Governance Insights Center
ESG Series

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ESG oversight: The corporate director's guide

Boards can lead the way on ESG.
Here's how to get there.

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Introduction

For some, the term ESG (environmental, social, and governance) still conjures notions of issues not linked to the financial performance of the company. But given the heightened focus from a variety of stakeholders (including regulators) today and the growing understanding of its impact on performance, ESG is a critical topic in the boardroom.

ESG presents real risks—and potentially even bigger opportunities.

Since we first published our director's guide to ESG in November 2020, much has changed, but the fundamental principle underpinning our guide remains the same—ESG issues are inextricably linked to a company's strategy and need to be part of the board agenda. The most noteworthy evolution since 2020 is that boards, management teams, and shareholders have come to agree that climate-related risks need to be part of the ESG discussion. Further, ESG is recognized as a broad term that captures the non-financial issues that have an impact on a company's financial performance and sustainability. It includes macro topics like climate-related risks and company-specific topics like cybersecurity.

ESG issues will impact nearly all companies in big or small ways. It is more important than ever that boards carefully consider which ESG topics are appropriate for them to oversee. Equally important is the development of governance structures that support effective oversight. Increasingly this looks like spreading responsibilities across standing committees and in some cases tasking a committee with specific oversight for the most material ESG topics for the company.

> "Capital markets benefit us all, powering our economy and making everyday life possible. Businesses can create jobs, families can get credit cards and mortgages, and people can save for retirement because auditors bring trust and transparency to our capital markets. Auditors address today's needs, and we see a future where the profession is leading the way for capital markets to help address large-scale transitions like climate, D&I, cybersecurity, algorithms, data privacy, and more."
>
> - Tim Ryan, Senior Partner and Chairman, PwC US

At the same time that the scope of ESG disclosures have evolved, there has been a momentous shake up in the voluntary and regulated disclosure standards that have defined the boundaries of ESG. Many of the names we have become comfortable with—SASB, CDSB, IIRC—have aligned under the International Sustainability Standards Board (ISSB), an IFRS organization. Further, the EU's Sustainable Finance Disclosure Regulation (SFDR) is starting to normalize financial market participant reporting on sustainability matters globally. Finally, in the US, the SEC recently proposed rules that would require companies to file additional ESG information in their registration statements, Form 10-Ks, and Form 10-Qs.

This guide captures the leading practices that have emerged, and questions that boards should consider when determining the governance structure that is most appropriate for overseeing ESG matters given the company's industry, size, growth trajectory, and strategy.

What is ESG?

Environmental, social, and governance (ESG) is on the minds of many investors and regulators today. It can represent risks and opportunities that will impact a company's ability to create sustainable long-term value. This includes environmental issues like climate-related risks and natural resource scarcity. It covers social issues like labor practices, product safety, and data security. And it involves corporate governance matters such as board diversity and executive pay, as well as operational governance issues such as corruption and bribery.

The table below paints a picture of the breadth of topics that can fall under the ESG umbrella. Not all of them will be relevant or material for every company. For example, a financial services firm might focus more on human capital and data security, while a food and beverage manufacturer may be more interested in how they source raw materials.

A view of the ESG landscape

Environmental Conserving the natural world | **Social** Investing in people & relationships | **Governance** Building trust in society

Climate	Pollution	Waste	Resource use	Employee	Customer	Business model	Business practices	Transparency	Leadership
Carbon emissions	Air	Packaging	Water stress	Basic needs & wellness	Product safety and quality	Operations resilience	Ethics	Tax	Board & management profile
Physical asset resilience	Water	Electronic	Energy management	Diversity & inclusion	Selling practices	Product design & lifecycle management	Competitive behavior	Accounting	Executive pay structure
	Soil	Hazardous	Biodiversity & land use	Hiring & advancement	Privacy & data security	Supply chain management			Purpose and values
	Other	Wastewater	Other	Worker experience		Accessibility			Risk and opportunity
		Other				Community investment			

What is ESG reporting?

ESG reporting is known by many names, including purpose-led reporting and sustainability reporting. Regardless of what it's called, the purpose is to convey how a company is weighing risks and shaping business strategy in the context of ESG issues. It conveys risks and opportunities from both a qualitative and quantitative perspective. To date, most of this reporting has been voluntary. Over time, regulators in some countries have begun mandating the inclusion of certain ESG data, such as targets and policies related to sustainability matters, in their regulatory filings.

As regulations evolve, voluntarily providing ESG information can help burnish a company's reputation. At the same time, withholding ESG information could potentially harm a company's valuation, access to capital, or its brand reputation.

Part 1: Understanding the ESG landscape

Directors have a responsibility to oversee company risk, ensuring material risks are identified, assessed, and mitigated. This includes ESG risks. The board also plays a role in challenging management to think creatively about strategic alternatives and opportunities—including around ESG topics.

In our most recent *Annual Corporate Directors Survey*, 64% of directors say that ESG is linked to their company's strategy, while 62% say ESG is linked to enterprise risk management (ERM). But what exactly does board oversight in these areas look like?

Management teams need a strategic plan that takes advantage of market opportunities and addresses material risks. In its oversight role, the board is responsible for ensuring that the company's strategy is appropriate, takes account of material risks, and is likely to deliver results. Because ESG is grounded in risks and opportunities, the ESG lens is often a more comprehensive way of packaging existing work and analysis.

The ESG investor landscape

Investors tend to view ESG through the lens of long-term value creation. The range of investors incorporating ESG into their process has quickly expanded, including institutional investors; hedge fund, fixed income, private equity fund investors, and more. In addition, a growing population of ESG investors limit their investments to sustainable companies, or take positions in laggard companies with the express intent of improving their ESG practices.

Long-term institutional shareholders

Institutional investors are urging companies to build ESG considerations into their long-term strategy, bringing it up during engagements and sometimes using shareholder proposals to force companies to take action. Some of the world's largest asset managers have used their vote against directors at companies that, in their view, lag on ESG. These investors are leading the call for more disclosures from companies, both qualitative and quantitative, so that they can better assess how the company is addressing ESG risks and opportunities. They want transparent reporting that demonstrates where companies are today and the goals they are striving to achieve in the future.

Fixed income investors and creditors

These investors are generally more focused on risks and are willing to accept a lower interest rate so long as certain ESG key performance indicators are met (or a higher one if they are missed). According to S&P Global, the global sustainable bond issuance is forecasted to exceed $1.5 trillion in 2022.

Hedge funds

Increasingly, hedge funds and other activists are incorporating ESG into their investment strategy. Their focus can range from areas where a company has failed to set or meet goals, lags their peers' practices, or has failed to adequately account for ESG in their strategy. While public campaigns and proxy fights that are entirely based on ESG factors are likely to remain uncommon, ESG is likely to feature in most attempts to influence management and other investors.

Private equity funds

ESG is quickly making it into due diligence and valuation models used by private equity firms impacting the cost and access to capital. Almost half of the respondents to a recent PwC survey say they integrate highly material ESG issues into commercial due diligence when making investment decisions, albeit on an ad hoc basis.

Impact investors

These investors, which can use any of the strategies above, focus on non-financial factors related to ESG topics as part of their analyses to identify risks and growth opportunities. They might focus on ESG risks along with financial performance, or specifically eliminate or select investments based on ethical guidelines. They may also track for positive impact that will benefit society or the environment. They rely on ESG disclosures to inform these investment decisions.

In general, companies with articulated ESG strategies are well positioned to access lower cost of capital, for instance through preferential rates, as more and more investors look to invest in ESG-conscious companies.

Companies must also consider how investors obtain ESG information. Some investors obtain the information directly from the company, while others use ESG data compiled by aggregators or determined by rating agencies (such as proxy advisory firms, ESG raters, and credit rating agencies). Other investors may use the data from these third parties as a basis to support their own independent analysis.

Investors and third parties rely on these ratings and data aggregation tools. As a result, a company's access to capital and debt and their brand perception can hinge on the disclosures it chooses to make.

ESG ratings help inform investment decisions

68% of investors use ESG ratings and scores in their investment decisions

Source: PwC, *Global investor survey*, December 2021.

Analyzing data and third-party raters

Rating agencies: Rating agencies gather data about a company's ESG efforts through direct surveys or through the company's publicly available disclosures. They then provide ESG scores based on their view of a company's risk exposure versus their industry peers. Qualitative and quantitative data inform these ratings. Rating agencies also guide investors through the publication of benchmarking data. And some use their ratings to create ESG indices that might be licensed to asset managers and others to create ESG funds and other financial products. MSCI, Institutional Shareholder Services (ISS), Sustainalytics, and S&P Global are among the most prominent. The methodologies used by these agencies vary and the resulting ratings are not consistently aligned with a particular ESG disclosure framework or set of standards and may not meet the needs of all institutional investors.

Data aggregators: Data aggregators compile and present public ESG data, making it easier for investors to access the data in one place. The prominent aggregators are Bloomberg and Refinitiv. There are also new entrants into this space that use enhanced technologies, such as artificial intelligence, to gather and analyze information and present it in data visualization tools. The most prominent companies here are Clarity AI and Arabesque.

Investor ratings: Some investors, such as State Street Global Advisors (SSGA), have their own mechanism of scoring ESG disclosures. In the case of SSGA, it is called the "Responsibility factor" or "R-factor." They draw on multiple data sources to generate an ESG score for listed companies.

The broader stakeholder landscape

The push by shareholders for more and better ESG information has been a catalyst for action by management and the board. But a company's customers, employees, communities, and suppliers are also typically looking for management to drive value creation, while balancing broader obligations that impact the bottom line. For example, consumer decisions can shape practices. Half of consumer packaged goods growth between 2015 and 2019 came from sustainability-marketed products. During that time, products marketed as sustainable grew seven times faster than those that were not. Employees can also impact company decisions. Companies looking to attract and retain top talent from the next generations have felt this impact as Gen Z and Millennials (who will make up 72% of the global workforce by 2029) show greater concern about where their employers stand on environmental and social issues.

Prioritizing all stakeholders

59% of directors agree that companies should prioritize a broader group of stakeholders in making company decisions (rather than just shareholders)

Source: PwC, *2021 Annual Corporate Directors Survey*, October 2021.

The ESG regulatory landscape

International regulation

Some overseas regulators have already incorporated elements of ESG into their mandatory reporting regimes. US companies operating internationally may already be familiar with the disclosure requirements of foreign regulators.

In Europe, the proposed Corporate Sustainability Reporting Directive (CSRD) will require entities to include mandatory sustainability disclosures in their filed documents. The CSRD aims to bring sustainability reporting on par with financial reporting over time. US companies with EU subsidiaries may be required to provide much more ESG-related information than they are accustomed to at home. This includes disclosure on the company's ESG strategy, targets, and progress, as well as its products and services, business relationships, and supply chain. The first set of draft standards is targeted to be ready by mid-2022. As currently proposed, companies will be expected to report on 2023 information as early as 2024, although there appears to be support to extend this effective date by a year. For a deeper discussion on the CSRD, see *Why US companies should not ignore Europe's ESG proposals*.

What companies are expected to be in the scope of CSRD?

As currently drafted, the CSRD will be mandatory for:

- all companies listed on EU-regulated markets (with certain limited exceptions) and
- all large EU companies, defined as exceeding at least two of the following metrics on two consecutive balance sheet dates:

Total assets
€20m
(about $22.6m as of 12/31/21)

Net revenue
€40m
(about $45.3m as of 12/31/21)

Average number of employees during fiscal year
250

Domestic regulation

The SEC and other regulators/agencies have clearly indicated that disclosure and other rules and regulations addressing ESG topics are among their highest priorities. However, it is also important to note that shareholders' and other stakeholders' expectations for ESG disclosures frequently extend beyond current regulatory requirements. In our current dynamic rulemaking environment, find our latest materials on our Governance Insights Center website, including the following:

- How boards can prepare for the SEC's climate-related disclosures
- How CISOs and boards can prepare for the new era of cyber transparency

> "Today's investors are looking for consistent, comparable, and decision-useful disclosures around climate risk, human capital, and cybersecurity. Companies and investors alike would benefit from clear rules of the road. I believe the SEC should step in when there's this level of demand for information relevant to investors' investment decisions."
>
> - SEC Chair Gary Gensler, September 2021

Part 2: Understanding the board's role in overseeing ESG

Companies that embed ESG into their strategy are better-positioned for success. They can spot growth potential in identifying and managing ESG issues. They can also shape the narrative around their brand and practices while expanding their investor base. So, as companies are starting to think about telling their ESG story and integrating it into their strategy, it's important to think through the "how" of implementation. This includes forming messaging, evaluating frameworks, and crafting disclosures.

If the company is already providing ESG metrics in a variety of places (such as on its corporate website or in social responsibility reports), directors may be well served to step back and consider the existing governance structures and if the messaging is clear and consistent across channels. Is it tied to the company's purpose and aligned with the business strategy? Does it focus on stakeholder needs and address material risks? This section outlines the important considerations as follows:

- Purpose and strategy
- Risks
- Disclosures
- Measuring and monitoring progress
- Using compensation to create incentives

Where does your company fall on the ESG maturity scale?

Grade your company's processes and disclosure to find its ESG maturity level.

Topic/Maturity	Limited	Evolving	Optimizing	Leading
Form of reporting	ESG report* available on company website	ESG report* on company website and references within proxy statement	ESG report,* disclosures on website, references in proxy statement, discussion of key risks and opportunities included in Form 10-K Disclosures are consistent across platforms	Evidence of an ESG reporting strategy across multiple platforms that are optimized for stakeholders that will be consuming the information there Disclosures are consistent across all platforms
Content of disclosure	No disclosure or traditional ESG report* that focuses on philanthropy versus strategy	ESG report* that qualitatively addresses material topics for the company but with minimal quantification	ESG report* aligned with material topics that includes metrics, targets, and a strategy to achieve them with significant quantitative data	ESG report* that describes a clear link between ESG and strategy Robust quantitative data to support disclosures
Use of standards and/or frameworks	None	Considered	Disclosures in line with one or more common standard or frameworks	Clear data table that illustrates disclosures in line with the standards and frameworks appropriate for the company's industry and size, with cross referencing Disclosure of material issues, relative to the standards and frameworks
Policies and procedures around data collection	Limited use of consistent internally documented policies or procedures	Established policies and procedures	Mature policies and procedures that are documented	Mature policies and procedures that are documented and tested
Reporting technology	Primarily manual accumulation from disparate data sources	Combination of manual accumulation and data automation tools	Data visualization and transformation tools are used to gather and analyze data into key metrics ESG data used to produce metrics is stored in a centralized location	Data visualization and transformation tools are used to gather and analyze data collected largely through integrated system automation and in some cases actively monitored Data stored in a centralized location
Internal controls over ESG reporting	Limited documentation of internal reviews	Documented internal quality reviews by preparers, but without a predetermined control structure and environment	Internal audit involved in defining and performing internal controls Subject to at least limited assurance	Mature and documented processes and controls over ESG data Subject to independent assurance with reasonable assurance on all metrics

**Note: ESG report may also be called a Corporate Social Responsibility Report or Sustainability Report.*

Purpose and strategy

A company's purpose is often expressed as the reason it's in business. But it's more than that. A company's purpose needs to be aligned to the overall business strategy—how the company will achieve returns year after year. As companies attempt to serve a diverse group of stakeholders, including investors, employees, customers, suppliers, and communities, it shouldn't come as a surprise that many struggle to balance all those interests. To help, the board and management need to work together to define what's important and measure progress.

The company should ensure that its purpose is reflected through its messaging and activities. And as part of its oversight role, it's up to the board to make sure these things all tie together.

Board considerations:

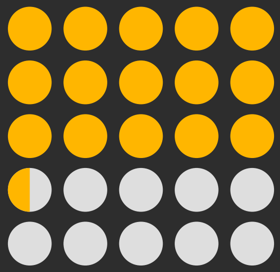
- Has the company clearly articulated a purpose that considers key stakeholder needs and aligns with business strategy?
- Has the company considered how its purpose compares to that articulated by its competitors?
- Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?

Risks

A key part of board oversight is taking a broad view of risk, and that may be harder in areas where management has less muscle memory because they may have less experience thinking of topics in the context of ESG. Environmental and social factors heavily influence some of the thorniest business challenges companies must overcome. These include workforce dynamics, innovating and incorporating new technologies, and supply chain disruptions due to natural disasters.

ESG disclosure standards are still evolving. The SEC and EU each have rules covering some items and not others. There is not a consistent standard boards can look to when building their risk register. One way to ensure that the company has a broad view of ESG-related risks is to review competitor disclosures. Do they discuss compelling ESG risks that the company has not identified?

The universe of identified risks is expanding and as companies improve how they assess ESG risks, the ERM process often needs to change as well. The probability and impact of ESG risks should be captured in the ERM effort. As a result, management will have a structured framework to use to manage and mitigate those risks. Sixty-two percent (62%) of directors say their boards include ESG in their ERM, up from 55% the year before.



ESG and enterprise risk management

62% of directors say ESG issues are a part of the board's enterprise risk management discussions

Source: PwC, *2021 Annual Corporate Directors Survey*, October 2021.

Board considerations:

- Does the company's existing risk processes include identification of any ESG risks? Would expanding the risk identification process lead to a broader scope of risks to be captured?
- Does the ERM process include assessment and mitigation plans for all ESG-related risks that have been identified?
- How does management prioritize ESG risks and opportunities? Are these ESG risks and opportunities included in capital allocation decisions?

Disclosures

Stakeholders want a comprehensive, cohesive story when it comes to ESG. Qualitative ESG messaging should reinforce the company's purpose statement, while quantitative metrics bring that purpose to life and help companies measure their progress toward goals. These ESG metrics also help investors compare companies across industries and set milestones along the way to long-term goals.

To effectively oversee these disclosure efforts, forward-looking boards are focusing on materiality, accuracy, and reliability of data. Materiality is a threshold criteria in deciding which metrics to disclose. But determining materiality for ESG purposes creates its own challenge, as discussed on the next page.

Boards are also concerned with how to ensure the accuracy of the information disclosed. This includes understanding the internal controls in place for both qualitative information and quantitative metrics. And when choosing to adopt a framework or standard that incorporates specific metrics, that consideration is given to the feasibility of meeting the provisions of the chosen framework/standard.

Finally, boards are looking at how they stack up against their competitors. What types of disclosures are they making? Which metrics have they adopted? How do their ratings from third-party agencies compare? Understanding the company's ratings and how they compare to peer companies could also help highlight areas for improvement.

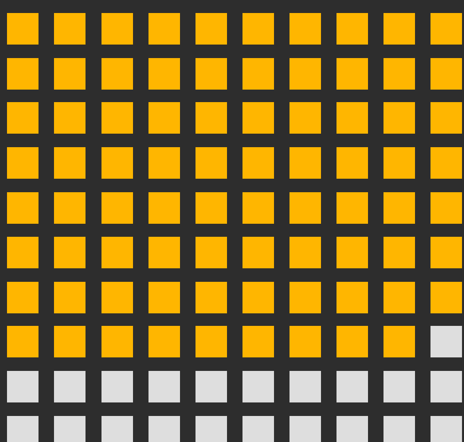
Board considerations:

- How is the company communicating its purpose and its goals in furtherance of long-term sustainable success? Is the company using both quantitative and qualitative information to measure its progress?
- How does the company monitor what competitors are doing, what the rating agencies are reporting, and other benchmarking data?
- Is the company transparently tracking their performance against milestone goals, as well as long-term goals, so stakeholders and others can monitor progress?
- What time periods should be presented in their ESG disclosures? For example, will the company only present current year data, or present a one or two-year comparative?
- Should the information be disclosed in the aggregate, or at a subsidiary level?

Materiality

As discussed in Part 1, investors are paying more attention to the ESG risks and opportunities facing the companies they invest in, and are in many cases using the information available in the market to make buy, sell, hold, and vote decisions. Leading companies are responding by bringing together multiple functions within the organization under close oversight by the board to identify and report on those ESG risks and opportunities that will impact resilience and value creation for the short, medium, and long term.

Today, 90% of the S&P 500's market value is tied up in intangible assets, such as human capital, customer loyalty, and brand identification, on which a company's ESG position can have substantial effects. Determining whether those ESG risks and opportunities will have a material impact on a company's strategy, messaging, risk assessment, and reporting is critical as companies compete for capital, and boards have a key oversight role to play. Additionally, many companies have expanded the population of who they consider the stakeholders beyond investors to include employees, customers, and communities. For a detailed discussion on materiality and the board's considerations, see Appendix A: A deeper dive into materiality.



How investors think about assurance

According to PwC's *Global investor survey*, 79% of respondents agree that they would place more trust in ESG information if it has been assured. Investors generally expect company data to be consistent, comparable, and reliable. They expect it to be developed under a robust system of processes and controls that is assured by an independent third party. The board may want to consider if the ESG data published by the company meets this expectation.

Source: PwC, *Global investor survey*, December 2021.

Reliability of ESG information

Once the company has settled on the qualitative and quantitative messaging it will disclose, the board will want to oversee the process for disclosure. After all, investors will be using this information to analyze the company and make investment decisions.

This starts with assessing the policies and procedures that are in place. The board needs to understand the internal controls over ESG disclosures. Determining that the right controls are in place to ensure consistency and accuracy of reporting is paramount. They may also want to consider stakeholder expectations for whether the company should consider obtaining some type of assurance over the ESG information disclosed.

Board considerations:

- Does the company have robust policies and procedures to support the development of its disclosures?
- Do the company's disclosures adhere to the requirements of particular frameworks or standards? Are disclosures meeting investor expectations?
- Has management found any gaps in the internal controls that support the completeness and accuracy of the disclosures? If so, how do they plan on mitigating those gaps? What is the role of the disclosure committee in the process?
- Would stakeholders be confident with the accuracy of the disclosure without independent assurance? Could independent assurance serve as a differentiating factor among peers?

ESG standards and frameworks

Using standards and frameworks allows for consistent and comparable disclosures, aiding investors in their decisions. Companies find it helpful to have structured guidance to follow, which can also provide a benchmark in support of third-party assurance over disclosed information.

Over the past several years, the set of standards and frameworks being used in the market has expanded and contracted several times, but still leaving companies various options to choose from. In order to make sense of the options, it is important to first understand the difference between standards and frameworks. Generally speaking, standards, which follow a typical process (including receiving public comments), offer specific guidance for measurement and disclosure. Frameworks, on the other hand, provide general guidelines on disclosure. This distinction is important because it gives the company a sense of what level of specificity to expect when adopting a standard or framework. In addition, when deciding the standards and/or frameworks to adopt, it will be helpful to assess the following:

- The scope of the information (e.g., a focus on environmental or all ESG topics)
- Is it industry specific or industry agnostic
- How is materiality considered (financial versus social)
- What is the target audience

While there remains a variety of frameworks and standards in place, some are starting to converge.

The major standards and frameworks:

Name	Standard or framework	Description	Notes
Global Reporting Initiative (GRI)	Standard	Provides ESG standards that address disclosures of socially material topics affecting a company's stakeholders. It also requires that companies determine the issues that are material in consultation with stakeholders. *According to their website:* GRI helps business and governments worldwide understand and communicate their impact on critical sustainability issues such as climate change, human rights, governance, and social well-being. This enables real action to create social, environmental, and economic benefits for everyone. The GRI Sustainability Standards are developed with true multi-stakeholder contributions and rooted in the public interest.	
Sustainability Accounting Standards Board (SASB)	Standard	Recommends topics and metrics for 77 different industries across all three pillars of ESG. These standards provide guidance on how organizations can align their reporting with investor needs and how companies gather standardized data. *According to their website:* The SASB's mission is to establish and improve industry specific disclosure standards across financially material environmental, social, and governance topics that facilitate communication between companies and investors about decision-useful information.	In June 2021, the SASB and the IIRC (see description below) merged to form the Value Reporting Foundation.**
The International Integrated Reporting Council (IIRC)	Framework	Issues an International <IR> Framework which helps companies disclose sustainability information based on financial and other capitals, which include manufactured, intellectual, human, social and relationship, and natural. *According to their website:* The International <IR> Framework and Integrated Thinking Principles have been developed and are used around the world, 75 countries, to advance communication about value creation, preservation, and erosion. The cycle of integrated reporting and thinking result in efficient and productive capital allocation, acting as a force for financial stability and sustainable development.	In June 2021, the SASB (see description above) and IIRC merged to form the Value Reporting Foundation.**

The major standards and frameworks:

Name	Standard or framework	Description	Notes
The Carbon Disclosure Project (CDP)	Framework	Supports various stakeholders by collecting data to measure company risks and opportunities on climate change, deforestation, and water security. *According to their website:* CDP is a framework which focuses investors, companies, and cities on taking urgent action to build a truly sustainable economy by measuring and understanding their environmental impact.	
Climate Disclosure Standards Board (CDSB)	Framework	Provides companies with a framework to disclose environmental and climate-related information at the same level of rigor as that of financial information. *According to their website:* The CDSB Framework sets out an approach for reporting environmental and social information in mainstream reports, such as annual reports, 10-K filing, or integrated reports. The CDSB Framework for reporting environmental and social information is designed to help organizations prepare and present environmental and social information in mainstream reports for the benefit of investors. It allows investors to assess the relationship between specific environmental and social matters and the organization's strategy, performance, and prospect.	See note below**
The Task Force on Climate-related Financial Disclosures (TCFD)	Framework	Provides 11 recommendations across four pillars: governance, strategy, risk management, and metrics and targets. *According to their website:* The TCFD's mission is to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit, and insurance underwriting decisions and, in turn, enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks.	

Note: **The International Sustainability Standards Board (ISSB) is a new board formed by the IFRS Foundation. The goal is to establish a global baseline for reporting, beginning with a focus on climate information leveraging existing frameworks. The CDSB was consolidated into the ISSB. The Value Reporting Foundation will be consolidated into the ISSB. The combined entity will lay the technical groundwork for a global sustainability disclosure standard-setter for the financial markets.

Additional disclosure guidance: A number of business associations have also developed recommendations to help members standardize ESG disclosures within their industries. The National Association of Real Estate Investment Trusts (NAREIT), for instance, produced a guide designed to help members better understand and navigate the ESG reporting frameworks, and the Edison Electric Institute (EEI) launched an ESG template to help member electric companies provide uniform ESG/sustainability information. Separately, the World Economic Forum's International Business Council issued a white paper that outlines a common set of metrics to support consistent reporting.

Board considerations:

- Has the company leveraged various ESG standards and frameworks to help determine whether it is addressing the most significant risks and issues facing the company?
- What considerations were taken into account when deciding on the standard and/or framework to adopt? For example, was the target audience, materiality considerations, and scope considered?
- Is management monitoring changes as certain standards and frameworks converge?

Where to disclose ESG information

Once a company has decided on its purpose, messaging, metrics, and which standards and frameworks to use, it will have to consider where to disclose the information. Among the most common platforms are proxy statements, CSR/sustainability reports, company websites, and annual reports. These choices are informed by stakeholder preferences and peer practices, as well as the liability risk associated with information being filed, furnished, or otherwise voluntarily disclosed.

Disclosure platforms

Proxy statements: More companies are including ESG information in their proxy statements as a way to communicate directly with investors. This disclosure often includes discussion of:

- the ESG risks and opportunities identified by the company, and their areas of focus,
- the governance and operations structures from a management perspective (for example, whether a committee or a specific person is responsible for developing and executing the company's ESG strategy and frequency of reporting to the board),
- how and how often the topic is discussed with various stakeholders, such as whether the topic was specifically targeted for shareholder engagement,
- progress against implementation goals, including the company's current state, periodic milestone goals, and other long-term goals, and
- links to the company's other sustainability information, including reports or materials on the company's website.

CSR/sustainability reports: A sustainability report has been the historic channel for many companies to communicate sustainability performance and impact—whether positive or negative. If a company is planning to use its CSR report to deliver ESG disclosures, be sure to consider whether it includes the ESG risks and opportunities that would be considered relevant to investors, as well as other stakeholders. Also, think about whether the sustainability activities described link to the company's purpose and overall business strategy.

90%

of companies in the S&P 500 publish a sustainability or ESG report

Source: Governance & Accountability Institute, Inc., "90% of S&P 500 Index Companies Publish Sustainability / Responsibility Reports in 2019," July 16, 2020.

Websites: Companies often house ESG information on their websites, with pages dedicated to their sustainability goals and efforts. The websites often include links to additional sustainability information, such as ESG score cards.

SEC annual and quarterly reportings: To the extent issues are material, companies may be required to disclose them in the risk factors, MD&A, or other sections of their SEC reporting.

Earnings calls: Some companies are using their earnings calls to showcase their ESG efforts. This approach allows them to improve corporate communication with investors on material ESG issues and demonstrate how their ESG efforts are embedded in their overall value creation plan.

Board considerations:

- Do the company's disclosures address various stakeholder preferences? For example, a customer or an employee will most likely refer to the company's website for ESG information, while an investor would more likely refer to either corporate responsibility reporting or annual reports.
- Are disclosures consistent across various platforms and appropriate for the different audiences of each? For example, are material risks disclosed in a corporate responsibility report aligned with those identified in the company's Form 10-K filing?
- Is the messaging being incorporated in operational discussions, such as quarterly analyst calls?
- Has the company considered its legal liability when including ESG information in SEC filings?

Measuring and monitoring progress

Initially, investors and other stakeholders were simply looking for data from companies on relevant ESG factors. Then the emphasis shifted to higher quality data and increased types of information. Aligning disclosures with one or more frameworks or standards was sufficient. Today, shareholders are looking for companies to set specific goals and milestones when developing their ESG strategy. They expect a company to track and report its progress against these goals and milestones. Further, they want to understand the governance structures, especially board oversight, that underpin the metrics, goals, and milestones.

Board considerations:

- How does the company determine which metrics, frameworks, and standards will be used for disclosure?
- What ESG commitments has the company made publicly, what is the strategy to achieve the commitments, and how is management monitoring performance?

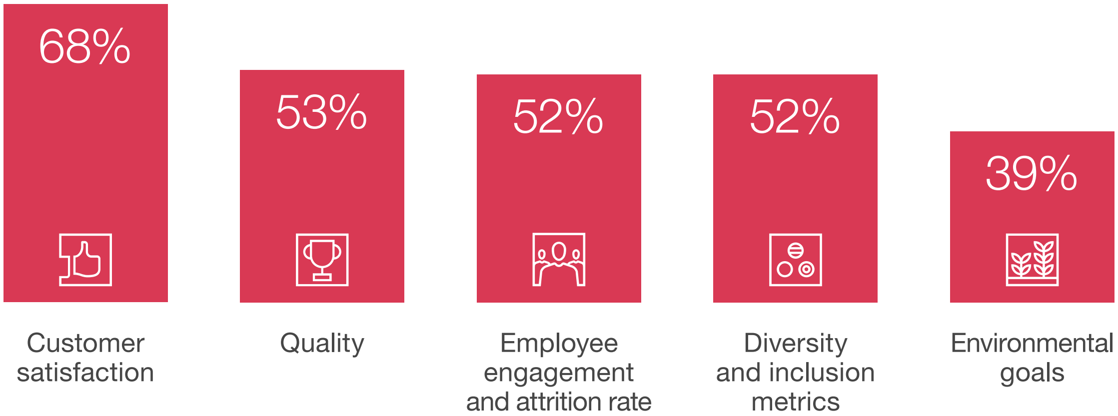
Using compensation to create incentives

Many investors are focused on the connection between ESG goals and executive compensation. By tying incentive plan metrics explicitly to the company's ESG strategy, a company is not only encouraging the achievement of those ESG goals, it is also signaling the importance of those issues. A growing number of shareholder proposals are asking companies to link the two. And a number of large companies have already taken steps to do so.

As boards work to integrate ESG concerns into discussions of company strategy, many are also considering how to create the right incentives for achievement of ESG-related goals. Incentive plans have long been driven primarily by traditional financial goals. That often means quantitative goals related to things like revenue, cash flow, units sold, EBITDA, earnings per share, or total shareholder return. But at many companies, a shift is underway as ESG goals become more common. As of March 2021, more than half of companies in the S&P 500 (57%) used at least one ESG metric in their plans.

ESG metrics tied to executive compensation

In our *2021 Annual Corporate Directors Survey,* we asked directors which non-financial metrics they think should be linked to executive compensation.



Source: PwC, *2021 Annual Corporate Directors Survey*, October 2021.

Board considerations:

- How does the company's compensation practices benchmark against peers as it relates to tying ESG to executive compensation? Do peer companies use ESG metrics, and if yes, what metrics do they use?
- Which goals are important for the company? What are the interim and long-term goals? And therefore, which metrics make sense for the company to use?

For additional considerations on tying ESG metrics to executive compensation, see *Purpose-driven leadership: The evolving role of ESG metrics in executive compensation plans*.

Part 3: Mapping ESG to oversight

Given how broad and complex ESG can be, how exactly does the board go about overseeing this area?

Over the past decade, practices have evolved organically as ESG has evolved from text-heavy corporate social responsibility reports to the investor-grade data and concrete strategies that are expected today. Poor controls over ESG information creates risk for companies, and that risk calls for new controls. More recently, regulatory changes and stakeholder pressure are pushing even more shifts. The board can play an important role in driving the maturity of these governance processes.

Corporate governance or operational governance?

The concept of combining environmental, social, and governance issues into an ESG wrapper often causes confusion. Does 'governance' refer to the traditional corporate governance topics like shareholder rights, board leadership, compensation, and ethics? Or does it refer to the governance systems in place to manage environmental and social risks and opportunities (operational governance)? Both answers can be correct, depending on the circumstances.

The nominating and governance committee is the traditional home for corporate governance matters. Operational governance discussions are likely to be split between the audit committee and the full board. Overseeing the policies, procedures, and controls to ensure accurate public communications is a core competency of the audit committee, whereas discussions of reporting lines, strategy ownership, and execution are more suited for the full board or a standalone ESG committee.

Allocating ESG oversight responsibility

Because ESG strategy should align with business strategy and focus on material risks and business drivers, the full board will want to understand how those risks and opportunities are being addressed. The board will also be interested in how management is using ESG to differentiate the company in the market. If this is a new area of focus for the board and the company, directors may need to assign detailed oversight to specific committees to help the ESG strategy launch smoothly. Ultimately, though, ESG issues will be relevant to all committees.

Equally important to the board oversight structure is how the board and management will interact and where accountability lies within the management team. According to PwC's *Global investor survey*, 66% of investors say that they are more confident that companies are on top of ESG risks and opportunities when someone in the C-suite is accountable. But the scope of ESG topics does not lend itself to a single reporting line. This makes it more important for the board and management to articulate how ownership and accountability is established inside the company. Once they are identified, the board will need regular access to the individuals responsible for developing and executing the ESG strategy.

Board considerations:

- Do we have a committee with the capacity, interest, and skills to take the lead on overseeing the company's overall ESG efforts? If not, will the full board take on this responsibility? Or should we create a new committee or add directors to the board/ committee to fill a skills gap?
- How will the committees stay aligned on ESG? Have committee charters and proxy statement disclosures been updated to clearly communicate the board's allocation of ESG oversight responsibility?

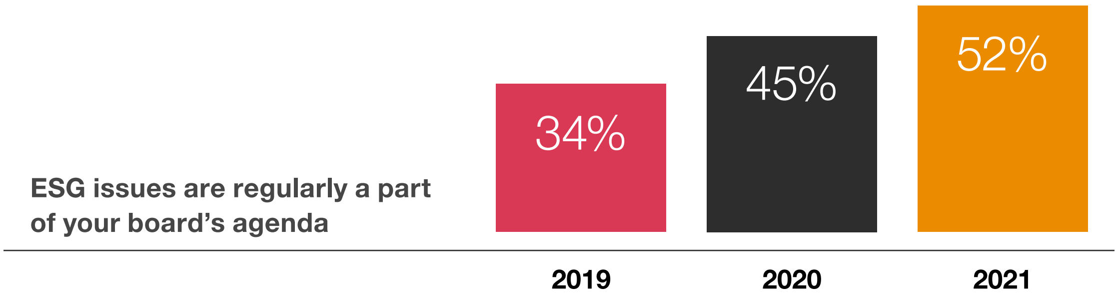
Getting the message across on board oversight

Investors are continuing to expect more and more transparency from boards in how they oversee particular topics, including ESG. In fact, some shareholders may vote against directors if oversight responsibilities aren't explicitly disclosed. Boards can find a number of ways to provide shareholders with the information they seek:

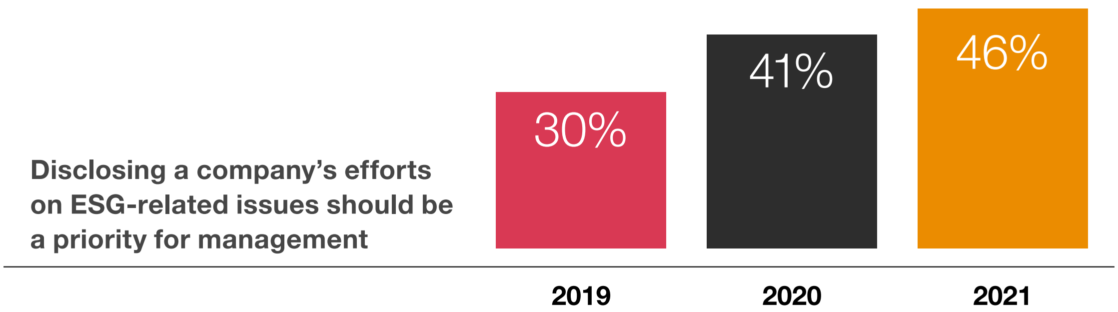
- Robust disclosure in the proxy statement describing the board's oversight efforts
- Updates to board committee charters to address committee oversight responsibilities related to ESG
- Additional information about directors' skills that enhance their contribution to ESG oversight efforts

Directors start to come around on ESG

In 2021, more than half of directors (52%) say that ESG issues are regularly a part of the board's agenda, up from prior years (34% in 2019 and 45% in 2020).



Directors are also much more likely to say that disclosing a company's efforts on ESG-related issues should be a priority for management.



Sources: PwC, *2019 Annual Corporate Directors Survey*, October 2019; PwC, *2020 Annual Corporate Directors Survey, September 2020*; PwC, *2021 Annual Corporate Directors Survey*, October 2021.

Integrating ESG into board oversight responsibilities

Full board

Oversee:

- **Strategy:** Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?
- **Messaging:** Do ESG messaging and activities align with the company's purpose and stakeholder interests?
- **Risk assessment:** Have material ESG risks been identified and incorporated into the ERM? Has the board allocated the oversight of these risks to the full board or individual committees?
- **Reporting:** What is the best communication platform to use for the company's ESG disclosures?

Audit committee

Oversee:

- **Disclosures:** Are the ESG disclosures (both qualitative and quantitative) investor grade? Which ESG frameworks and/or standards are the company using?
- **Processes and controls:** Are there processes and controls in place to ensure ESG disclosures are accurate, comparable, and consistent?
- **Assurance:** Should independent assurance be obtained to ensure ESG disclosures are reliable?

For more information on ESG and the audit committee see: *The audit committee's role in sustainability/ESG oversight*.

Compensation committee

Oversee:

- **Accountability:** Are the ESG goals and milestones effectively integrated into executive compensation plans?
- **Talent and culture:** How is management organized to execute the ESG strategy? Are the right people and processes in place? Does the company have a culture that embraces ESG efforts?

For more information on ESG in executive compensation see: *Purpose-driven leadership: The evolving role of ESG metrics in executive compensation plans*.

Nominating and governance committee

Oversee:

- **Engagement:** Is the company's ESG story being effectively communicated to investors and other stakeholders?
- **Board composition:** Does the board have the necessary expertise and skills to oversee ESG risks and opportunities?
- **Education:** Does the board understand why ESG is important to investors and other stakeholders? Is the board appropriately educated on ESG?

For more information about shareholder engagement and board composition see: *Board composition: The road to strategic refreshment and succession* and *Director-shareholder engagement: getting it right*.

Making time for ESG on the board agenda

In the past, ESG topics and data may have been reviewed by the board on an ad hoc basis, perhaps centered around the publication of proxy materials and an ESG report. However, ESG is now a recurring topic at most board meetings and sometimes in every committee meeting, as 52% of directors say ESG is a regular part of their agendas.

Given the demands and expectations for board involvement in ESG oversight, it's important to create the right cadence. The board needs to regularly hear from management on ESG strategy, reporting progress against goals, and challenges that have arisen. Some topics, such as human capital during a labor crunch, may need frequent updates. By taking a considered approach to spreading responsibilities across the full board and appropriate committees, and setting expectations for management reporting, the board can ensure ESG topics receive the attention they need without putting undue pressure on their time.

Additionally, high-performing boards and directors are always embracing educational opportunities. Because ESG topics are wide-ranging and can be very complex, it's an area well-suited to different types of director education. Many boards engage outside experts to provide the board with briefings and specific training on ESG. Others send directors to intensive programs focused on specific areas of ESG.

Board considerations:

- Which topics have a direct impact on near-term performance or capital allocation decisions? Are there topics the board needs to monitor but don't require direct input?
- Can performance be monitored using a dashboard or does it require time for discussion on the agenda?
- Are there any skills or abilities identified during the board evaluation process that should be prioritized for more intensive board education programs?

Conclusion

Companies have made rapid strides in unlocking the business value of ESG in recent years. The ESG issues a company faces vary widely by industry and company maturity, and there's no one-size-fits-all solution. The rapidly evolving regulatory environment, including the proposed SEC rules for cyber and climate-related disclosures, means that companies should take action now to reduce the burden of future disclosure requirements. Directors have a big role to play in guiding management to allocate the appropriate resources and attention. Forward-looking companies value being a frontrunner on ESG issues because they see the connection to the company's long-term success.

Appendix A: A deeper dive into materiality

Background

As discussed in Part 1, investors are paying more attention to the ESG risks and opportunities facing the companies in which they invest, and are in many cases using the information available in the market to make, buy, sell, hold, and vote decisions. Leading companies are responding by bringing together multiple functions within the organization under close oversight by the board to identify and report on those ESG risks and opportunities that will impact resilience and value creation for the short, medium, and long term.

Today, 90% of the S&P 500's market value is tied up in intangible assets, such as human capital, customer loyalty, and brand identification, which can be substantially affected by a company's ESG position. Determining whether those ESG risks and opportunities will have a material impact on a company's strategy, messaging, risk assessment, and reporting is critical as companies compete for capital. Boards have a key oversight role to play. Additionally, many companies have expanded the population of who they consider stakeholders beyond investors to include employees, customers, and communities.

Materiality in the context of ESG information

When materiality is considered in the ESG context, it often has a broader lens than investor-focused federal securities laws and may consider the environmental and social impacts of a company's activities.

In performing a materiality assessment, it is helpful to think about where a company might disclose and/or communicate ESG risks and opportunities, and the corresponding regulatory requirements, where applicable. Regardless of where it is presented, the information should be developed under a system of processes, policies, and procedures around measurement and reporting to help ensure its completeness, accuracy, and reliability.

In financial statements

For some companies, ESG risks and/or opportunities may have a material impact on the financial statements under the US GAAP financial reporting framework. For instance, a company may be executing on a plan to reduce emissions, which may result in a significant change in the manner in which certain of its physical manufacturing assets will be used. Which could lead to a material impairment which will be disclosed in the financial statements.

In documents filed or furnished to the SEC

Because the time horizon over which ESG-related risks and opportunities will impact a company vary by company and industry, certain risks may exist that don't yet have a material impact on the financial statements but have the potential to be material. Management may choose to disclose these risks in SEC filings because they view them to be important to the company's strategy and/or operations, even if not otherwise required to include them as risk factors. While there is significant judgment in determining what constitutes material disclosure that should be included in an SEC document, federal securities laws provide the context for management to make those decisions.

In other company communications

Reporting on financially material ESG risks and opportunities in the financial statements and SEC documents is targeted at investors and done within the construct of securities laws and US GAAP. There is, of course, other ESG-related information that could be of interest to a broader set of stakeholders that the company may decide to actively monitor, manage, and report on in an ESG or sustainability report, for example.

The factors that influence the financial impact of and investor interest in different ESG risks and opportunities are evolving, and as such, something disclosed in the risk factors section of the Form 10-K today may impact the financial statements tomorrow. Further, the regulatory requirements for reporting are evolving quickly, as shown by the recent publication of the SEC rule proposal on climate-related disclosures and the EU's adoption or proposal of various sustainability reporting requirements.

Over the past several years, strong investor interest has shifted the analysis of how both climate- and diversity-related actions must be assessed for materiality. As such, the assessment of financial and non-financial impacts of ESG issues should not be static. To ensure that materiality assessments reflect the dynamic nature of investor and broader stakeholder concerns and also remain current in this evolving landscape, companies should have a robust process for regularly reviewing their ESG materiality assessments, the factors covered in those assessments (including the applicable regulatory requirements), and decisions about what to disclose and where.

The board's role

It should be noted that not all ESG risks and opportunities need to be discussed at the board level. Given the strong interest of institutional investors, the impact of certain ESG matters on risk assessment, talent recruitment and retention concerns, regulatory changes, and the potential impact on brand value, overall ESG strategy is an appropriate topic for a board to discuss regularly. The level of detail and the balance of time committed to ESG issues will vary by company. Management's judgment about which of the issues to bring to the board should be informed by a materiality analysis. The board should understand management's process for identifying the ESG issues relevant to the company, assessing those issues for materiality, and deciding what to disclose and where. The board should understand and challenge management's materiality assessment process.

The board may want to consider asking management the following questions:

- How has management determined those ESG risks and opportunities that could have a material impact on strategy, operations, or financial performance?
- Beyond investors, which groups of stakeholders is the company accountable to? Is the company considering the interests of employees, customers, suppliers, and communities? Has there been an assessment of how the broader group of stakeholders could impact long-term value?
- How has management assessed what ESG-related information is relevant for each of its stakeholder groups? For employees: the decision to join or stay at the company. For communities: whether to support or oppose a facility in their town. For investors: to buy, sell, or hold the stock. To cast a vote for or against a particular director. To wage a proxy fight.
- Has management engaged with investors and other key stakeholder groups about ESG to inform the company's materiality analysis? For example, have the ESG concerns of institutional investors been considered? Have employees been consulted on which ESG issues are most likely to affect their decisions about employment?
- Is the materiality analysis used as a strategic business tool—to identify both risks and opportunities arising from ESG issues—as well as to guide disclosure decisions, taking into account regulatory and reporting requirements?
- How does management determine the ESG matters to be discussed with and reported to the board?
- What is the process to ensure communications are aligned with the company's purpose and the messaging is consistent across financial and other company reporting?

Appendix B: Summary of board considerations

Topic	Question	Page
Purpose and strategy	• Has the company clearly articulated a purpose that considers key stakeholder needs and aligns with business strategy? • Has the company considered how its purpose compares to that articulated by its competitors? • Are ESG risks and opportunities integrated into the company's long-term strategy? How is the company measuring and monitoring its progress against milestones and goals set as part of the strategy?	13
Risks	• Does the company's existing risk processes include identification of any ESG risks? Would expanding the risk identification process lead to a broader scope of risks to be captured? • Does the ERM process include assessment and mitigation plans for all ESG-related risks that have been identified? • How does management prioritize ESG risks and opportunities? Are these ESG risks and opportunities included in capital allocation decisions?	13
Disclosures	• How is the company communicating its purpose and its goals in furtherance of long-term sustainable success? Is the company using both quantitative and qualitative information to measure its progress? • How does the company monitor what competitors are doing, what the rating agencies are reporting, and other benchmarking data? • Is the company transparently tracking their performance against milestone goals, as well as long-term goals, so stakeholders and others can monitor progress? • What time periods should be presented in their ESG disclosures? For example, will the company only present current year data, or present a one or two-year comparative? • Should the information be disclosed on the aggregate, at a company or subsidiary level?	15

Topic	Question	Page
Reliability of ESG information	• Does the company have robust policies and procedures to support the development of its disclosures? • Do the company's disclosures adhere to the requirements of particular frameworks or standards? Are the disclosures investor-grade? • Has management found any gaps in the internal controls that support the completeness and accuracy of the disclosures? If so, how does management plan on mitigating those gaps? What is the role of the disclosure committee in the process? • Would stakeholders be confident with the accuracy of the disclosure without independent assurance? Could independent assurance serve as a differentiating factor among peers?	17
ESG standards and frameworks	• Has the company leveraged various ESG standards and frameworks to help determine whether it is addressing the most significant risks and issues facing the company? • What considerations were taken into account when deciding on the standard and/or framework to adopt? For example, was the target audience, materiality considerations, and scope considered? • Is management monitoring changes as certain standards and frameworks converge?	17
Where to disclose ESG information	• Do the company's disclosures address various stakeholder preferences? For example, a customer or an employee will most likely refer to the company's website for ESG information, while an investor would more likely refer to either corporate responsibility reporting, annual reports, or proxy statements. • Are disclosures consistent across various platforms and appropriate for the different audiences of each? For example, are material risks disclosed in a corporate responsibility report aligned with those identified in the company's Form 10-K filing? • Is the messaging being incorporated in operational discussions, such as quarterly analyst calls? • Has the company considered its legal liability when including ESG information in SEC filings?	21

Topic	Question	Page
Measuring and monitoring progress	• How does the company determine which metrics, frameworks, and standards will be used for disclosure? • What ESG commitments has the company made publicly, what is the strategy to achieve the commitments, and how is management monitoring performance?	23
Using compensation to create incentives	• How does the company's compensation practices benchmark against peers as it relates to tying ESG to executive compensation? Do peer companies use ESG metrics and if yes, what metrics do they use? • Which goals are important for the company? What are the interim and long-term goals? And therefore, which metrics make sense for the company to use?	23

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner, or a member of PwC's Governance Insights Center.

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