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How sustainability changed corporate governance

Interview with Prof. Dr. Martin Artz. He is leading the Institute of Management Accounting & Control at the University of Münster.

Interview conducted by: Andrea Kanzler

Prof. Dr. Martin Artz's research focus is on the areas of management accounting and control, Sustainability Measurement, data-driven performance measurement and strategy implementation.

1. How has the integration of sustainability performance management evolved in corporate governance strategies over the past decade?

Companies that have seen specific aspects of sustainability as a key driver of business success have always measured and managed these specific sustainability dimensions. If we take for instance, biological food or fair trade policies for fashion or coffee, some companies have engaged, maybe for a share of their product portfolio, in sustainability for a long time. What is new – and that has started around the Paris Climate Agreement – is that all companies start broader initiatives to capture their sustainable impacts due to differences in customer recognition and particularly upcoming regulation in many countries.

2. What key metrics or indicators do you believe are most crucial for assessing sustainability performance in today's economy?

I would like to differentiate between two groups of metrics here: if sustainability is key for the company's business model, then the business model and the specific key drivers of business success define the relevant sustainability metrics. For instance, the fashion company engaged in sustainable products may care about metrics to capture supply chain policies such as child labor or safety at local production plans and their customers' willingness to pay for this product segment. The second group of companies is broader and addresses a broader set of stakeholders and the public due to the visibility of the topic and regulatory initiatives in many countries. Here, some of the "classis" are certainly CO_2 emission equivalents, safety violations in the supply chain, or diversity in corporate governance such as gender quota.

3. How do you see the role of controlling departments evolving in facilitating and driving sustainability initiatives within organizations?

I think the financial management department in companies can – if well prepared and ready to accept the resulting challenges – get into the driver's seat of the change. Accounting and controlling have always been responsible for defining measurement standards, transferring real practices into financial and non-financial metrics, consolidating budgets, taking care of reporting processes, and integrating numbers into performance management practices. This experience and history make them the ideal candidate to facilitate the change. However, we should also note that their competence mainly refers to "traditional", financial measures and corporate accounting systems are often not ready to integrate non-financial metrics to the same degree as financial metrics. This means financial management departments and their self-understanding and role need a change in case they would like to drive the change towards sustainability.

4. What are some common challenges companies face when implementing sustainability performance management systems, and how can they overcome these obstacles?

I see four challenges: strategy, education, measurement, and governance. All these four areas are interlinked to each other. Strategy does not mean that firms need a sustainability strategy. But they clearly must define the role of sustainability for their strategy. Is it part of the business model? Is it a reputation issue? Is it part of facing regulatory

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challenges? The importance of different subdimensions of sustainability for the firm's strategy is a precondition for performance management. Second, education. Companies need to enhance the education level of their employees about sustainability: its importance, its measurement, and management. This refers to expert knowledge in certain areas as well as to basic knowledge for all employes in the organization. Third, measurement. Conventional enterprise resource planning and accounting systems are not tailored to certain dimensions of sustainability that may require to process non-financial measures such as quantities (instead of costs) or safety violations. Even if we look at more traditional costing: most costing systems can calculate product margins per period but calculating product lifetime costs (including potential savings due to recycling) is a challenge. Finally, governance. Organizations need to redefine roles and responsibilities along sustainability.

5. In your opinion, what are the most effective strategies for ensuring alignment between sustainability goals and overall corporate strategy?

Alignment challenges are the same for any type of goals, including sustainability. Ensuring clarity of objectives (and why these objectives matter now to the organization), designing incentives which may also include compensation, delegating decision rights, and approving budgets, as well as ensuring that organizational members have the knowledge and skill set to contribute effectively to the organizational objectives. I think what makes sustainability targets special is to explain organizational members their particular importance now and to invest in education. Many managers understand and accept financial objectives such as profit goals. Sustainability goals, often measured in non-financial terms are new.

6. How do you assess the impact of sustainability initiatives on long-term financial performance, and what evidence suggests a positive correlation?

This is indeed a tricky question since it is usually hard to estimate "what would have happened in case we did not do the initiative." But I think it is also an essential question because companies must estimate their financial returns for any type of investment. And even if some sustainability investments are done as a social initiative, transparency about their effects and costs is essential. One way, of course, is tracking academic studies on effects on certain initiatives. Another way is using historical firm data and exploit whether some changes in the past have shown some desirable performance effects.

7. Could you provide examples of companies that have successfully integrated sustainability into their corporate governance practices, and what lessons can be learned from their experiences?

The answer to this question requires a clear-cut definition of sustainability, which is probably tough. I would, therefore, like to answer the question from a different angle: there is probably no company that has not successfully integrated some aspects of sustainability since long-run existence is a natural objective of any company and a significant driver of firm value. Oil and gas companies invest heavily in renewable energy, tobacco companies innovate healthier products, and McDonald's has changed its business model significantly over the years, including the introduction of salad in menus and recyclable plastics. Although one may criticize these efforts as too small, they underline that responding to customers or regulators is part of good management. Of course, of particular interest are companies that are doing exceptionally well with a remarkable focus on sustainability in their corporate governance, such as the Outdoor company Vaude (particularly sustainability in materials and recycling) or dm-drogerie marketing (particularly employee orientation and work culture). We know from research that returns to investments in sustainability are often underestimated when they are done. For instance, companies treating their employees well enjoy exceptionally high financial performance in the long-run, even though the objective has

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never been to earn these returns in the first place.

8. With the growing focus on environmental, social, and governance (ESG) factors by investors, how do you see the landscape of corporate governance evolving in response to these demands?

We observe changes in practice in firms incorporating sustainability into their governance structures. Some firms have already done this for a long time since certain aspects of the environmental or social dimensions have been part of their competitive advantage. Others are more recently changing due to more recent changes in expectations from investors, suppliers, customers, or regulators. The range of corporate governance changes is broad, ranging from formal elements such as adjusting compensation systems, creating new executive roles (e.g., Head of Sustainability), or changing investment policies to informal ones such as a change in corporate norms and guidelines. However, what we also observe is that firms that do not see sustainability practices as part of their competitive advantage are reluctant to adjust their governance completely. For instance, for incorporating sustainability metrics in their compensation systems for top executives, we observe that more or less all firms started to do so, but only for a minor share of firms; these dimensions are really impactful for bonus pay.

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