ONE ADVISORY

ESG Committees: why constitute them and is there value added?

By Paul Johnston

Overview

Environmental, social and governance (ESG) considerations are fast emerging as a crucial non-financial boardroom priority. In a recent survey, 31% of boards ranked ESG concerns among the top three emerging risks[1]. This is not a new topic, but the COVID-19 pandemic has arguably served to sharpen focus on the way in which companies align with, and are perceived to align with, broader societal priorities.

Driven by long-term value considerations and changing social expectations, institutional investors are increasingly citing ESG factors as a key driver in their capital allocation decisions; the government and regulators are in turn placing further requirements upon companies to be transparent on their environmental and social impact; and companies are responding to these demands by placing ESG factors at the centre of their business and improving ESG-related disclosures.

A key question for directors is how they ensure that ESG considerations are properly woven into the decision-making process. We see boards responding to this question with a number of solutions – for example, dedicating further time on the board agenda to ESG factors, a dedicated non-executive director to lead on ESG matters, and the possible constitution of an ESG committee.

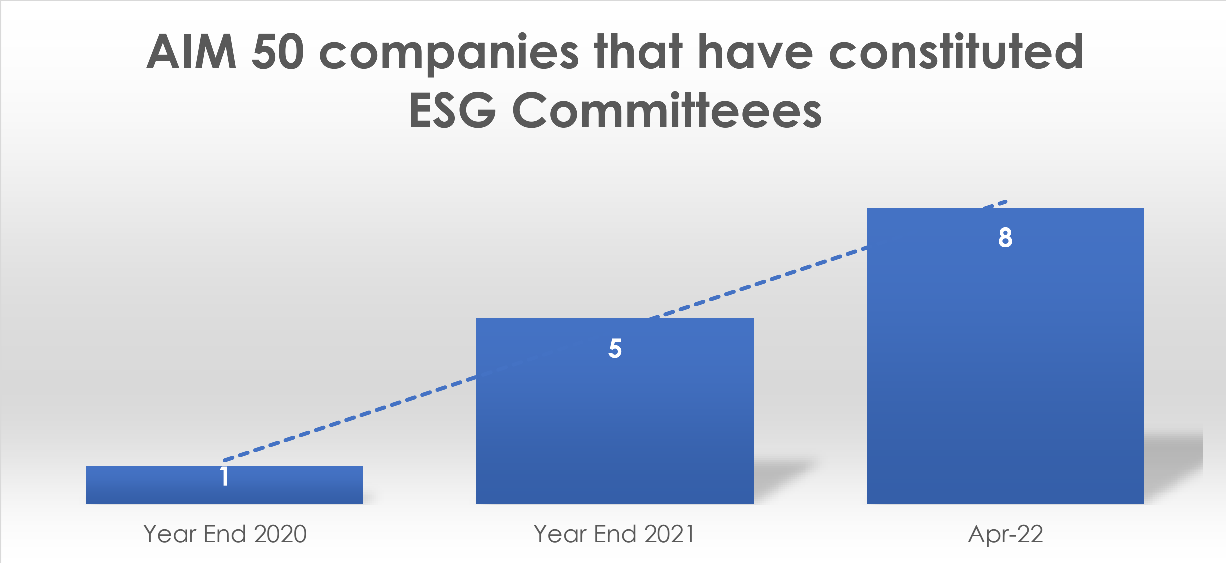
As with so many areas of corporate governance, there is no one size fits all approach. The article examines the trend we see in the number of AIM-50 companies constituting ESG committees, alongside their typical remit and responsibilities. Finally, we consider the potential rationale for constituting these committees and alternative options.

The number of ESG Committees continues to increase

Our research looked at the number of AIM-50 boards that had set up dedicated ESG committees at board level over the previous two years – in effect, the period since the onset of the COVID-19 pandemic.

We see over this two-year period that there has been a considerable increase in the number of companies establishing board-level ESG committees. Within our sample, only one company in the AIM-50 (2%) had an ESG committee in 2020. This number had increased to 1-in-10 (5 companies) in 2021 and, as at end-April 2022, had increased further to 1-in-6 (8 companies).

[1] *Gartner Board of Directors Survey, 2021.* https://www.gartner.com/en/articles/6-key-takeaways-from-the-gartner-board-of-directors-survey



Clearly, therefore, forming a dedicated ESG committee is an increasingly popular arrangement amongst larger AIM-listed companies. There will be a number of considerations for directors in deciding whether to follow suit. It is worth noting that there is a slight negative correlation between company size and the decision to constitute ESG committees – in other words, based on our admittedly small sample, it is the smaller companies in our sample that are marginally more likely to establish these committees.

What are ESG committees doing?

From a review of publicly available terms of reference of ESG committees, we see that the remit of an ESG committee tends to focus on the following areas:

- Understanding the views of key stakeholder groups on ESG matters and monitoring prevailing ESG trends. Focal areas on many committee agenda have tended to include initiatives to support diversity (most notably, gender diversity), environmental management systems, sustainability and TCFD reporting;
- Assisting the board with (or leading on behalf of the board on) the development the Company's ESG strategy, and to identify priorities and key performance indicators that the ESG committee can monitor in the delivery of this strategy;
- Monitoring performance against such priorities and key performance indicators;
- Monitoring ESG risk in collaboration with the Audit or Risk Committee(s);
- Assessing the extent to which, in collaboration with the Remuneration Committee, management are and should be incentivised on ESG factors; and
- Guiding the Company's ESG communications strategy.

How this will work in practice will depend on a number of factors, not least the maturity of the Company's ESG strategy, the assessment of the materiality of ESG factors in the market(s) in which the Company operates, and the extent to which the ESG committee is embedded within the business and the Company's decision-making structure.

The board and the ESG committee should expect to dedicate significant time over the first year of incorporation toward understanding the ESG landscape and the views of key stakeholders, alongside defining the delineation in responsibilities in the ESG space across the Company and identifying where the committee can most effectively add value. While there might rightly be some overlap in responsibilities – the interaction between the ESG committee and Remuneration Committee in ensuring management are properly incentivised for delivering on ESG priorities is likely to be important, for example – it will be critical to ensure that each board committee and the board itself, alongside management, are clear on where the delineation in responsibilities lies. The agenda cycle can become slightly more regular thereafter as responsibilities become clearer, management information improves and Committee members' knowledge on the landscape improves.

To expedite this process, one ESG committee chair that we have spoken with recommends that boards commission an external evaluation to identify the materiality of the Company's ESG risks, so that the Committee's remit and responsibilities can be set at the right level. Similarly, boards should consider, as part of their ongoing succession planning, the need for those with particular ESG and / or sustainability skills and capabilities amongst the board's membership, in part to lead on the Committee's work and in part to ensure that directors prepared for increasingly sophisticated responsible- / ESG-oriented investors.

Why set up an ESG Committee?

A number of companies disclose in their most recent annual reports a renewed focus on sustainability and the importance of being a responsible business. Many of these companies are in turn putting together dedicated strategies on ESG – for example, ASOS plc's "2030 ESG Goals" - and it follows that ESG committees serve as a dedicated vehicle to provide further focus to the way in which these strategies develop.

The significant majority of AIM-listed companies remain under no regulatory obligation to report against the Task Force for Climate-Related Disclosures (TCFD) Recommendations, though this is likely to change over the longer term as part of the UK's wider net zero strategy. Nonetheless, from a strategic point of view, embedding long-term climate change considerations into the board decision-making process could well be prudent and, from a tactical point of view, there may be a potential competitive advantage and / or enhancements to the company's brand from 'early adopting' TCFD. ESG committees can help to give the Board further focus on reporting initiatives like TCFD or the UN Sustainable Development Goals.

Alternative models to ESG committees

As already mentioned, one key area for directors to consider is the Company's ESG risk profile and perhaps the wider risk profile in the sector or sectors in which the Company operates. One ESG Committee Chair told us that the constitution of a non-board ESG Committee that reports into the board was an effective arrangement for their company at the current time. However, it may not be suitable for higher risk entities, where some ESG considerations can be very strategically significant and risk-carrying. In that instance, it may be prudent for ESG strategy to be explicitly remitted to the Board.

Similarly, amongst our sample of AIM-50 companies, we see that several boards have decided to appoint sustainability committees, with a real focus on the E of ESG, as well as other boards which have delegated some ESG responsibilities to Health and Safety Committees. Just as many companies that follow the UK Corporate Governance Code have appointed a non-executive director with specific responsibility to lead on workforce engagement, we see that some AIM companies amongst our sample are appointing NEDs as ESG leads on the board.

As we discussed earlier in this article, there is no one size fits all approach. However, as our report indicates, we see that more and more boards are taking significant steps to clearly embed ESG within the board governance structure. Given the increased importance of issues such as climate change, sustainability, diversity and inclusion and responsible business to a wide range of stakeholders, we would encourage all boards to give this consideration going forward.

We assist many of our clients in all aspects of Board governance. *If you would like assistance with your corporate governance arrangements, support with development of ESG policies or committee terms of reference, or advice on how as an AIM company you can most effectively respond to developing ESG-related reporting requirements, please get in touch with us using the details below.*

ONE Advisory's Company Secretarial, Governance & Compliance team's expertise and knowledge of best practise in small and mid-cap growth companies can ensure that your Board receives the advice and support needed to facilitate good corporate governance.

Methodology

Market constituents are as at February 2022 and analysis looks at the latest set of accounts and the previous accounts. As one company within the constituent index (the AIM 50 Index) was newly listed in 2020 and other newly listed in 2021 and therefore did not produce at least two sets of separate annual accounts, the sample within the report is 48 companies.

We define ESG Committee as a board-level Committee (with at least one Director of the board as a member of the Committee) with the Committee reporting directly to the board. Our reflections on the remit and responsibilities of the ESG Committee is based upon publicly available information within companies' annual reports and / or publicly available Committee terms of reference.

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