Audit Committee Leadership Network

December 2021

VIEWPOINTS

ESG Oversight and Governance

Environmental, social, and governance (ESG) matters have become a boardroom priority for public companies, including those represented in the Audit Committee Leadership Network (ACLN). Regulators, investors, customers, and society at large are making decisions on the basis of companies' ESG goals and performance, making it imperative that ESG reporting be transparent, high quality, and accurate. Reporting on ESG performance can have a significant impact on a company's reputation and long-term success, as well as on its ability to secure capital, talent, future customers, or license to operate.

Regulators around the globe are demanding that climate risk and sustainability be incorporated into public company disclosures. In the United States, the SEC has signaled that companies should expect new requirements for ESG disclosure. The SEC has also stressed the importance of internal controls on ESG data and disclosures.[1]

Given the increasing importance of ESG reporting, many companies have already tasked audit committees with its governance. Some have created disclosure committees within management, focused specifically on ESG. Companies are leveraging audit committees' experience with financial reporting and internal controls and applying these to ensure that ESG reporting is accurate, reliable, and consistent, as well as compliant with external standards and regulations.

Some ACLN members said that their audit committees are already overseeing assurance of ESG disclosures, including definitions of ESG metrics, measurement methodology, accountability tracking, and the cost of enhanced disclosure. One director said, *"ESG gets to the same kinds of things—internal information and the same kind of controls. Who else is better equipped in the company to do that? The audit committee is best equipped."*[2]

On November 16, 2021, ACLN members met virtually for a members-only discussion on ESG oversight and governance.

A list of participants is provided in Appendix 1 (page 9).

Executive summary

ACLN members discussed the following topics:

- **Oversight of ESG reporting should be a responsibility of the audit committee.** There was a strong consensus that audit committees should handle oversight of ESG reporting, primarily because they have the skills needed to meet external demands for integrity in the reported data. Many members' companies have already tasked their audit committees with oversight of ESG reporting.

- **ESG disclosure committees in management can ensure diversity of perspectives and focus on reporting quality.** Several members described the formation of an ESG disclosure committee or a nonfinancial disclosure committee, separate from their financial disclosure committee. The new committees have broad representation across the company, including not only finance and audit, but also legal, human resources (HR), and investor relations. Many members saw an ESG disclosure committee as a strong practice that they can bring back to their own companies.

- **Cross-functional ESG committees can strengthen linkages around ESG.** Some members took the concept of an ESG disclosure committee further and advocated for cross-functional teams that would manage ESG issues within the organization, similar to a cross-functional risk committee at the executive level. One member said that a cross-functional ESG committee would enable richer discussion, better understanding, and potentially earlier identification of possible issues.

- **Members debated whether Sarbanes-Oxley (SOX) or "SOX-lite" testing is appropriate for ESG disclosures.** Most agreed that the methodology developed to comply with SOX has proven useful, but some members thought that ESG data is different and that it may not be practical to apply the same rigor or standards. One member worried that the SEC may expect a *"very high threshold around the controls and the reporting of this"* and that a "SOX-lite" controls environment could make companies vulnerable to future legal or regulatory actions.

For a list of reflection questions, see Appendix 2 (page 10).

Oversight of ESG reporting should be a responsibility of the audit committee

Members agreed that audit committees should be responsible for ESG reporting oversight. Some said that the audit committees at their organizations were already tasked with ESG reporting, while others noted that they are expecting and preparing for the new responsibilities. Members offered a variety of reasons for this governance decision.

- **Audit committees are skilled in controls and audit methodology and can ensure that metrics are assessed objectively.** One member compared ESG reporting to proxy reporting. A lot of the data in proxy reports comes from HR systems, he noted, but finance and the audit committee review the data and ensure that it has been subjected to the proper controls. The member said that ESG reporting is similar: *"If there is a metric that is being put out there, either as a goal or in terms of performance against that goal, that is something that the audit committee and the finance organization should have oversight on."* This member emphasized that it is important to *"use the expertise of people to do what* *they are good at."* He opined, *"In my view, the audit committee is well placed [to ensure] consistency in reporting and [make] sure that there are controls around reporting."*

Other members agreed. One pointed out that the audit committee at his company applies the same methodology to ESG reporting as to financial data *"in a way that you can demonstrate was done properly and with transparency."* He added that methodology, control environment, and external assurance are in the general purview of the audit committee. At this member's company, an ESG committee determines the ESG metrics, but the process is always done in consultation with the audit committee, which helps assure that the metrics are assessed as objectively as possible.

- **Oversight by audit committees ensures consistency and standardization.** One director said that the nominations/governance committee can serve as a *"coordinating council"* and can make decisions on which ESG metrics to use. Other committees can get involved as necessary, he added, but any information that leaves the company should follow the same standards, and the audit committee is the best place to ensure that. This director said, *"Any report that we put out to stakeholders, and not just investors, really does require audit review."* Another director stressed that oversight by audit committees ensures a level of consistency. He said that ESG should be measured in the same way in all parts of the business, and the audit committee is the entity that can ensure the same methodology is used across the organization. Otherwise, he warned, *"It would be the equivalent of keeping two sets of books, if you're measuring things in different ways. To tell the public that you're measuring them for your own use—I think that's dangerous."*
- **Audit committees are experienced in interacting with the SEC.** Another member noted that *"as ESG gets more regulatorily defined both overseas, in the EU, and in the US, audit will be the place for reporting purposes. It will be the primary jurisdiction."* A director of another company agreed and noted that if the SEC mandates ESG disclosures in corporate filings, other committees might not have the experience or feel comfortable interacting with the SEC. These other committees, this director added, would also have to learn how to respond to comment letters and questions. The member opined, *"I do feel that it's better to leave it in the expert hands of the audit committee, which does this on a periodic basis."*
- **The strategic importance and volume of disclosures may require audit committees' oversight of ESG reporting.** A director said that she is already working with the chair of the ESG committee to ensure the committee is ready for the new reporting requirements. She said that her organization was involved in COP26 and that *"from a strategy standpoint, there's a lot of focus on ESG at the company, and there's a significant amount of disclosure already."* The significance of ESG to the company, its embeddedness in the company's strategy, and the volume of the disclosures has necessitated the audit committee's involvement.

- **Audit committees help link strategy, finance, and operations.** A member pointed out that there are *"cultural reasons"* for tasking audit committees with ESG reporting oversight. He explained that the governance committee at his company works on the ESG strategy, but said, *"You've got to have an effective collaboration between the nuts-and-bolts people and the strategy people. The audit committee, whether or not it's also a risk committee, tends to be a place where you do get oversight of some of the nuts-and-bolts stuff. You get oversight of the priorities of the finance function."* He offered an example from his company, where the finance function is going through modernization and the audit committee brings a perspective as to how *"ESG data is going to have to flow into that kind of system."* Audit committees, he suggested, offer a balanced view and ensure that *"all aspects are brought to the table."*

Finally, a director emphasized that the audit committee is *"where this skill set resides on the board to most effectively fill this role."* This director asked, *"If not us, then who?"*

ESG disclosure committees in management can ensure diversity of perspectives and focus on reporting quality

Two members said that their companies formed a separate ESG disclosure committee that operates parallel to their companies' disclosure committees. One explained, *"We talked about whether to bring ESG into our already standing disclosure committee; we decided that ESG might get lost in the shuffle. I wanted some real focus on it."* The member's idea of forming a stand-alone ESG disclosure committee encountered initial resistance from management, but this changed after the committee began its work.

The director said that the committee now includes finance and audit, but also legal, human resources, and investor relations. It is cochaired by the head of investor relations and the chief accounting officer. The director stressed that this diversity is necessary and reflects *"how ESG pervades and permeates almost every dimension"* of a company. In addition, the cochairs bring in different and vital perspectives, with one chair having expertise in what investors are looking for in ESG disclosures and the other being knowledgeable in the kinds of controls and systems that are necessary.

This director also observed that this composition of the ESG disclosure committee enables the education of its members and facilitates culture change. He added, *"Some of the culture change happens just by having people at the table and observing and participating in some of these discussions … It's just the value of getting people who ordinarily weren't engaged on a regular basis on ESG, and all of a sudden they realize, 'Well, wait a minute, we haven't thought about this, have we? And what about this piece over here?'"*

Another member described a new ESG disclosure committee with participation from audit, human resources, legal, the corporate secretary's group, and investor relations, as well as the ESG leader in government affairs, the chief accounting officer, the head of internal audit, and a legal executive. The member views the committee as *"an equivalent"* to the company's financial disclosure committee.

One director said that her audit committee carries a large load of responsibilities around reporting on social issues. Disclosures on the "S" dimension of ESG at her company, because of its industry sector, are substantial. This member thought that an ESG disclosure committee would be good practice for her own company: *"Having a nonfinancial disclosure committee is something that we have not really thought about, and it is something that I'll take away from this conversation."*

Cross-functional ESG committees can strengthen linkages around ESG

One member said that his audit committee will have a role in making sure data is accurate, but that he was concerned about *"how we make sure that all parts of the company, and I think about it in management terms for now, are tied together around ESG."* He noted that the model of the ESG disclosure committee that had been described during the meeting did not include operations and engineering, *"people that are at the forefront of actually designing, justifying, implementing the projects that will drive better environmental performance,"* and added, *"I think that's a really important linkage."*

The director wondered whether the evolution around risk management at companies might be a useful model for ESG. In the past, he said, risk discussions were siloed, but *"as we started talking about what the risks are and how we mitigate them, the work began with accounting and legal people, and over time it has blossomed out to include people from all segments of the company, and this has led to much richer discussions, understanding, and early identification of issues."*

Another member saw parallels between ESG and enterprise risk management (ERM). She noted that ERM is discussed in her audit committee, but that the audit committee is not responsible for everything ERM related. The member said that ERM is discussed at joint cross-functional meetings. She envisioned ESG evolving in a similar way at most companies: *"Policy and process around [ERM] in a lot of boards are not held within the audit committee, but [the audit committee] is one of many committees that have responsibilities … There will be opportunities where we will have joint committee meetings around ESG issues, just like we have around ERM issues."*

Other members agreed that a cross-functional management committee may be desirable. One said, *"I absolutely think that it needs to be a cross-functional effort from many, many perspectives because there's no single lens on this. We've been talking about an investor lens, but … you know there's going to be many lenses on this, and without getting to more commonality, it's a struggle."* This member said that ESG is part of her company's overall strategy and that *"it touches on things, even advertising or client commitments, that may not* *be a part of public reporting but may become part of your clients' expectation in their own reporting."*

Members debated whether Sarbanes-Oxley (SOX) or "SOX-lite" testing is appropriate for ESG disclosures

A member said that some level of internal controls and testing will be needed for ESG reporting, especially if the SEC requires ESG disclosures in filings. Most members agreed that SOX methodology could be helpful if applied to ESG, but they differed on the level of testing that would be needed for ESG data.

One member observed that ESG data is different and said, *"I don't know that we can apply the same rigidity or exact standards or approach, but I do think that the methodology around SOX is useful."* He added that ESG data should be subject to similar processes: the data should be examined for *"where it comes from, is it reliable, is it useful, is it repeatable."* Because ESG data is different, he said, that he is not uncomfortable with the idea of SOX-lite controls. He said: *"it's really more the idea that we need to be able to test and confirm ESG data."*

Another member, however, thought that the new SEC disclosure rules would require *"a very high threshold around the controls and the reporting of ESG."* A third observed that the SEC had already made the comment that *"if you think it's important enough to put it in your ESG report, why is it not important enough to put in your quarterly and annual filings?"*

One director said that the ACLN discussion around ESG governance and reporting did not imply a "SOX-lite" regime to her. She observed that the conversation had focused on a number of risks and concerns, and she worried about legal actions related to ESG, as well as about meeting the controls expectation that the SEC might have for companies.

A member noted that when SOX came into force, companies had needed to create and maintain compliance documentation and make it available to auditors. It is unlikely, she said, that this requirement would be any lighter for ESG reporting. Another member opined, *"If they're important enough to make a disclosure around them, you're going to have to put some pretty significant control structures around them."* He added that companies already report information that is not in their financial statements, including automotive deliveries, transferrable subscription rights, and numbers of subscribers. He observed that these already have strong control structures around them *"because the last thing you want to do is report on one of those and then, the next quarter, have to restate it."* The member advised companies to gear up to produce a single statement integrating financial and nonfinancial information: *"It may not be that everything we put into an ESG report ends up in an SEC filing, but a lot of what's material is going to end up in your quarterly or annual report."*

A director shared her concern that companies would need time to prepare for the change and to build a control environment for auditable ESG data and reporting. She emphasized that companies will need a *"ramp-up period."*

ESG governance models and approaches among member companies

A 2021 EY Center for Board Matters report found that among Fortune 100 companies, responsibility for ESG resided in different locations: 85% have designated a board committee to oversee ESG matters; 53% task the nominating/governance committee with ESG oversight; 13% say that their public policy committee carries the responsibility; 11% have created a sustainability committee to lead on ESG issues; and 3% have made ESG an audit committee responsibility.[3]

ACLN members reported a similar variety of approaches, describing different levels of coordination and cooperation between their boards and within their organizations as they seek to ensure company-wide alignment around ESG targets and to provide accurate sustainability reporting. In many member companies, nomination and governance committees are tasked with policy and oversight for ESG. In some companies in heavily regulated sectors, responsibility for ESG has been given to a compliance and regulatory committee. Companies with established risk committees—banks, for example—have tasked such committees with the oversight of ESG risk. Other boards have created new structures to drive the ESG agenda. These include sustainability or ESG committees and disclosure committees focused specifically on ESG reporting.

Members also described a variety of forms of collaboration around ESG strategy and reporting. A human resources group might focus on the social dimension of ESG and drive reporting on issues like diversity, equity, inclusion, and safety. In some cases, public policy and governance committees have partnered with human resources to oversee disclosures on that agenda.

But many members said that governing ESG is not easy and has required substantial evolution in their companies. One remarked, *"We want to do good. The idea of being carbon neutral is right. How do you go about doing it?"* Another member noted that ESG reporting has also been a challenge: *"Our job is to ensure that what we say is true. In the absence of accepted accounting principles, that is very problematic. The purpose of reporting is undercut if people don't believe the disclosures made."*

Conclusions

Members agreed that models of ESG governance vary across companies and sectors. However, they envisioned that audit committees are or will soon be leading on ESG reporting. Members offered examples of good practices that can be helpful as companies prepare for new SEC disclosure requirements on ESG: establishment of an ESG disclosure committee alongside companies' financial disclosure committee and a cross-functional ESG committee to bring together perspectives and capabilities around ESG issues. Getting ESG reporting right is important not only as a response to investors' and stakeholders' pressure and evolving regulatory requirements but also because, as one member pointed out, ESG reporting is part of a company's *"continuity of knowledge":*

> *The people that are sitting around the tables today and tomorrow and probably five years from now will not be around when those tickets get punched. Having processes, … written disclosures, and … the documentation that's needed is going to be imperative so that we understand what decisions were made, why they were made, how they were anticipated to flow over time, so that you've got that continuity of knowledge going forward.*

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

Appendix 1: Participants

The following members of the ACLN participated in part or all of the meeting:

- Eva Boratto, UPS
- Barbara Byrne, ViacomCBS
- Janet Clark, Texas Instruments
- Dan Dickinson, Caterpillar
- Dave Dillon, 3M and Union Pacific
- Sam Di Piazza, AT&T
- Bill Easter, Delta Air Lines
- Gretchen Haggerty, Johnson Controls
- Charles Holley, Amgen and Carrier Global
- Michele Hooper, United Airlines
- Akhil Johri, Boeing and Cardinal Health
- Kelly Kramer, Gilead
- Nick LePan, CIBC
- Mike Losh, Aon
- Suzanne Nora Johnson, Pfizer
- Louise Parent, FIS
- Ann-Marie Petach, Jones Lang LaSalle
- Kimberly Ross, Cigna
- Tom Schoewe, General Motors
- Leslie Seidman, GE
- John Stephens, Freeport-McMoran
- Fred Terrell, Bank of New York Mellon
- Jim Turley, Citigroup and Emerson Electric
- John Veihmeyer, Ford
- David Weinberg, The Coca-Cola Company

The EY organization was represented in all or part of the meeting by the following:

- John King, Americas Vice Chair – Assurance, Ernst & Young LLP
- Stephen Klemash, Leader, EY Americas Center for Board Matters, Ernst & Young LLP
- Patrick Niemann, Partner, EY Americas Center for Board Matters, Ernst & Young LLP

Appendix 2: Reflection questions for audit committees

- What are the roles of the audit committee, nominations/governance committee, and compensation/talent committee in ESG-related policies and disclosures?
- How are these committees coordinating their activities?
- What are your views on forming a sustainability committee or an ESG committee?
- Is ESG governance at your company concentrated in a single committee, or more widely distributed within the board? What challenges have you seen?
- What is the role of the audit committee in ESG governance in your organization?
- What key factors drive change in the audit committee's role?
- To what extent is your audit committee working to add ESG skills to its capabilities?
- How will the role of committees around ESG evolve?

Endnotes

[1] See Securities and Exchange Commission, *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operation* (Securities and Exchange Commission: Washington, DC, 2020).

[2] *ViewPoints* reflect the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from conversations with network members in connection with the meeting.

[3] EY Center for Board Matters, *What Boards Should Know about ESG Developments in the 2021 Proxy Season* (Ernst & Young LLP, 2021), 5.