manage sustainability risks.
- ESG risks are taken into account when establishing, implementing and maintaining effective reporting within the firm and with third parties.

BOARD GUIDANCE:

- *The Board, with the support of management, should initiate the development of individual and collective learning opportunities to educate Board members and top management on the ESG concept and enable currency on regulations, trends, and leading practices.*
- *The Board, together with management, should discuss current and wanted future ESG maturity. This will set strategic ambition for further actions such as materiality assessment of risks and opportunities, and identification of strategic KPIs.*
- *The Board should question management if the company is doing scenario planning to test the sustainability of its business model against accelerating ESG risks as well as whether the identified risks and opportunities were filtered based on their materiality to the company's performance. These aspects should be discussed and practical actions aligned with the Board.*
- *Time should be set aside on the Boards' agenda to challenge assumptions, review contingency plans, and verify that management is incorporating low-risk/high-impact (material) scenarios into its ERM frameworks and strategy.*
- *The Board should consider analysing ESG megatrends and identify key management members as well as external advisors (if relevant) to regularly report to the Board on material business environment developments and data points for continuous improvement of oversight of strategy and risk. The described matters could also be presented together with monitoring of sustainability KPIs, as provided in the further chapter MEASURE.*

25 Examples of stakeholder ESG priority topics clarified through a materiality assessment can be found here.
26 Jamie Smith, Neri Bukspan, and Velislava Ivanova, "Five ways boards can unlock ESG's strategic value," EY, accessed 13 May 2022.

3.6. STAKEHOLDER ENGAGEMENT

Company stakeholders include entities or individuals who have relationships and reasonable expectations from the organization. Stakeholders can include not only investors in the organization, such as employees and shareholders, but also those who have other relationships with the company, such as other workers who are not employees, suppliers, vulnerable groups, local communities, and NGOs or other civil society organizations, among others (*see Annex 4*). Identification of stakeholder groups relevant for the company, finding their inter-relations through stakeholder mapping, tackling the material needs and issues experienced by stakeholders is an important step for the enterprise's ESG journey, especially from the social perspective. The described actions should be implemented during the risk assessment procedures.

Another fundamental step involves using their feedback when defining the priority areas for ESG initiatives. Moreover, the most important stakeholders of the company could be involved when defining and implementing the initiatives as well as reaching other ESG targets. Such an approach will increase not only their satisfaction but also trust in the enterprise, which is crucial for its success. On the company's side, addressed needs and a high level of stakeholder involvement will help to effectively realise the promised ESG improvements and due to constant communication with stakeholders, the risk of reputation damage will be lower in case of failure to comply with the goals.

In the area of stakeholder management, the Board should ensure that periodic collaboration initiatives are established and materiality assessments involve a broad range of stakeholders. This will help with timely understanding and addressing of emerging stakeholder needs and potential risks for business.

3.7. SHAPE THE STRATEGY AND SET GOALS

Incorporating ESG factors into the business strategy brings benefits. For example, significant value is created through development of new sustainable products or services meeting the needs of ESG-conscious customers and making the company more resilient to increasing ESG risks[27]. As a first step, the Board should understand the relationship between ESG and the company's strategy in order to reshape it. This includes ways of aligning relevant ESG initiatives to business operations. This relation can be seen through the long-term value approach that covers four value dimensions:

- **Customer value**. Design, development, and delivery of products and services that meet customer or end-consumer needs, with an emphasis on innovation, trust, brand.

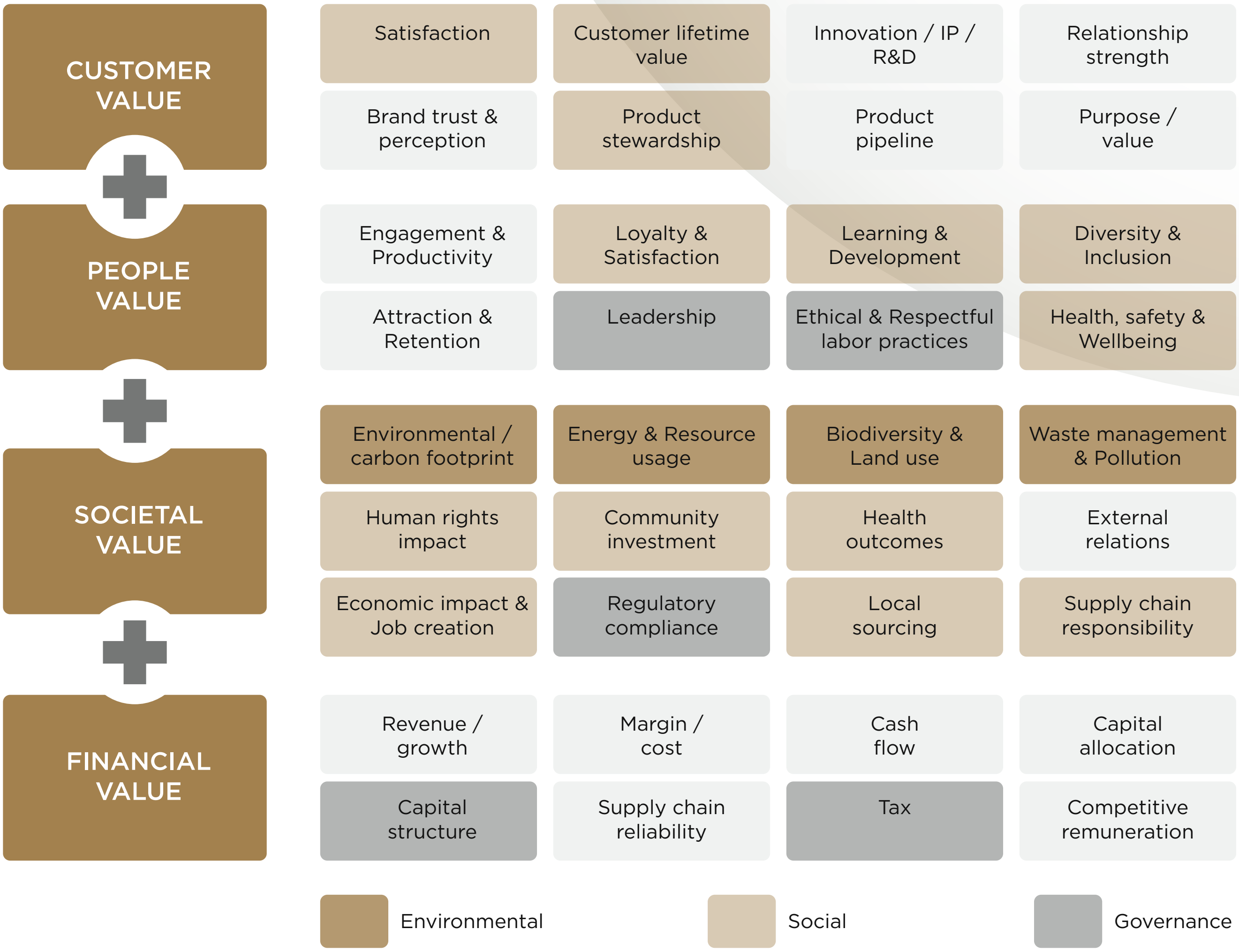
- **People value**. Value is created through the employment and development of people, concerning culture, engagement, leadership, expertise, and skills.

- **Societal value**. Impact a company has from an environmental, supply chain, regulatory, community, and economic perspective.

- **Financial value**. Improving a company's value through revenue generation, cost optimization, and capital structure.

Each type of value can be matched with different drivers related to ESG and other general business aspects as showed below.. All of them must be clarified, measured, and finally monitored within a company to understand and communicate the overall value of the company.

27 Julie Linn Teigland and Andrew Hobbs, "How can Boards strengthen governance to accelerate their ESG journeys?" EY, accessed 13 May 2022.



A good source of suitable examples for ESG-related goals can be found on the website of a global research initiative – the Embedding Project[28].

3.8. DEFINE BUSINESS CASE FOR ESG

Business case for ESG is determined through the ESG maturity level (*see sub-chapter 3.1*) of a company and materiality assessments. It addresses the areas for improvements and innovations that can increase a company's competitiveness in the market and create long-term value for its stakeholders. Business case needs to be properly determined by calculating the financial and non-financial costs of opportunity as well as potential value, including consideration of risks and benefits to the company and key stakeholders. One of the practical examples of the business case is engineered wood. It is a sustainable alternative to the traditional elements of concrete, steel, and glass used in the construction industry. If we consider the potential costs and value of this technology adoption, it requires more initial investments, compared to well-developed traditional practices and technology in the market. However, engineered wood has a perspective to scale and become more attractive in the long-term as the market will demand more sustainable and less energy intensive solutions, due to regulation and limited natural resources.

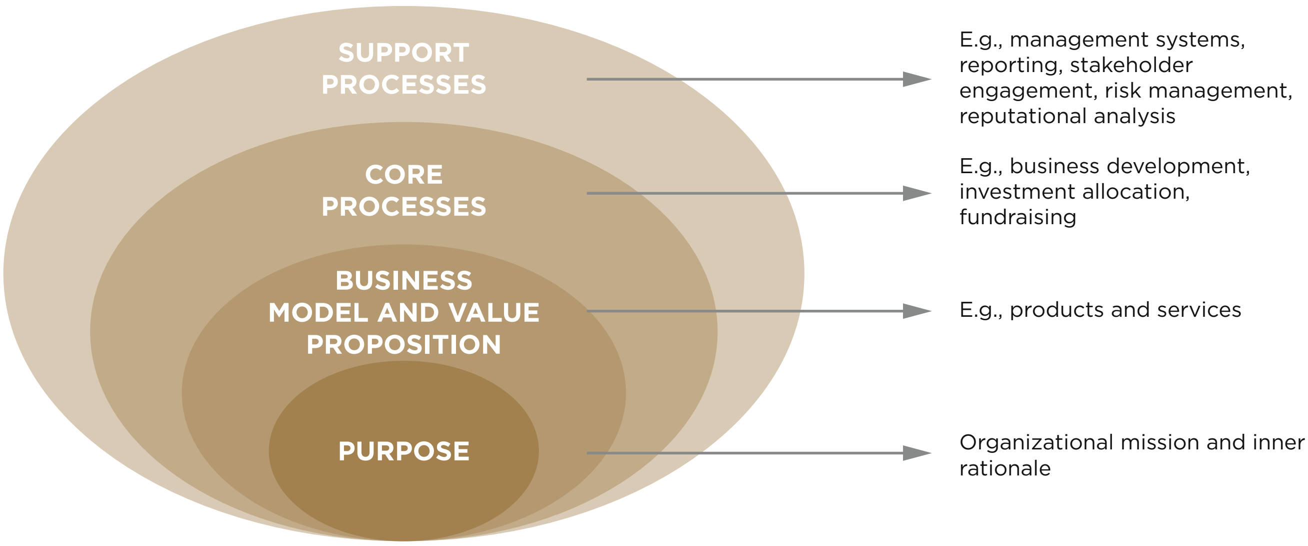
The Board and management could discuss ESG business cases in alignment with strategic options during strategy sessions. To be able to evaluate and make decisions on a business case implementation, the Board and executives should also be well-informed about changes in ESG risks and opportunities as well as the potential impact on the overall business model.

28 See the website: https://www.embeddingproject.org/goals-database.

3.9. INTEGRATION OF ESG AND IMPORTANCE OF LEADERSHIP

After defining a purpose-driven strategy and business case, the Board and top-level management need to take leadership in re-aligning the company's culture and corporate values as well as organizational structure, human and other resources, competencies and skills of employees and management with the ESG-driven strategy. The leadership should move beyond viewing sustainability as a compliance exercise, driving strategic change within the organisation and thus growth for the long term. This means overseeing integration of defined priority topics and initiatives into overall strategy, business model, core processes like business development and capital allocation, and support processes such as reporting and risk management, as illustrated below.

POSSIBLE LEVELS OF SUSTAINABILITY INTEGRATION



On more practical terms, management could consider starting change by selecting a priority area, e.g., the company's risk management process, and provide the Board with timely updates related to strategic opportunities and risks. For example, the Committee of Sponsoring Organizations (COSO) updated its risk management framework indicating the importance of monitoring key selected areas (i.e., governance; culture; strategy and objective-setting) for risk mitigation[29].

The topic on ESG integration into business operations is covered in more detail in the following chapter – ACTIVATE.

BOARD GUIDANCE:

- *The Board should discuss with the management and ensure that the company has a consistent stakeholder value narrative that is linked to strategy, supported by relevant metrics (including risk management), and tied to key performance outcomes.*
- *The Board should initiate strategic sessions to discuss with the management the links between ESG and the company's current strategy based on the maturity assessment results (see sub-chapter 3.3).*
- *The Board should initiate sessions where management would present potential business cases for ESG incorporation. During the sessions, the potential of opportunities should be discussed (see sub-chapter 3.15) that will define the priority area to start ESG integration in the company's activities.*

29 EY Center for Board Matters, "Six priorities for Boards in 2021", EY, accessed 30 June 2022.

ACTIVATE

3.10. DETERMINE GOVERNANCE STRUCTURE FOR SUSTAINABILITY

Governance structure is crucial to providing proper accountability around an enterprise's strategy for long-term value creation, settled goals, and measured progress against these goals[30]. It should be determined by the common agreement between the Board and executives, based on the company's operating circumstances as well as the current and planned advancement of its sustainability journey. There are several ways for creating a reliable oversight structure for sustainability that all play an important role in reaching ESG goals. The following components could be combined and implemented together or one by one, depending on the needs and priorities of a company:

- Establish the Chief Sustainability Officer (CSO) position to oversee the ESG area on the strategic and enterprise risk management level. Some Boards may also choose to create a Board Sustainability Committee to explicitly focus on ESG risks and opportunities.
- Establish a cross-functional management-level ESG committee consisting of executives from the finance, operation, production, human resources, communications, legal, IT, or other relevant departments. It may also include representatives from the company's lines of business.
- Have an effective oversight structure, assign ESG responsibilities to the existing departments, i.e., at the operational level, including relevant ESG initiative implementation. For instance, the finance or controlling department can be responsible for ESG goal alignment with the approach they take to financial obligation and executive pay, ESG reporting, and other disclosure processes, while the legal department can be responsible for ESG governance and regulatory compliance.

Finally, it is recommended to define clear responsibilities on both the management and operational levels, which is crucial for implementing ESG-related initiatives.

3.11. INTEGRATE SUSTAINABILITY INTO CROSS-FUNCTIONAL ACTIVITIES

3.11.1. PREPARE ESG-RELATED CORPORATE POLICIES

Governance structure for ESG, topic-related objectives, targets, and responsibilities should be captured in the charters and policies (e.g., environment, sustainability, human resources, etc.) of the company by creating new or updating existing guidelines. These documents should specify the accountability of the Board, executive management, and specific departments as well as reporting procedures based on the business case for ESG.

3.11.2. ENABLE ESG ACTIVITIES AND INNOVATIONS IN OPERATIONS AND DECISION-MAKING

To enable ESG activities in operations and decision-making, policies and other guiding documents should be disclosed. Communication about structures for governing ESG, including the activities, experiences, and the Board's competencies in this area, is important for building the confidence of employees and other stakeholders in the Board's leadership[31]. In addition, periodic discussions within the established company structure (e.g., ESG committee or other responsible structures) would help the Board ensure proper alignment of priorities, clarity on roles, and set up of the response mechanisms to the forecasted risks and stakeholder needs. Finally, to ensure constant improvement, the responsible executives or departments should be challenged (*see Board guidance*) to demonstrate their progress towards ESG goal integration into company operations and related risk management processes.

30 Andrew Hobbs, "How the Board can foster sustainability and innovation," EY, accessed 13 May 2022.
31 Jamie Smith, Neri Bukspan, and Velislava Ivanova, "Five ways Boards can unlock ESG's strategic value," EY, accessed 13 May 2022.

3.12. MOBILIZE THE WORKFORCE

To successfully reach ESG goals, enterprises should educate the workforce. The role of the Board here is to provide leadership in broadening ESG knowledge within the layers of the company, inspiring employees to think about how the company's activity can positively impact the environment and/or society, which spurs business innovation as well as builds workforce morale. The Board could consider some ways to develop an understanding of ESG issues within the enterprise and mobilize the workforce, which include:

- Build a knowledge base adapted for the current needs of your employees. Close the knowledge gap on ESG by providing training opportunities in areas relevant to the company's activity, e.g., health and safety, climate change, etc. This will lead employees to think more about the efficiency of business operations, which spurs business innovation and builds workforce morale[32].
- Arrange periodical sessions to introduce sustainability within the organisation, e.g., ESG aspects in the company's strategy, governance of the area, policies and relevant updates, ongoing and future initiatives.
- Leverage existing communication channels to provide ESG content effectively and use the power of recognition by inviting leaders or partners of the company to talk about sustainability[33]. Clear and timely communication will help get people involved in initiatives or events.
- Consider launching ESG-based remuneration and incentive plans[34], especially to enhance the leadership's accountability on sustainability.

BOARD GUIDANCE:

- *The Board, together with management, should reach an agreement on the company's governance structure and processes around ESG, including an agreement on how this will be communicated to external stakeholders and employees.*
- *While integrating ESG into the enterprise's activities, the Board should ask for updates on the integration process and results, ESG-related KPIs, status or initiatives, etc.*
- *Overall, the Board should demonstrate leadership in broadening ESG knowledge and communicating on sustainability practices within the company, or other activities appropriate for organisational culture.*
- *Also, the Board should consider if and how the company's investments in reskilling workers or recruiting new employees are meeting current and future skills gaps[35], including ESG-related.*

32 Susan H. Sevens, CEO of WeSpire, interviewed by Chris Hagler, "How to engage employees for ESG goals"," 6 May 2021.
33 Susan H. Sevens, CEO of WeSpire, interviewed by Chris Hagler, "How to engage employees for ESG goals"," 6 May 2021.
34 Julie Linn Teigland and Andrew Hobbs, "How can Boards strengthen governance to accelerate their ESG journeys?" EY, accessed 13 May 2022.
35 EY Center for Board Matters, "Six priorities for Boards in 2021", EY, accessed 30 June 2022.

MEASURE

3.13. ACCOUNTABILITY AND REPORTING STANDARDS

A number of stakeholders focus on the responsibility and accountability of the Board and management teams in making progress against ESG goals[36]. Consequently, it is not enough for the enterprises to report only on financial accountability. ESG disclosures provide a forward-looking view and insights to stakeholders into how the company is building resilience and strengthening its competitive positioning. Non-financial reporting on the value delivered to customers, people, and society becomes a must.

The Board should contribute when selecting the reporting standard. Decisions on reporting and the reporting structure to be implemented should be taken after understanding key factors of the enterprise's activity, in the following order:

- What are key aspects of organizational structure and priority activities, including strategic ESG KPIs?
- What are the company's legal/regulatory obligations related to the ESG factors that should be covered by the reporting standard?
- What are the expectations and needs of the key stakeholder(s) targeted by the enterprise? For example, if a company wants to release green bonds/attract green investment, key stakeholders interested in the ESG report could be investors.

By aligning reporting to external frameworks, companies can determine whether they are providing the comparable, decision-useful ESG data that stakeholders seek as well as benchmark their company against other market players. There is a variety of standards that identify sets of all ESG areas to be reported on a periodic basis to the stakeholders:

- **The GRI Universal Standards and GRI Topic Standards**[37] can be used to prepare sustainability reports, disclosing all ESG topics. Areas are related to contextual information about the enterprise and its sustainability practices, material topics and disclosures specific to them are explained. This framework considers a wide range of interest, thus it is relevant for a broad set of stakeholders.
- **The Integrated Reporting Framework**[38] can be used as a guide for writing an integrated report evaluating the company's ability to create value over time. It suggests that enterprises assess six forms of capital: natural, social, human, financial, intellectual, and manufactured. The key audience is investors.
- **The Sustainability Accounting Standards Board (SASB) Standards**[39] consists of the industry-specific minimal set of financially material ESG topics and their metrics, to be disclosed to the investors.
- **Nasdaq's ESG Reporting Guide**[40] provides a list of ESG metrics with detailed measurement instructions for each topic. It acts as an informational reference for listed (or to be listed) companies that strive to meet disclosure obligations[41].

36 Julie Linn Teigland and Andrew Hobbs, "How can Boards strengthen governance to accelerate their ESG journeys?" EY, accessed 13 May 2022.
37 "GRI Standards", GRI, accessed 13 May 2022.
38 "International <IR> Framework," Value Reporting Foundation, accessed 13 May 2022.
39 "SASB Standards: Standards Overview", Value Reporting Foundation, accessed 13 May 2022.
40 "ESG Reporting Guide 2.0", Nasdaq, May 2019.
41 "ESG Reporting Guide", Nasdaq, accessed 13 May 2022.

It is important to set the measurement scope for ESG initiatives as well as indicate the KPIs to measure and communicate progress later on. Suitable metrics should be defined considering its objectivity, reliability, and consistency. ESG-related KPIs should be measurable and have a set timeframe used to communicate the periodic progress externally[42]. Examples of metrics and sector-specific indicators can be found in the already presented standards, such as the GRI or Nasdaq's ESG Reporting Guide.

3.14. MONITORING AND COMMUNICATION ON ESG GOALS IMPLEMENTATION

Robust disclosure processes and controls, such as periodic monitoring of ESG targets, must underpin ESG reporting. Companies should have rigorous disclosure processes and controls in place, including those related to data quality. As a first step, periodic management reporting meetings on ESG priority areas could help follow progress and identify risks. Also, impacts of changing ESG risks and opportunities on the reporting framework and processes should be periodically discussed between the Board and management. A schedule of ESG-related discussions is recommended to be agreed upon and set beforehand[43].

Moreover, involving internal auditors and obtaining internal and external assurance provides credible, quality ESG data to the marketplace and builds stakeholder confidence in the reliability of this information. Thus, companies should consider these aspects as well.

Finally, reporting on ESG includes internal and external communication. The progress against sustainability targets and the company's commitments to its stakeholders should be included in the company's annual report and publicly disclosed. The Board needs to oversee the accuracy of communication on ESG-related performance to the stakeholders. This will decrease the possibility of greenwashing cases and reputational as well as financial damage.

BOARD GUIDANCE:

- *During the reporting standard selection process, the Board should evaluate and discuss with the management if a company has clear ESG commitments and targets that are or will be communicated both internally and externally; how these targets align with the regulatory landscape relevant to the company as well as the needs of key stakeholders.*
- *Based on need, Boards should delegate to the management to create a long-term value dashboard with regular briefings to the Board to ensure shareholder and stakeholder value improvement manifests from a balanced focus between financial, people, customer, and social value drivers.*
- *The Board should consider how the company tells its ESG story through various channels and confirm that messaging is consistent and data quality is validated.*

42 Jamie Smith, Neri Bukspan, and Velislava Ivanova, "Five ways Boards can unlock ESG's strategic value," EY, accessed 13 May 2022.
43 Jurgita Ashley, Thompson Hine LLP, and Randi Val Morrison, "ESG Governance: Board and Management Roles & Responsibilities," Harward Law School Forum on Corporate Governance, November 2021.

INNOVATE

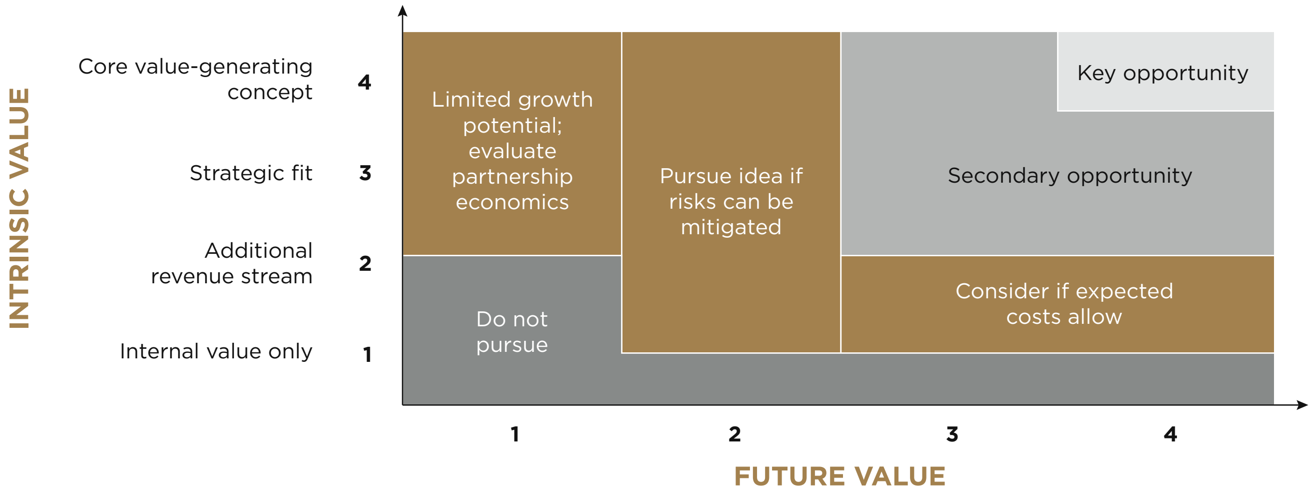
The enterprise should consider sustainable innovation activities in every part of the process in identifying and implementing ESG priorities to enhance business as well as sustainability performance. For example, the Board can question management about the sustainable innovation activities during the assessment of material ESG risks and opportunities, ESG impacts on the enterprise business model, or development of the strategic approach and objectives for sustainability. The below sub-chapters provide more insights on ways the Board could assess opportunities for innovation.

3.15. IMPROVE SUSTAINABILITY ATTRIBUTES

Companies already face increased demand for sustainability from customers and other stakeholders. At the same time, companies select and work on implementing different strategic priorities in addressing ESG issues, relying on the expected market and the imperative of stakeholders for change. This shift also brings opportunities to capture value and show leadership, not just focus on ESG-related risk management. So, it demands the creation of more sustainable products or services or to enhance the existing ones as well as deliver value through business model innovation.

The Board can use the future value potential assessment model to question management and prioritize suggested improvements or development of new products or services. The model assesses the intrinsic value of the future product or service from internal-only to the core value-generating concept and the expected future value. Also, it suggests potential areas to consider (e.g., expected costs or potential risks).

FUTURE VALUE POTENTIAL ASSESSMENT



A growing phenomenon of "eco-labelling" implementation could be taken as an example. In this case, before investing in ecolabeling, a company should assess the future value potential of it, including costs, through market analysis and prepare the business case that is usually organised by management level employees. The Board should then validate the idea before other stages of development. Thus, the Board could use the following questions when discussing opportunity with management:

- Does development of a new ecolabel have external (customer) demand, i.e., creates not just internal value?
- Does the company's growth potential, infused by the ecolabel implementation, have any limits?
- What partnership opportunities for ecolabel development and implementation does the company have in the market? How should they be pursued (establishing new or continuing existing partnerships)?
- What are potential future risks that could be brought on by implementation of the ecolabel? Can the company mitigate these risks properly?
- Will the implementation of the ecolabel create economic profitability for the company? And what are the expected costs in developing and implementing the ecolabel?
- Finally, does development of the ecolabel fit with the company's strategy? And if yes, consider if it can be a new core-value generating opportunity that may be a new promising innovation or foster expansion to a new market.

ANNEX 1.
LIST OF USEFUL RESOURCES

1. **Sustainability goals and commitments database,** based on issue, company, sector, level of influence, or SDG target. See here: https://www.embeddingproject.org/goals-database
2. **ESG Industry Materiality Map** – an online tool for materiality assessment, indicating the current key ESG issues for the selected sector and/or sub-industry. See here: https://www.msci.com/our-solutions/esg-investing/esg-industry-materiality-map
3. **SDG-grounded metrics,** useful for ESG priorities-based reporting and progress monitoring. See here: https://www3.weforum.org/docs/WEF_IBC_Measuring_Stakeholder_Capitalism_Report_2020.pdf
4. **Information and leading practices for ESG risks integration** into ERM structures and processes, utilizing the principles in COSO's ERM framework. See here: https://docs.wbcsd.org/2018/10/COSO_WBCSD_ESGERM_Guidance.pdf

ANNEX 2.
TERMS AND ABBREVIATIONS

Terms and abbreviations	Description
COSO	Committee of Sponsoring Organizations
CSO	Chief Sustainability Officer
CSRD	Corporate Sustainability Reporting Directive
ERM	Enterprise Risk Management
ESG	Environmental, Social and Governance
EU	European Union
FESG	Financial, Environmental, Social and Governance
GRI	Global Reporting Initiative
IR	Integrated Reporting
IT	Information technology
KPI	Key Performance Indicator
NGO	Non-governmental organization
R&D	Research and Development
SASB	Sustainability Accounting Standards Board
SBTI	Science Based Targets Initiative
SDGs	Sustainable Development Goals
SFDR	Sustainable Finance Disclosure Regulation
UN	United Nations

ANNEX 3.
BENEFITS, OPPORTUNITIES, AND POSSIBLE GAINS A COMPANY CAN ACHIEVE THROUGH ESG INTEGRATION[44]

Soft (intangible) aspects	Hard (tangible) aspects
Better opportunities to access financial and other resources	Improved financial performance, profitability
Attract socially aware consumers	Higher shareholder value
Brand loyalty	Lower operating costs
Corporate reputation and public image	Higher margins
Customer satisfaction	Productivity uplift
Easier attraction and retention of employees	Improved capital management
Improved co-operation with investors	Higher equity returns
More qualitative and committed management	Investment and asset optimization
Reduced uncertainty and risk	Share price performance
Stakeholder (incl. customer) loyalty	Higher sales growth
	Tax incentives
	Top-line growth, outperform peers

ANNEX 4.
EXAMPLE OF A LIST OF POTENTIAL STAKEHOLDER GROUPS

Potential stakeholder groups:

1. Shareholders
2. Employees
3. Potential employees
4. Trade unions
5. Management
6. Contractors, vendors
7. Suppliers
8. Creditors
9. Investors
10. Clients/customers
11. Potential customers
12. Community
13. Local authorities, municipalities
14. State and governmental institutions
15. International organizations
16. Regulatory offices
17. Business associations
18. Competition
19. Media
20. NGOs

44 Andris Grafs, “Integration of Environmental, Social and Governance (ESG) Aspects in Company Strategy and Business Model”, 2022