FCLTGLOBAL
FOCUSING CAPITAL ON THE LONG TERM

REPORT

Sustainability or Strategy:

BRIDGING THE GAP BETWEEN CLIMATE CHANGE AND LONG-TERM VALUE CREATION

Focusing capital on the long term to support a sustainable and prosperous economy.

Millions of people around the world are saving money to meet personal goals—funding a comfortable retirement, saving for someone's education, or buying a home, to name a few.

The funds to support these goals are safeguarded by institutional investors—pension funds, sovereign wealth funds, insurers, and asset managers—who invest in companies for the prospect of growth and security. These savers, their communities, and the institutions that support them make up the global investment value chain, and each benefit from long-term decisions in different ways.

Data shows that long-term-oriented investors deliver superior performance, and long-term-oriented companies outperform in terms of revenue, earnings, and job creation. But despite overwhelming evidence of the superiority of long-term investments, short-term pressures are hard to avoid. A majority of corporate executives agree that longer time horizons for business decisions would improve performance, and yet half say they would delay value-creating projects if it would mean missing quarterly earnings targets.

Today, the balance remains skewed toward short-term financial targets at the expense of long-term value creation.

FCLTGlobal's mission is to focus capital on the long term to support a sustainable and prosperous economy. We are a non-profit organization whose members are leading companies and investors worldwide that develops actionable research and tools to drive long-term value creation for savers and communities.

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This document benefited from the insight and advice of FCLTGlobal's Members and other experts. We are grateful for all the input we have received, but the final document is our own and the views expressed do not necessarily represent the views of FCLTGlobal's Members or others. The information in this article is true and accurate to the best of FCLTGlobal's knowledge. All recommendations are made without guarantee on the part of FCLTGlobal. Reliance upon information in this material is at the sole discretion of the reader; FCLTGlobal disclaims any liability in connection with the use of this article.

Executive Summary

The past few years has seen significant growth in climate change goals from the corporate and investor community. A growing number of companies have pledged to decarbonize their operations and impacts, at least partially. Similarly, investors are committing to decarbonize their portfolios and in doing so, have engaged companies on their climate goals and strategies. However, despite investor attention, climate change is still not widely reflected in strategy and performance communications to investors.

A detailed analysis of the world's 100 largest companies' climate and business communications revealed the following[1]:

- Eighty-four have set climate change commitments; the majority of which were made or updated as of January 2020.
- However, only 27 mention climate change in investor presentations on long-term strategic planning. Of these, only eight featured climate change as a central component in strategy communications to investors.
- Only 26 companies reference climate change in their most recent financial results disclosures. Of these, only seven provided meaningful details on climate change implications on capital allocations and investments.
- Seventy-nine companies reference climate change in their annual reports. However, only 25 disclosed plans to take advantage of climate business opportunities. Only 13 provided details on planned capital allocation in support of this.

FCLTGlobal's research findings suggest that companies could do more to bridge the gap between their climate change approach and their long-term value creation strategies. To build investor trust, companies must also communicate how they plan to generate value and stay resilient in a low-carbon future.

To facilitate this integration, FCLTGlobal has created a *Climate Transition Conversation Guide*, which will help companies develop a consolidated view of their plan to transition to a low-carbon future. Developed in consultation with FCLTGlobal's corporate and institutional investor members, the guide outlines a series of questions that companies can ask themselves to assess how climate change affects every aspect of their long-term strategy. Elements include:

- **Corporate Purpose:** How does climate change affect how the company intends to create value now and in the future?
- **External Environment:** How does climate change impact the company's core drivers of growth, the competitive environment, and management's view of the market?
- **Strategy, Goals, and Key Performance Indicators (KPIs):** How does climate change affect the company's long-term strategic plan? What goals and KPIs would best showcase the integration of climate into the company's strategic plan?
- **Capital Allocation and Investments:** How does climate change affect the company's capital allocation plans?
- **Risks:** How has climate change been reflected in the company's risk management efforts?
- **Accountability and Incentive Alignment:** How is the company structured to allow for the integration of climate change into its strategic plan at all levels?

Companies can use this guide to drive internal conversations and develop a climate transition plan that is integrally linked with their long-term strategy. The guide also serves as reference for investors who wish to engage with portfolio companies on integration efforts.

Growth in Climate Change Ambitions

In recent years, companies and investors have been increasingly concerned and vocal about the financial impacts of climate change. Many have pledged to take action to transition their enterprises for a low-carbon future, which is critical to preventing the worst impacts of climate change and remaining resilient in a low carbon future.

Among corporations, about one in five of the Forbes Global 2000 have set net-zero or other long-term decarbonization targets.[2] According to an analysis by FCLTGlobal, 84 out of the world's 100 largest companies have set climate change goals, most of whom have announced new or updated commitments since January 1, 2020.[3]

For their part, investors are making climate an important factor in their investment decisions. Over 450 financial firms, representing more than $130 trillion in assets, have committed to net-zero transition outcomes in their investments, and over 615 of the world's largest investors are collectively engaging companies on their climate goals and strategies.[4,5]

On the face of it, these mutually reinforcing commitments appear to set the stage to mobilize capital and drive progress for the climate change transition. However, transforming these good intentions into action has proved to be complicated. Companies have been slow to provide details on how their climate commitments are altering their strategic plans, capital-allocation priorities, and vision for long-term value creation. This lack of clarity leaves uncertainty on both the scope of climate change efforts and how it affects "business as usual" within companies. It also poses risk. Companies that wait to implement robust and resilient transition efforts may be disrupted or face difficulties in the future.

To align goals with meaningful action, every company needs a climate change plan that is integrated with their business strategy, with details on how the company plans to generate value and remain resilient in a transitioning world. Such a plan will allow the company and investors to understand and agree on their transition pathway and will serve as a basis for accountability to each other and external stakeholders.

Financial Implications are Not Reflected in Climate Change Disclosures

Despite the groundswell of climate pledges, investors have grown skeptical of corporate net-zero and sustainability targets. The problem is not a lack of disclosure by companies. On the contrary, investors are awash in corporate disclosures on climate change. Ninety-five percent of S&P500 companies report on their climate and environmental, social, and governance (ESG) performance.[6]

Yet investors say this reporting lacks specifics on how companies are adapting their financial and strategic planning to address the climate threat, and how the threat is affecting performance. An October 2020 survey of nearly 3,000 investment professionals found that 40 percent factor climate risk into decision making, but about half said they lack the details they need, including scenario analysis, climate-risk disclosures, carbon-emissions pricing, and details on climate's impact on corporate strategy.[7] This is leading them to doubt whether the pledges are truly leading to change. A 2021 Edelman survey of institutional investors found that 79 percent were concerned that companies were not "effectively executing on their net-zero pledges."[8]

Numerous other studies have found a disconnect between the quantity and usefulness of corporate climate reporting and are raising concerns about whether companies are serious about implementing their pledges. The 2021 Status Report of the Taskforce for Climate-Related Financial Disclosure (TCFD) found that disclosure of climate change's financial impact on businesses and strategies remains low. [9] In a similar vein, the November 2021 European Financial Reporting Advisory Group's recent assessment of European companies' sustainability reporting noted that the link between sustainability strategies and companies' financial objectives is "quite limited."[10] These assessments underscore that investors are looking for climate information that demonstrates integration with business strategy.

FCLTGlobal member working groups held in May and September 2021 noted similar shortcomings. In discussing climate-related information, investors said:

- Many companies have set goals, but don't seem to know what to do next.
- Climate and financial strategies don't match up.
- There is poor information on how the climate goals will change behavior across the organization.
- Most climate discussions focus on risk — there is less discussion on opportunity.
- Companies do not provide information on how they are looking to transform the company internally, including corporate culture, given the net-zero goal.
- Climate data is poor — and largely not comparable.
- The information provided is not material.

Companies are increasingly frustrated with the persistent pressure from investors to disclose more. Yet, many executives themselves acknowledge that climate efforts have yet to be integrated into the fabric of their strategic thinking. A 2021 Russell Reynolds' survey found that 45 percent of C-suite executives surveyed felt that their company's approach to sustainability was primarily motivated by brand management, rather than value creation or risk reduction.[11]

GROWTH OF CLIMATE DISCLOSURE GUIDANCE AND REGULATIONS

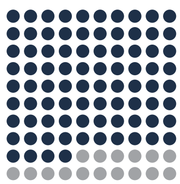
In response to investor concerns about disclosures that lack relevance, comparability, and quality, various initiatives have launched to provide guidance on financial reporting. The major initiatives below have recently highlighted the importance of underlying disclosures for climate transition planning.

- **Taskforce on Climate-Related Financial Disclosure (TCFD):** Developed by and for the financial community, TCFD's guidelines have fast emerged as the leading standard for climate disclosure. The guidelines, which call on companies to disclose their climate-related governance, strategy, risk and metrics/targets, were updated in late 2021 to specifically reflect climate transition planning.[12] The TCFD is supported by over 2,600 organizations globally and has been incorporated by most major ESG disclosure standards.
- **IFRS Climate-related Disclosures Exposure Draft:** The International Sustainability Standards Board (ISSB) was launched in 2021 to develop a "comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs."[13] Their climate disclosure exposure draft, which draws on the TCFD, outlines a set of metrics on a company's exposure to climate risks and opportunities that are intended for inclusion in an enterprise's general purpose financial reporting. The draft includes several metrics related to climate transition planning, including financial planning.
- **US Securities and Exchange Commission's Rules to Enhance and Standardize Climate-Related Disclosures for Investors:** On March 21, 2022, the SEC issued a draft rule that would require public companies to include certain climate-related information in their registration statements and periodic disclosures, such as the annual form 10-K.[14] The draft rule, which also builds on the TCFD, calls for disclosure of: material climate impacts on a company's business, strategy, and outlook; corporate governance systems of climate risks; and climate-related financial disclosures and climate transition plans, if any.

Research Findings: A Gap between Climate Change and Long-Term Corporate Strategy

Research from FCLTGlobal underscores a wide gap between corporate climate goals and disclosures on one hand, and corporate communications on long-term strategic plans on the other. This gap has contributed to a disconnect with investors on how companies are positioned for resilience in a transitioning world.

Our detailed assessment of the 100 largest public companies by market capitalization in the MSCI ACWI Index revealed the following findings:

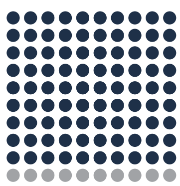


84 SET CLIMATE CHANGE GOALS

Ambitious climate change goals and reporting are ubiquitous among large companies across sectors.

Eighty-four of the 100 companies have set climate change goals. **Sixty-nine** of these goals are "net zero" or "climate neutral," representing a corporate ambition to decarbonize in significant ways.

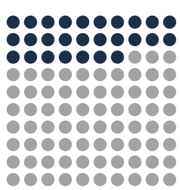
Seventy-three companies set or updated climate goals after January 1, 2020, reflecting a response to pressure to ratchet up climate ambitions.



90 INCORPORATED CLIMATE CHANGE IN ESG REPORTS

On climate change reporting, 90 of the 100 companies have a stand-alone ESG or sustainability report which incorporates climate change.

However, most of these disclosures did not focus on how climate change affects corporate long-term strategic plans.



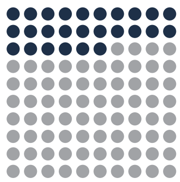
27 REFERENCED CLIMATE CHANGE IN STRATEGIC PLAN

Companies are not integrating climate plans into investor communications on long-term strategic plans.

Despite the proliferation of climate change goals, just 27 companies referenced climate change or ESG in long-term strategy presentations to investors.

Nineteen of these references were minimal or siloed, suggesting that climate change is still not a priority to the institution's plans to create value and remain resilient. **Only eight** companies provided substantive disclosures—four in the energy sector and two in transportation. These companies were likely motivated by investors heightened attention to these carbon-intensive sectors.

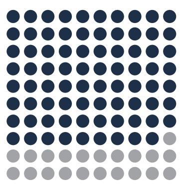
All companies that have integrated climate change into their strategic plans have set climate change goals. However, **over half** of the companies that set climate change goals (including 48 that have set net-zero goals) have not yet disclosed the integration of climate into their strategic plans.



26 REFERENCED CLIMATE OR ESG IN THEIR LATEST FINANCIAL COMMUNICATIONS

Many companies use quarterly or semi-annual communications to demonstrate their business and financial performance, but these disclosures generally lacked substance on climate change.

Like strategic plans, 26 companies referenced climate or ESG in their latest financial communications as of December 31, 2021. However, **only seven** companies provided substantive details on how their climate-integrated strategic plans are being implemented, such as changes to capital allocations or research and development (R&D) progress. **Four of these seven** demonstrated strong climate integration in their long-term strategic plans.



79 DISCUSSED CLIMATE CHANGE IN ANNUAL REPORTS

Companies provide more disclosure on climate change in their annual reports than any other business communication vehicle, but discussion was largely retrospective.

Seventy-nine out of the 100 companies discussed climate change in their annual report. However, discussions were largely high level, focusing on climate as a part of the operating environment rather than providing details on how climate is making a substantive difference to the business strategy. **Only 25** companies disclosed how they plan to take advantage of climate-related business opportunities and **only 13** provided details on planned capital allocation in support of climate change efforts.

Building Investor Confidence through Integrated Climate Transition Plans

Investors need more from portfolio companies to be able to incorporate climate plans into their own strategies. To be credible to investors, companies need to show how their climate change approaches, including transition efforts, are integrated into their long-term strategic plans. More specifically, they need to communicate how their climate ambitions are supported by capital allocation and R&D efforts, driven by business goals and KPIs, and are essential to creating value in the short and long term.

Developing and showcasing such integrated climate transition and business plans will position the company for evolving expectations going forward. It will also build investor confidence in climate transition efforts. If investors clearly understand a company's strategy and how climate change is integrated, they will be able to assess how it may contribute to investors' own net-zero goals. Overall, they will be more willing support the company's climate transition and hold its stock over the long term.

Climate Transition Conversation Guide

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The content that follows lays out a "Climate Transition Conversation Guide" that companies can use to develop an integrated climate transition strategy. Companies can use this tool as an internal "due diligence" effort to assess how each element of their long-term strategic plan is affected by climate change. The information generated by this tool can be used to drive internal deliberations and decision making as companies develop a climate transition plan that is integrally linked with their long-term strategy. Investors can use the guide to engage portfolio companies on the details of this integration.

The Climate Transition Conversation Guide is based on a previous successful FCLTGlobal framework, titled "Driving the conversation: Long-term roadmaps for long-term success," which helped corporations build and articulate their long-term value-creation strategy.[15] The framework was based on surveys of investment decision makers on their priorities for long-term communication, as well as what corporate management teams prioritize for board-level communications.

The Climate Transition Conversation Guide will allow companies to:

- Articulate how climate change fits into the company's vision for the future based on competitive advantages and drivers for growth;
- Showcase climate change factors in the strategic plan, long-term objectives, and capital-allocation strategies;
- Identify climate-relevant KPIs and risks, and establish links to accountability systems within the enterprise.

Questions to ask

1 Corporate Purpose
How does climate change affect how the company intends to create value now and in the future?

2 External Environment
How does climate change impact the company's core drivers of growth, the competitive environment, and management's view of the market?

3 Strategy, Goals, and KPIs
How does climate change affect the company's long-term strategic plan? What goals and KPIs would best showcase the integration of climate into the company's strategic plan?

4 Capital Allocation and Investments
How does climate change affect the company's capital allocation plans?

5 Risks
How has climate change been reflected in the company's risk management efforts?

6 Accountability and Incentive Alignment
How is the company structured to allow for the integration of climate change into its strategic plan at all levels?

Corporate Purpose

The statement of corporate purpose articulates how the corporation intends to create value now and in the long term. Researchers have noted that a well-defined statement of corporate purpose is a "meaningful and enduring reason to exist that aligns with long-term financial performance, provides a clear context for daily decision making, and unifies and motivates relevant stakeholders."[16] Studies have found that businesses with a clear corporate purpose outperform their peers on a range of financial metrics including growth, profitability, and market valuation.[17]

The Enacting Purpose Initiative's SCORE Framework provides guidance on how to develop a corporate purpose statement that focuses on simplification, connection, ownership, rewards, and exemplification.[18,19]

Companies can begin by assessing their statement of corporate purpose to see whether it is still relevant in a low carbon future. Where appropriate, the statement could be updated to explicitly feature the company's role in facilitating the climate transition or delivering climate solutions.

Of the 100 companies we assessed:

19% discussed how climate change affected corporate strategy in their annual reports.

1% referenced how climate change impacts corporate purpose in long-term strategic plan presentations to investors.

1 Corporate Purpose

How does climate change affect how the company intends to create value now and in the future?

Questions to ask

a. Is the company's approach to value creation affected by climate change or its climate commitment?

b. Does climate change threaten the success of the company's purpose?

c. Could the company's purpose be enhanced by climate change? For instance, could the company contribute to climate change solutions?

Leading practice

BP's statement of corporate purpose puts climate change at the center of what the company is and how it will create value. *"Our purpose is reimagining energy for people and our planet. We want to help the world reach net zero and improve people's lives."*[20]

Tesla's mission is to "accelerate the world's transition to sustainable energy."[21] This provides the foundation not only for the company's iconic electric car business, but also encompasses the ecosystem of the company's energy related businesses, including charging, storage, and consumption.

Unilever's mission is to "make sustainable living commonplace."[22] This captures the company's strategy to incorporate ESG considerations, including climate change, into the core of its business strategy.

Resources

- Statement of Purpose Guidance Document, Hermes EOS, 2019[23]
- A sense of purpose, Larry Fink's 2018 Letter to CEOs, BlackRock, 2018[24]
- Walking the talk: Multi-stakeholder capitalism in practice, FCLTGlobal, 2022[25]

Climate Transition Conversation Guide

External Environment

Once the company has reconsidered its corporate purpose to factor in climate change, the next step is to assess how the company's market context has evolved. This analysis will give management and the board a sense of how the company is positioned to generate value across time horizons, and how it can gain or maintain a competitive advantage.

This information is important to investors. FCLTGlobal's 2019 Investor Preferences Study found that 62 percent wanted company commentary on competitive advantages, and 48 percent wanted discussion on the core drivers of growth.[26]

Climate change could impact the external operating environment of firms in a range of ways. For instance, it could open access to investment and capital, unlock opportunities for innovation, affect customer preferences, or exacerbate supply chain issues. Each potential impact merits consideration to get a complete view of climate impacts on the external environment.

Of the 100 companies we assessed:

63% addressed how climate change affected external business environments in their annual reports.

10% of annual reports referenced how climate scenario analyses affected their climate strategy.

2 External Environment

How does climate change impact the company's core drivers of growth, the competitive environment, and management's view of the market?

Questions to ask

a. How does climate change affect the industry across time horizons and recognized impact scenarios? Are these impacts material?

b. Do climate change impacts affect the company's core drivers of growth? Are the drivers of growth enhanced, changed, or at greater risk?

c. Will the transition to a low-carbon future unlock business opportunities, technology, capital, and markets?

d. Does climate change affect the company's customers and supply chain? How is the company positioned to meet their evolving needs?

e. Is the company positioned to capitalize on climate change solutions? Is there an opportunity to develop a competitive advantage?

f. What could the company learn from its competitors' approach to climate change?

Leading practice

BlackRock's strategic plan features "sustainable investing" as a critical investment driver and notes that future investors will be looking for "sustainability at the center of portfolios."[27] The company then outlines a host of climate investment solutions that are intended to meet this market opportunity.

Dow's strategic plan presentation includes an extensive discussion on how the company sees climate change and sustainability drivers affecting their major market verticals, enabling an "$800B addressable market."[28] The details presented underscore climate-related opportunities as being a "market led growth driver," affecting the company's plans on its packaging, infrastructure, consumer, and mobility businesses.

Resources

- Use of scenario analysis in disclosure of climate change risks and opportunities, TCFD, 2017[29]
- Climate Risk Technical Bulletin, Sustainability Accounting Standards Board, 2021[30]

Strategy, Goals, and KPIs

A long-term strategic plan builds on management's understanding of the growth drivers and the competitive landscape and seeks to translate the corporate purpose into specific goals and KPIs. A well-structured strategic plan:

- Provides a clear picture of the company's direction at the enterprise and business unit level across its short- and long-term planning horizon (ideally, three, five, and ten years)
- Includes operational and financial goals and related assumptions
- Incorporates an action plan on how management intends to achieve the goals in question
- Features KPIs to track corporate performance against the action plan

A strategic plan that includes the details above forms the basis of executive compensation, as well as the foundation of the investor-corporate dialogue.

It is important to keep in mind that a climate target is not necessarily a goal that is relevant in the context of the long-term strategic plan. However, where companies have set ambitious climate change targets, particularly net-zero goals, the strategic plan needs to reflect how the company's climate goals affect its business planning. As a part of this, the company can consider whether and how existing business and financial goals should be adjusted given the climate context, as well as whether the company should adopt new business goals that reflect its plan to generate value in a carbon constrained future.

Climate considerations can also be reflected in the KPIs that inform strategic planning. As with goals, while the company may measure and otherwise disclose several climate change KPIs, only KPIs relevant to the strategic plan should be reflected. Similarly, companies can assess their existing KPIs and consider incorporating new ones that showcase climate integration into business. Well-chosen KPIs could also help companies better demonstrate progress in the transition to net zero, even when that pathway potentially results in short-term emissions increases.

TCFD's Guidance on Metrics, Targets, and Transition Plans provides helpful guidance for companies to consider in developing climate integrated KPIs.[31] These could include KPIs that measure:

- The firm's continued exposure to climate risk (e.g. assets in flood prone areas, assets that are at risk of being stranded, or those at risk of value erosion)
- The drivers of climate risk (e.g. changes in investor or consumer sentiment towards the product or the industry; regulatory trends)
- Risk mitigation (e.g. investments in green technology; new products launched that drive climate change solutions)

Planning and investments related to R&D provide important information in these situations. FCLTGlobal's research notes: "the tendency to cut long-horizon projects has left companies with unbalanced innovation portfolios favoring short-term projects that offer more certain, but ultimately lower incremental returns."[32] Studies have shown that R&D investments, while still achieving superior growth in returns, scale and profitability, are a key characteristic of winning companies.[33]

Time horizon is key in making these decisions. Where companies delay taking the steps needed to bolster their climate resilience, they will face higher costs, which in turn will affect investor returns. Corporate strategic plans that reflect climate change should incorporate action being planned in the short, medium, and long term.

Strategy, Goals, and KPIs *(continued)*

Of the 100 companies we assessed:

29% identified specific financial goals that incorporated climate change considerations in their annual reports.

9% highlighted climate-related financial goals and climate-specific R&D efforts in strategic plans presentations.

3 Strategy, Goals, and KPIs

How does climate change affect the company's long-term strategic plan? What goals and KPIs would best showcase the integration of climate into the company's strategic plan?

Questions to ask

a. What is the time horizon for the company's strategic plan?

b. Has the company made a climate commitment? Have the commitment and climate impacts across relevant time horizons been factored into its strategic plan?

c. To what extent will climate be integrated into the company's strategic plan by 2030? What action steps will the company take immediately to operationalize this integration?

d. What are the company's biggest challenges in integrating climate into its strategic plan?

e. Does climate change or the climate commitment impact existing, new, and planned products or business lines? Over which time horizon?

f. Does climate change or the climate commitment positively or negatively affect sales, income and earnings projections, and goals? Over which time horizon?

g. Are there opportunities for the company to adjust its R&D portfolio to accommodate climate impacts or operationalize its climate commitment?

h. Do climate change or relevant commitments impact existing KPIs (e.g., profitability, revenue growth, costs)?

i. Would new KPIs that better reflect climate impacts on the strategic plan (e.g., expected revenue growth from climate change opportunities) be helpful or warranted?

Leading practice

Enel's 3-year strategic plan lays out climate change as the center of the company's plan, noting how the climate transition will transform the energy world in the coming decades and displaying an ambition to be a "super major" in the renewable sector.[34] The strategy is underpinned by specific long-term goals on growing production of emissions free electricity while continuing to generate value to shareholders in the medium and long term.

Shell's strategic plan focuses on the company's net-zero goal (net-zero by 2050) and provides details on how the company will get there, including 2030 energy transition milestones.[35] The company also included an ambition to *"profitably decarbonize while maintaining 2025 growth objectives,"* for instance by investing in sustainable aviation fuel and gaining ground in EV charging.

ASML's annual report discusses the company's vision to improve its energy efficiency and value chain. It also addresses the strategic and technological challenges that the company faces to implement this vision.[36]

Honeywell International's strategic plan features the company's climate and ESG efforts as a core part of its plan to "break through to the next level of value creation." The presentation notes that approximately 60 percent of Honeywell's new product R&D activity is directed towards ESG-oriented outcomes, and the company plans to grow sales in its sustainability technology solutions business unit from approximately $200M to $700M in three years.[37]

Resources

- IFRS S2 Climate-related Disclosures, IFRS, 2022[38]
- Funding the future: Investing in long horizon innovation, FCLTGlobal, 2020[39]
- Guidance on Metrics, Targets and Transition Plans, TCFD, 2021[40]

Capital Allocation and Investments

Once the strategic plan has been developed, details on capital allocations and investments indicate how the company intends to distribute its financial resources to execute the plan. Details of interest include the sources of capital and how the company intends to use it.

Effective capital allocation has always been an investor priority. Fifty-two percent of investment decision makers in FCLTGlobal's 2019 Investor Guidance Preferences Study identified capital allocation as a top element for inclusion in long-term roadmaps.[41]

A company's climate risk exposure and ambition can significantly affect its capital stock. Operationalizing the climate goals could involve the need to acquire and/or retire assets given regulatory incentives, investor pressure, and customer preferences. Investors, especially those involved in the Climate Action 100+ initiative have been especially focused on capital allocation of carbon intensive companies and the risk of stranded assets.[42] Similarly, as companies look for opportunities to generate value in a net-zero future, acquiring new capital stock or businesses could become a priority.

Thinking through capital-allocation implications of climate strategies become especially important given the growing focus on climate integration into financial statements. IFRS guidance, which has been endorsed by investor groups globally, calls on companies to reflect climate matters on existing inventories, assumptions about useful lives of assets, the value of property, plants, equipment and intangible assets, and asset impairments and contingencies that a company may need to hold on account of climate risks.[43]

Of the 100 companies we assessed:

13% showcased capital allocation in support of climate priorities, including a specific planned monetary spend in their annual reports.

7% provided capital allocation plans in strategic plan presentations.

4 Capital Allocation and Investments

How does climate change affect the company's capital allocation plans?

Questions to ask

a. Will the company's existing capital assets be impacted by the physical or transition impacts of climate change or the implementation of its climate commitment?

b. Are any capital assets at risk of being stranded on account of the climate transition? What is the strategy for at-risk assets?

c. Do the company's financial or accounting assumptions (e.g., depreciation schedules, internal hurdle rates, weighted average cost of capital) need to be revised to take relevant climate commitments into account?

d. How will climate change be reflected in the company's planned capital expenditures? Are there opportunities to acquire assets to operationalize its climate commitment?

e. How does the company's capital allocation strategy reflect assets in transition, including investments needed to decarbonize such assets?

f. What is the company's strategy on investing resources (e.g. capital, talent, or others) to explore opportunities to generate value in line with its climate commitment? Which businesses and initiatives are best positioned in this regard?

Capital Allocation and Investments *(continued)*

Leading practice

BP's strategic plan progress update states that the company plans to increase the proportion of capital expenditures in its transition growth business (including bioenergy, convenience, electric vehicle charging, hydrogen, and renewables) to more than 40 percent by 2025 and is aiming for 50 percent by 2030.[44] Additionally, BP's ESG investor pack declares: "Each new material capex investment approved in 2020 was evaluated to be consistent with the Paris goals."[45] The company also identifies the carbon price factored into investment appraisals, and growth in capital investments into its non-oil and gas business.

Volkswagen's net-zero announcement included details of the company's planned investments in decarbonization efforts, including accelerating the production and use of electric cars.[46] The company's strategic plan presentation showcases how capital will be deployed in support of its new strategy to become a software-driven mobility company, including planned investments in electric vehicles, hybrid powertrains, and software.[47]

DSM's strategic plan references the use of an internal price on carbon, which is increasing, to "guide its investments and operational decisions" as the company looks to achieve its climate change goals.[48]

Resources

- Effects of climate-related matters on financial statements, IFRS, 2020[49]
- Accounting for climate: Integrating climate-related matters into financial reporting, CDSB, 2020[50]

Risks

A robust risk management process helps companies proactively identify threats to the execution of the strategic plan and address how they will be mitigated.

However, for this to be successful, companies must first implement a holistic risk management process, which considers climate change as an enterprise risk and the range of ways that climate risk is addressed across the organization. In 2018, COSO released guidance on how enterprises could integrate ESG across their risk management frameworks, which provides a useful framework for companies to consider for the integration of climate change risks.[51]

Of the 100 companies we assessed:

57% noted exposure to the climate risks in their annual reports but narrative is largely boilerplate.

0% referenced climate risks in strategic plan presentations.

5 Risks
How has climate change been reflected in the company's risk management efforts?

Questions to ask

a. What is the scope of the company's existing efforts to identify climate risks? Does it cover risks to operations and supply chain?

b. Is climate reflected in the company's risk inventory? How do climate trends impact the existing risk inventory?

c. How does the enterprise risk management process allow the company to identify the new, emerging and changing impacts of climate change on the business? Does the company have a process to factor in the latest climate science into its climate risk assessment?

d. What is the company's tolerance for the risks that have been identified?

e. To what extent can the company's climate risk exposure be mitigated through insurance, contingency reserves, and other mechanisms? Does the company plan to respond if the scope of risks exceeds this level?

f. Does the company face the potential that climate risks could precipitate losses that would threaten its purpose?

Leading practice

Unilever's annual report includes details about several high-level scenario analyses that the company conducted (in accordance with TCFD requirements) on some of the potential impacts of climate change on their business. This includes considering the potential climate impact on certain agricultural commodities to help adapt their strategies and financial planning.[52]

Prosus' annual report includes a detailed matrix laying out the company's key risks and impacts on capital.[53] The matrix identifies sources of risk, measures to respond to risk, and changes to be monitored. Climate is identified as a source of risk to financial and natural capital.

Taiwan Semiconductor's annual report identifies the various risks that climate change poses to the company and traces how these could be translated into business strategies or opportunities, and steps taken toward realizing them.[54]

Resources

- Applying enterprise risk management to environmental, social and governance risks, COSO & WBCSD, 2018[55]

Accountability and Incentive Alignment

Details on accountability and incentive alignment provide insight into how the company is positioned to operationalize the strategic plan and achieve long-term objectives. This could include details about (i) corporate systems for climate change, (ii) how knowledgeable management and the board on climate change, (iii) workforce capacity and culture for implementing climate strategies, and (iv) incentive schemes linked to climate change.

Russell Reynolds' 2021 corporate survey indicates that climate change and sustainability pledges made by companies have not yet translated into the day to day working of most of their employees.[56]

Of the 100 companies we assessed:

21% noted the board's role in overseeing climate strategy and implementation in their annual reports.

10% discussed how climate is integrated in compensation plans in their annual reports.

6 Accountability and Incentive Alignment

How is the company structured to allow for the integration of climate change into its strategic plan at all levels?

Questions to ask

a. How does the company's board oversee climate risks? Is the climate commitment addressed in board discussions of strategy, risk, and compensation? How frequently does the board discuss climate change?

b. Is responsibility for overseeing climate risks and implementing the climate commitment spread across corporate leadership, including the named executive officers?

c. How knowledgeable are the board, senior management, and the workforce on climate impacts on the business? Do they have access to training or capacity building on climate change?

d. Has the company put systems in place to engage employees across the organizational structure on the implementation of its integrated climate and business strategy?

e. How are executives and employees at all levels incentivized for performance on the integrated climate and business strategy? What is the nature of the linkage?

Leading practice

Verizon's proxy statement includes details on how each of its board committees engages on climate change and environmental sustainability.[57] This includes its finance committee, which oversees the company's capital allocation efforts, including its green finance program and renewable energy purchase agreements. The company also discloses how all top managers are involved in the implementation of its climate efforts. The board has linked ten percent of the short-term incentive award for corporate employees to an ESG metric that includes climate change and diversity targets.

Resources

- Long-term habits of a highly effective corporate board, FCLTGlobal, 2019[58]
- Risk of rewards: Tailoring executive pay for long-term success, FCLTGlobal, 2021[59]

Alignment with Climate Disclosure Frameworks

While the questions above are oriented towards helping companies develop an integrated business and climate-transition strategy rather than climate change disclosure, having clearly thought through perspectives on each of the topics above positions companies to provide detailed climate information across disclosure standards.

Below, we have mapped the elements of the Climate Transition Conversation Guide against the major climate change and ESG disclosure standards.

<table>
<tr><th>Climate Conversation Guide</th><th>TCFD recommendations</th><th>ISSB climate change exposure draft</th></tr>
<tr><td>Corporate Purpose: How does climate change affect how the company intends to create value now and in the future?</td><td rowspan="4">Strategy
Disclose the actual and potential impacts of climate-related risks and opportunities on the organization’s businesses, strategy, and financial planning where such information is material.

Metrics and Targets
Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.</td><td>Sec. 12: Climate impacts on business model and value chain</td></tr>
<tr><td>External Environment: How does climate change impact the company’s core drivers of growth, the competitive environment, and management’s view of the market?</td><td>Sec. 12: Climate impacts on business model and value chain

Sec. 15: Climate scenario analysis</td></tr>
<tr><td>Strategy, Goals, and KPIs: ow does climate change affect the company’s long-term strategic plan? What goals and KPIs would best showcase the integration of climate into the company’s strategic plan?</td><td>Sec. 13: Impacts on man-agement’s strategy and deci-sion making, including transi-tion planning and related goals

Sec. 19–24: Metrics and targets</td></tr>
<tr><td>Capital Allocation and Investments: How does climate change affect the company’s capital allocation plans?</td><td>Sec. 14: Impacts on financial position, financial position including capital allocation plans and sources of funding</td></tr>
<tr><td>Risks: How has climate change been reflected in the company’s risk management efforts?</td><td>Risk Management
Disclose how the organization identifies, assesses, and manages climate-related risks.</td><td>Sec. 16–18: Risk management processes</td></tr>
<tr><td>Accountability and Incentive Alignment: How is the company structured to allow for the integration of climate change into its strategic plan at all levels?</td><td>Governance
Disclose the organization’s governance around climate change risks and opportunities.</td><td>Sec. 4–6: Governance processes, controls and procedures used to monitor and manage climate related risks and opportunities</td></tr>
</table>

Communicating Climate Transition Strategies to Investors

Once a company develops an integrated climate and business transition strategy, the details need to be communicated to investors across various channels. These channels include:

- **Strategic plan communications:** Details of the climate-adjusted long-term strategic plan could be shared with investors using presentations and other formats. The integrated climate transition and business plan should be featured on the investor relations website if the company is publicly traded and otherwise proactively shared with investors. Relevant details to feature include a vision for how the company intends to generate value in a net-zero future, business goals, and capital-allocation plans that incorporate climate considerations and climate-related external headwinds influencing the company's operating environment.
- **Financial reporting:** Details on the company's progress in achieving elements of the strategic plan could be provided in annual financial reporting and perhaps more frequently depending on the company's business. Highlights could include the company's progress in allocating capital, achieving specific KPIs, and meeting long-term goals.
- **Annual reports or integrated reports:** Annual reports or integrated reports provide an opportunity for a detailed discussion about the integrated climate and business transition strategy. Companies could use the annual report to feature the rationale for the integrated climate and business strategy, including the results of climate scenario analyses or climate risk and opportunity assessments that inform the strategy. A growing number of companies are also using annual reports to report on TCFD indicators.
- **Investor-corporate dialogue:** As noted earlier, investors are looking for companies to provide details of their climate transition strategies. In addition to the disclosure vehicles noted above, companies can proactively relate the details of this strategy in investor-corporate communications. Potential channels include one-on-one dialogues, investor days, and topic-specific presentations. However, care should be taken not to overstate the extent of the company's climate efforts. Topics identified as priorities in climate or ESG specific discussions should be reflected across the company's strategy communications vehicles.

Conclusion

To generate value and remain resilient in the long term, companies and investors must be responsive to challenges posed by climate change. This will require a redeployment of capital in historic proportions, presenting both risks and opportunities. Companies need to proactively anticipate this shift and analyze how the transition may affect their strategic plans.

The companies who demonstrate these efforts to investors will not only distinguish themselves from their peers but will gain the trust of investors. Investors are already engaging their portfolio companies on these issues to ensure that their investments are aligned with future opportunities and constraints.

The Climate Transition Conversation Guide provides a framework for companies to conduct this assessment and credibly establish robust climate-responsive strategies. The framework can also help companies communicate the information investors need to smartly invest in a net-zero world. Where investors and companies are aligned, capital can be deployed for long-term prosperity.

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