

Approaches to Strengthening Corporate Governance by Integrating Sustainability Challenges into Corporate Strategy to Enhance Corporate Value

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CSR Committee, Business Policy Forum, Japan

Executive Summary

1. Background

In recent years, sustainability challenges—such as climate change and other environmental issues, as well as social issues including human rights and geopolitical risks—have become increasingly severe and complex. In this context, rules and regulations have now been revised so as to require large corporations to make public their information on related issues.

This is why sustainability challenges are having a greater impact than ever on corporate performance and long-term corporate viability. It is now necessary for corporations to manage their businesses by incorporating sustainability challenges into their management strategies to enhance corporate value. This requires a strengthened corporate governance framework.

2. Major Subjects of the Report

This report summarizes the challenges faced by corporations and potential solutions, based on interviews with 26 corporations or institutional investors that have been proactively advancing sustainability initiatives.

(1) Fundamental Framework to Incorporate Sustainability Challenges into Corporate Management Strategy

(a) Making Proper Use of Business Management Cycle

A basic approach to corporate management is to run the PDCA (Plan–Do–Check–Act) cycle. Sustainability management can be governed through a similar process.

Chart 1: Business Management Cycle Aligned with a Management Strategy
Integrating Sustainability Challenges



(b) Roles of the “Supervisory Function” and the “Execution Function” in Operating the Business Management Cycle

It is important that both the supervisory function and the execution function

of the management bodies work together in parallel in the business operation. The two functions, which bear some part of responsibility in common, are expected to collaborate with each other while fulfilling their respective roles to achieve sustainable corporate value creation.

One typical example of the tasks of the two functions, or supervisory function and execution function, are shown in chart 2. It exhibits the tasks for the divided stages of i) Establishment of Management Strategy, ii) Implementation, iii) Evaluation and Disclosure and iv) Improvement. These stages are important elements in the business management cycle that should be processed based on the corporate strategy that contains a route to achieve sustainability challenges.

Chart 2: Example: Typical Roles of the Supervisory and Execution Function in the Governance Mechanism of the Business Management Cycle

		Typical Roles in Governance Mechanism	
Business Management Cycle		Supervisory Function	Execution Function
	Establishment of Management Strategy	<ul style="list-style-type: none"> ● Discussion to select material topics or to establish business strategy or KPIs, especially in medium- to long-term ● Encouraging the adoption of projects that require bold risk-taking ● Collecting information in need through stakeholder engagement 	<ul style="list-style-type: none"> ● Identifying material topics and establishing a business strategy and KPIs taking into account operational requirements, available technologies and know-how, and workforce conditions ● Formulation of implementation programs with business divisions and corporate office divisions
	Implementation	<ul style="list-style-type: none"> ● Monitoring progress against KPIs ● Checking critical points regarding the balance between costs and earnings or the trade-offs between merits and demerits 	<ul style="list-style-type: none"> ● Establishing the in-house organization to promote operations by either business divisions or corporate office divisions ● Checking KPI progress ● Introducing an internal system to promote programs across the organization based on PDCA cycle method ● Coordination between business divisions ● Stakeholder engagement to support operational decision-making
	Evaluation & Disclosure	<ul style="list-style-type: none"> ● Evaluation of essential KPIs ● Evaluating performance of top executives and reflecting the results on their rewards ● Discussing and determining the method for disclosing information 	<ul style="list-style-type: none"> ● Establishing an electronic system to collect wide-ranging data efficiently ● Evaluating overall KPI performances ● Promoting information disclosure based on the disclosure strategy
	Improvement	<ul style="list-style-type: none"> ● Revising the corporate fundamental strategy when needed 	<ul style="list-style-type: none"> ● Revising and advancing Implementation programs in line with the updated business strategy

(c) Management Measures Depending on the Conditions of each Corporation

The governance framework for integrating sustainability challenges into corporate strategy varies by company purpose and strategy, and should be designed and implemented by each corporation. The governance framework is not established merely by arranging the structure. But rather, it is essentially important to modify the structure with proper remedies to improve its effectiveness during on-going operations, and to improve the framework depending on the level of integration of sustainability challenges in the corporate business strategy.

In the viewpoint of the two functions of governance, some cases found in the interview showed that different bodies, or the board of directors and the management team shared the responsibility of the two functions. While other cases showed different structures that the board of directors lead both two functions or that the management team seemed to preside over the two functions.

(2) Practical Solutions for Coordinating the Supervisory Function and the Execution Function

The following points are the measures that were suggested in the interview research as the practical solutions regarding the way to coordinate between the Supervisory function and the Execution function.

(a) Measures for the Supervisory Function

i) The ways for the supervisory function to engage in the process to identify material topics of the corporation

Two major ways were found in the research regarding the body structure of the supervisory function to engage considerably in the process of identifying

material topics of the corporation.

One way was that the members of the supervisory function joined in the early-stage discussion by the top operating team several times. Another way was that the body of supervisory function itself did engage in the planning process as the main players.

ii) Outlining the concrete skills in need for sustainability management and applying them when selecting the members for the supervisory function

When outlining “ESG” or “sustainability” as the skills in need for the supervisory function members, concrete definition of the skills with expected achievements or practical experiences are the essential factor.

And at the time to form the board as the supervisory function with persons with the skills, examples include appointing external directors with the required expertise or inviting external experts to provide advice to the board.

iii) The ways to operate the board as the supervisory function

In many cases, unofficial advisory committees which were different from the board itself were set up to deal with diverse and varied agenda for the board of directors. When this kind of unofficial committee would be established, some tips should be important such as defining clear pre-determined roles or providing fair authority in the corporate governance structure.

(b) Measures for the Execution Function

i) The position of chief officers in charge and the support staff for the execution function team

Several positions are assigned for a chief officer in charge of sustainability challenges. Examples include the CEO, CFO, and a sustainability chief officer (e.g., CSuO). More broadly, the role may be assigned to a member of the C-suite ("CXO"). The important step in assigning CXO is to clearly communicate internally and externally of the corporation the

key tasks of the position or the reason of the assignment as the CXO , and to update the scope of the tasks of a CXO so that the scope should match the business strategy to solve sustainability challenges.

The structure of the supporting team for a CXO was found to be roughly divided into two styles. One style was a centralized system that programs for sustainability challenges were led by a special team in the headquarters departments. Another was the de-centralized system that business operation sections developed and advanced the related programs with support from the corporate headquarter section.

ii) Establishing an expert committee to enhance information sharing, discussion, and implementation of initiatives

There are two major reasons for corporations to establish an expert committee regarding sustainability challenges. One is to aim to enhance information exchange among the management team. And another is to have thorough discussions and make decisions thereafter for individual programs.

The form of an expert committee does vary depending on the reason of the establishment. It might take the style of an advisory committee for a management team, an advisory committee for the CXO. The way to operate an expert committee may also take different styles in the point of the member list of the committee, or whether executives or top officials of business operation divisions would participate or not, or in the process of selecting agendas of the committee meetings.

(3) Further Subjects to be Discussed

When a corporation incorporates sustainability challenges into its business strategy, it is required to evaluate from the fundamental viewpoint if the activities

for sustainability challenges would make a substantive contribution to addressing them, rather than merely creating a superficial appearance, as well as whether the related activities would cause to increase the corporate values.

The typical topics in that evaluation are as follows:

(a) The Structure to Share Management Responsibility between the Board of Directors and the Top Operation Team

i) Supplementary institutional arrangement for the board of directors

It is an essential element to incorporate sustainability challenges into corporate management strategy when designing a medium and long-term corporate blueprint or a story to expand corporate values furthermore. During the process of designing, the board of directors should assume the role to lead the major part of it. On the other hand, the board of directors should also be supported by supplementary institutional arrangement, considering that more than a third of board members of almost all of listed corporations at the Prime Market of Tokyo Stock Exchange are independent outside directors in recent years. The major examples of the supplementary arrangement are as follows.

- A) Providing independent outside directors sufficient information on inside events and figures.
- B) Limiting the number of discussion agendas appropriately.
- C) Setting up opportunities to get advice from experts of various and specialized areas to promote deep discussion.

ii) Appropriate role sharing between the board of directors and the top operation team

One idea of the role sharing between the top operation team, especially CEO, and the board of directors, particularly independent outside directors, is to take shared responsibility with proper coordination in approaching employees to enhance their engagement.

In this process, it is needed to consider the difference in the time axis between the medium and long-term time frame to reap the outcome of sustainability management and the short-term period to collect the output of daily practices with regard to sustainability management. Development of sustainability management that covers the whole corporation requires to inspire empathy of a wide range of employees and to encourage improved activities of them. This is why it is effective to carry out well-coordinated approaches by both the board of directors and the top operation team to advance the momentum of in-house engagement.

(b) Further Topics to be Considered

Major topics to be considered further are as follows:

- A) Integrating risk management of sustainability challenges in the total risk management framework of the whole corporation.
- B) Intensified governance structure regarding sustainability management covering the whole group companies of the corporation.
- C) Determining key performance indicators, or numerical indicators where possible, that has essential linkage to sustained value creation, as well as linking them to payroll programs for employees.
- D) Proactive reaction both to increased requirement for information disclosure and for stakeholder engagement.
- E) Constructing partnership with outside entities as an approach to accelerate real solution of sustainability challenges.

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Member of CSR Committee of Business Policy Forum, Japan

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Tetsuyuki Kagaya	Professor, Graduate School of Business Administration, Hitotsubashi University
(the committee)	
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Yukio Hori Holdings, Inc.	Manager, Sustainable Management Office, Sompo
Megumi Inomata	General Manager of sustainability Group, Japan Foreign Trade Council, Inc.
Yuki Iwai Limited (~3 rd)	Senior Manager, CSuO Division, CEO Office , Fujitsu
Masahiro Ishino	General Manager, CSR Section, Sustainability Department, Sony Group Corporation
Akihiro Inatsugi	Executive Director, Global Sustainability Strategy, Bridgestone Corporation
Hiroyuki Kawata Limited (4 th ~)	Senior Manager, CSuO Division, CEO Office , Fujitsu
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Koichi Kaneda	Senior Specialist, Sustainability Innovation Department, Corporate Headquarters, NTT DATA Group Corporation
Yoshiko Nagamitsu	Team Leader, Planning Team, Sustainability Department, Mitsubishi Corporation
Kaori Nishihara	Senior manager, Social Impact & Affairs, ASAHI GROUP HOLDINGS, LTD.
Shigeki Matsui	General Manager, Corporate Sustainability Strategic Management Division, Strategic Corporate Value

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Yuuko Shiota	Executive Officer, General Manager, Sustainability Department, ESG Promotion Department, MARUI GROUP CO.,LTD.
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Yukihiro Sakamoto	Deputy Director , Corporate Accounting, Disclosure and CSR Policy Office, Economic and Industrial Policy Bureau
Yukiko Ishizuki	Assistant Director, Corporate Accounting, Disclosure and CSR Policy Office, Ministry of Economy, Trade and Industry
Nodoka Yamada	Assistant Director, Corporate Accounting, Disclosure and CSR Policy Office, Ministry of Economy, Trade and Industry
Hidemi Tomita	CEO, Institute for Sustainability Management
Endo Erika	Manager, Sustainability Group, Japan Foreign Trade Council, Inc.
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Akira Kitabatake	General manager, Planning & research div.,Business Policy Forum,Japan
Hiroaki Konishi	Senior researcher, Planning & research div.,Business Policy Forum,Japan

Takeshi Nozawa	Researcher, Institute for Sustainability Management CEO, EcoNetworks Co.
Shiho Funahara	Researcher, Institute for Sustainability Management Researcher, EcoNetworks Co.
Moho Tsunoda	Researcher, Institute for Sustainability Management Researcher, EcoNetworks Co.