The Role of the Board in Overseeing ESG

By Kristen Sullivan, Maureen Bujno, and Jon Raphael, Deloitte



INTRODUCTION

In corporate boardrooms, few topics seem to be generating more conversation than environmental, social, and governance (ESG) matters. The Center for Audit Quality (CAQ) observed that 95 percent of companies published some type of ESG disclosure in 2020.[1] According to *Board Practices Quarterly*, diversity, equity, and inclusion; human capital management; and environmental and sustainability matters ranked among the top four board priorities this year.[2]

Despite this increasing focus, many companies are at the beginning of their ESG journey. As a company's ESG focus sharpens and as the landscape progresses, boards should be aware that the *G* raises several governance questions directors should consider.

KEY PROJECTIONS

There are several key projections that boards should be aware of as they enhance their ESG governance activities over the coming year:

- **Growing need for ESG and business alignment**. As ESG becomes increasingly prominent, more companies are likely to focus on aligning their ESG objectives and metrics with the overall strategic drivers of the business. A materiality determination can help drive this strategic alignment. Synchronizing key performance indicators (KPIs) for the overall business with ESG-specific KPIs can lead to overall enhancements in ESG programs.

[1] The Center for Audit Quality, "S&P 500 and ESG Reporting" (August 9, 2021).
[2] Board Practices Quarterly, "2021 Boardroom Agenda" (February 2021).

"If a company's current disclosures are made outside of its SEC filings, they often are not subject to the same governance and control frameworks as the company's SEC disclosures. The cost and time needed to develop and implement new processes, technology, and capabilities could be significant for some companies."

– Jon Raphael, national managing partner for Audit & Assurance, Deloitte & Touche LLP

- **ESG's rising stature on board agendas**. With surging interest from investors, consumers, and other stakeholders, ESG will likely increasingly become a standing board/audit committee meeting agenda item.
- **Compliance with SEC requirements**. The SEC will roll out new regulations governing the disclosure of specific ESG information. The board/audit committee should not only stay on top of these new regulations, but also understand how management is addressing SEC expectations. For example, this past September the SEC posted an open comment letter to provide an example format of the types of comments they have issued about a company's disclosures.[3]
- **Convergence of standards**. Many companies are looking to recognized ESG standards and frameworks to guide their activities. We expect this trend to increase as the move toward convergence of recognized standards and frameworks takes shape under the new International Sustainability Standards Board (ISSB), announced in November at the UN Climate Change Conference in Glasgow. This shift can result in greater clarity and certainty in meeting stakeholder expectations and make it easier for companies to apply broader ESG standards to measure performance against their ESG goals.
- **Heightened demand for alignment of ESG disclosures and financial statements**. As regulatory action is announced and an authoritative standard setting body progresses, there will be a heightened demand for companies to align their ESG disclosures and assumptions with their financial statements and disclosures regarding potential financial implications of the ESG initiatives and goals.
- **Increased focus on the essential role of assurance**. Assurance is a critical component of an effective governance process and is intended to enhance the confidence and trust in the ESG subject matter prepared, as well as to reflect performance against ESG risks and objectives. As the SEC's new ESG rules gain traction, we expect to see greater emphasis on assurance provided by the independent auditor to promote consistency with the audited financial statement's key assumptions and disclosures. Not surprisingly, some of the world's largest companies use public company auditors to provide assurance over specific parts of their ESG reporting, and we expect that trend to continue and expand.

BOARD IMPLICATIONS

To help boards prepare to address what is on the horizon for ESG and stay ahead of the rapidly changing environment, we've put forth leading practices for boards to consider. Each of these areas will likely become increasingly important as they embark on or expand their governance and oversight responsibilities in response to today's demands.

[3] US Securities and Exchange Commission, "Sample Letter to Companies Regarding Climate Change Disclosures" (September 2021).

To set a proper governance structure, board members should understand how sustainability is linked to strategy, opportunities, and risks.

1. **Define the board's governance infrastructure**

   Boards should define ESG oversight responsibilities across the board itself and its committees, and identify the steps needed to operationalize them. Board members should be deliberate about overseeing the overall ESG program as well as specific ESG objectives, risks, and opportunities.

   Deloitte's study of S&P 500 proxy statements in 2020 revealed substantial differences in how boards oversee ESG matters.[4] We also found significant variation in governance structures among industries. The largest percentage of boards delegated oversight responsibility to the nominating and governance committee (41%), while almost 30 percent had not disclosed whether the board had defined the structure, demonstrating that this remains an evolving area.

   To set a proper governance structure, board members should understand how sustainability is linked to strategy, opportunities, and risks. Considering the complexity of a typical sustainability integration, directors should also be familiar with the specifics, including measurement criteria, to monitor progress. The ESG lead committee or board should counsel and challenge the sustainability leader on a regular basis to understand how the program is maturing. Together, they should agree on whether the *E*, *S*, and *G* owners will report to the full board or to a subcommittee. Coordination among committees is critical, given the broad scope of ESG measures. At a minimum, the audit committee should be reviewing the company's sustainability report to understand key assumptions made and the controls supporting key metrics and goals that are disclosed.

   As the structure continues to be defined, the board should work with management to understand who will present on ESG topics, the type and level of information shared, and the cadence of ESG on the agenda(s).

2. **Understanding the ESG management structure**

   Where ESG resides within the company's management can have a significant impact and should be a focus of the board. To exert sufficient influence, drive accountability, and ensure alignment with the business strategy, the lead should be a senior executive. The CEO also plays a critical role in setting the tone at the top and underscoring the importance of the ESG program.

   Management teams should consider developing a formal ESG/sustainability management committee made up of cross-functional company leaders with assigned responsibility and accountability. The senior executive leading the sustainability efforts should also lead the committee, which should focus on a cross-section of ESG trends and activities.

[4] Deloitte Center for Board Effectiveness, *On the audit committee's agenda: Defining the role of the audit committee in overseeing ESG* (November 2020).

Audit committees should understand which ESG risks are deemed material and should be captured in sustainability disclosures.

3. **ESG integrated into the company's strategic fabric**
   ESG success depends on a well-defined strategy that aligns with the company's purpose and strategic direction. Monitoring goals and metrics, such as stakeholder assessments and KPIs, are a telltale sign of whether any strategic ESG plan has the necessary rigor and accountability built in. When it comes to metrics, consistency is key. ESG disclosures, investor relations reports, MD&A, and financial statements should all be based on the same assumptions. The strategic information that management shares with the board may shift to align strategic objectives with ESG program pillars and stakeholder expectations. Directors can also ask how effectively ESG has been woven into the company's culture. Embedding ESG into company values and employee communications will not only help to ensure that it is part of the larger strategic direction, but also demonstrate to stakeholders that there is a strong, companywide commitment to ESG.

4. **Align risk and ESG oversight**
   Sustainability risks are business risks. A study by the Forum for Sustainable and Responsible Investment found that investors with $17.1 trillion in assets domiciled in the United States have adopted sustainable investing strategies, underscoring the link between ESG reporting, risks, and opportunities.[5] These are powerful arguments in favor of adding ESG to the board's risk infrastructure and fully integrating it into the company's enterprise risk management activities.

   There are many factors to consider in adding ESG to the company's risk infrastructure. For many boards, the audit committee is the primary owner of risk oversight. However, it is increasingly common for the audit committee to retain oversight of the company's overall risk management efforts, as well as financial risk.

   The audit committee should coordinate with the board/committee leading the oversight of ESG efforts to understand how ESG risks may already be included on the organization's risk map, who the risk owner is, and which committee is overseeing that risk. In addition, committees should understand which ESG risks are deemed material and should be captured in sustainability disclosures. Audit committees should also understand how ESG risks are being continuously identified.

5. **Understand the company's ESG maturity**
   It is important for boards to understand where the company is on its ESG journey. This assessment can begin with specific questions related to ESG:

   - Are the company's sustainability efforts embedded in strategic decision making?
   - Has the company defined the key elements of its program and performed an ESG materiality assessment?
   - Is the program aligned to recognized standards or frameworks?
   - What disclosures are currently being made, and through what avenues?

[5] Forum for Sustainable and Responsible Investment, "Trends Report" (November 16, 2020).

- Has the company engaged internal audit or obtained assurance?

The company can use an ESG maturity model to assess the development of key elements, including the board/audit committee itself and risk and management controls, as well as ESG and climate reporting and disclosures.

6. Overseeing the adoption of an ESG framework

Given the clear market expectation for standardizing ESG performance measures, companies should consider whether adopting one or more existing standards or frameworks can help them to achieve their objectives. Going forward, the board should be engaged in any standards selection process and should be mindful of alignment that may be necessary based on the selection.

Currently, the leading global ESG standard frameworks include these:

- Sustainability Accounting Standards Board (SASB)
- Climate Disclosure Standards Board (CDSB)
- Task Force on Climate-related Financial Disclosures (TCFD)
- Greenhouse Gas (GHG) Protocol
- Global Reporting Initiative (GRI)

At the recent UN Climate Change Conference in Glasgow, the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB) to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs. The foundation expects to merge the CDSB and the Value Reporting Foundation (VRF, which houses the Integrated Reporting Framework and the SASB Standards) into the ISSB by June 2022. As part of this major standards initiative, other leading investor-focused sustainability disclosure organizations have agreed to consolidate their standards into the new board as well.

Investors have made their ESG expectations known and will likely continue to use their voting power to hold companies accountable for meaningful progress.

7. Assure, disclose, and communicate

Investors tell us that ESG information is not nearly as robust or accessible as they would like. Even for companies with more extensive disclosures, questions arise about the quality, credibility, and reliability of the information. Investors have made their ESG expectations known and will likely continue to use their voting power to hold companies accountable for meaningful progress. If not already being captured, going forward, management should discuss specific investor expectations and plans to address them with the board or committee at least annually.

The merits of an ESG disclosure strategy. Stakeholder needs are continuing to evolve and, as a result, companies need a disclosure strategy that integrates ESG performance into multiple avenues. A carefully conceived disclosure strategy can not only improve the quality of ESG performance information, but also enhance trust and drive business performance. Board members should understand the framework management is using to communicate the

company's sustainability story to specific stakeholders. This includes knowing how ESG metrics are communicated on the company's website, disclosed in a separate sustainability report, or integrated in an SEC filing.

The value of third-party assurance. As ESG gains prominence, there is also an increased focus by stakeholders on the integrity of a company's ESG disclosures. To instill confidence, companies should consider the value of getting third-party assurance on ESG disclosures. Overseeing the quality of both the ESG program and disclosures must be an objective process performed by an independent third party following quality control and professional standards. At the board level, this oversight resides with the audit committee. The CAQ observes that third-party assurance from a public company audit firm can improve the reliability of ESG information and the overall credibility of the disclosure.[6]

CONCLUSION

Given the growing consensus around ESG performance tied to company value, boards have a great deal to consider. With so much riding on the company's successful implementation and governance of ESG, boards will benefit greatly from continuing education as they carry out their oversight responsibilities.

ADDITIONAL QUESTIONS FOR BOARDS TO ASK

- Do we have a clear understanding of how management has assigned ownership of ESG overall as well as the individual components?
- Has management considered establishing a sustainability management committee to align company-wide sustainability goals?
- Has management aligned ESG execution with the enterprise risk management program?
- Have we considered how to coordinate the ESG oversight structure and continual monitoring? How will this process fit in with risk oversight responsibilities?
- Do we have a clear understanding of the company's ESG maturity and steps that the company plans to take to continue to evolve it?

[6] The Center for Audit Quality, "S&P 500 and ESG Reporting" (August 9, 2021).

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Kristen Sullivan


Maureen Bujno


Jon Raphael

Kristen Sullivan is a partner and leads Deloitte & Touche LLP's Sustainability and ESG services, working with clients to help address their sustainability and non-financial disclosure strategy needs. Sullivan also serves as the Deloitte Touche Tohmatsu Limited's (DTTL) Americas Region Sustainability Services leader, the Global Audit & Assurance Climate Services leader, and the Integrated Reporting Community of Practice leader. Sullivan brings extensive experience in delivering sustainability risk assessment, governance, strategy alignment, measurement, reporting and assurance services.

Maureen Bujno is a managing director in Deloitte's Center for Board Effectiveness and the Audit & Assurance Governance leader. As a leading subject matter resource with over 17 years of experience focused on a variety of corporate governance topics, Bujno advises boards, committees, and executives on governance challenges, rules, and leading practices. She is an author and frequent speaker to public and private company boards and other audiences, including significant nonprofit entities, on a broad range of governance topics, including boardroom agenda and hot topics; proxy season and shareholder-related topics; audit committee leading practices; private and nonprofit organizational governance; IPO/SPAC governance; the board's role in risk oversight, strategic risks, and environmental, social, and governance (ESG) issues; and considerations for board service.

Jon Raphael has more than 25 years of financial services, assurance, and controls experience, actively serving many of Deloitte's largest multinational public clients in a variety of roles. Raphael also has diverse leadership experience in ESG, transformation, change management, training, and quality. Raphael is a member of the Audit & Assurance Executive Committee. In his role as the firm's ESG Strategic Growth Offering leader, along with national managing partner for ESG Assurance, he leads our cross-business strategy, enablement/accelerators, and client service delivery of ESG services and related offerings. In his role as the national managing partner for Audit Transformation, he leads a large multifunctional team that is reimagining the end-to-end audit experience through Deloitte's Omnia technology platform, fully enabled by Deloitte's global technology organization.