The audit committee’s role in sustainability/ESG oversight

How audit committees can stay ahead of the curve

Because ESG encompasses strategy, risk and opportunity, the board plays a vital role. But ESG is a broad topic, and the board should consider assigning various aspects of oversight to specific committees. Here we outline the role the audit committee can play in overseeing ESG disclosures.

August 2022
Why the hype about ESG disclosures?

In recent discussions about environmental, social, and governance (ESG) issues, large institutional investors have been the loudest in the push for greater corporate transparency. Investors want to know how companies are addressing ESG risks and opportunities because of their potential impact on shareholder value. They are using the ESG information offered by companies in their investment process and decision-making.

Environmental issues such as climate change and social issues such as racial injustice and inequality can affect a company’s cost of capital, long-term growth prospects, and ultimately, its viability. That may be one reason why 31% of S&P 500 companies cited “ESG” when discussing business strategy on their earnings calls for Q4 2021—the highest in at least the past 10 years.

Another group of stakeholders, global and national regulators, are also upping the ante on ESG reporting. In Europe, the European Commission has proposed expanding its Corporate Sustainability Reporting Directive rules to include large, unlisted companies. This change would more than quadruple the number of businesses that must disclose detailed ESG information. In the US, the SEC proposed disclosure rules on climate change and cybersecurity, with proposed human capital management disclosure rules expected later this year. It also established a Climate and ESG Task Force at the Division of Enforcement to investigate material gaps or misstatements in corporate disclosures under existing rules. All of this activity illustrates the elevation of ESG as an important topic for boards and companies.
The audit committee’s role in ESG reporting

All of these developments are accelerating the gathering and disclosing of ESG information as a business imperative. **Forty-three percent (43%) of directors** say their boards have assigned ESG oversight to the entire board. Where ESG is a new area of focus for the board, directors may additionally need to assign detailed oversight of different components of ESG to specific committees. As the demand for ESG disclosures rises, the audit committee has a critical role in overseeing management’s development of investor-grade ESG disclosures.

Who oversees ESG?

As companies fulfill these demands, they need to select the ESG metrics that are material value drivers for the business. They must also ensure the ESG data they disclose is accurate and reliable. This requires developing policies, processes, internal controls and governance similar to those they have for collecting and disclosing financial information. Because the audit committee has the most experience overseeing these kinds of matters, it is best positioned to oversee ESG disclosures, controls, processes, and assurance.

The audit committee’s expertise in financial reporting enables it to understand and assess the soundness of the methodologies and policies management is using to develop its metrics and other ESG disclosures. They can also help determine whether a company’s internal controls are sufficient for ensuring the accuracy, reliability, and consistency of the data over time.

Note: 2% responded None/Not applicable
What to consider when thinking about materiality

Background

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 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.

Material considerations globally

European and other international regulations tend to think about materiality differently. The view here is that companies should balance financial materiality against the interest of all stakeholders, not just shareholders. This “double materiality” covers:

- **Financial materiality** – how ESG issues will impact a company’s financial performance and ability to create long-term value.
- **Social materiality** – how a company’s actions impact people and the planet.
Overseeing ESG disclosures

As investors and other stakeholders push for more ESG information, companies have already increased their disclosures voluntarily. US companies often provide this information in standalone sustainability reports, on their websites, in regulatory filings, and stakeholder presentations. Although 92% of S&P 500 companies publish annual sustainability reports, stakeholders continue to apply pressure. They want higher-quality, more consistent ESG disclosures that comply with recognized standards and frameworks.

To address the disparate reporting among companies, some of the world’s largest institutional investors have publicly expressed support for moving to a single global standard. Several have encouraged companies to report their ESG information using the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB). But without rules-based reporting requirements, companies have many options. (For information on other standards and frameworks, see ESG oversight: The corporate director’s guide.)

When approaching ESG disclosures, management must first determine which ESG information is material to their company’s operations and performance. Then, they should choose the most appropriate places to make the disclosures. This could be a sustainability report, a regulatory filing such as a form 10-K, or on their corporate website. Finally, because companies often disclose ESG information in several places, management needs to ensure the information is consistent across platforms.
Overseeing ESG processes and controls

Some companies are realizing they don’t have the technology systems and information-gathering processes in place to comply with the demands for greater ESG disclosure. They often track this data in spreadsheets with little uniformity around the types of information they gather. The lack of standardization makes it challenging to produce reliable data that can be consistently replicated. For companies to go from limited to leading, they will need real-time reporting and analytics, as well as effective policies and compliance monitoring.

That’s why the ESG information a company discloses should be collected, consolidated, and disclosed with the same rigor as financial information. This means setting standards and policies to establish and maintain robust governance. The SEC has also emphasized the need for disclosure controls and procedures for ESG metrics included in SEC filings. These cannot be developed overnight. They need to be designed, documented, and tested to ensure they operate as intended. Information technology options to gather ESG data are limited today, but evolving quickly.

Throughout this process, management can call on internal audit for guidance. Using their knowledge of the company’s operations and their competencies in processes and controls, internal audit can make recommendations about processes, control design, and data governance. It can also help with compliance and monitoring consistency and comparability by benchmarking the company’s efforts against its peers.

To oversee ESG processes and controls, the audit committee may want to ask the following questions:

• How is the company collecting ESG information?
• What are the data collection policies?
• What controls are in place to ensure that ESG information is reliable and complete?
• What additional resources may be necessary to implement new ESG processes and controls?
• How is the disclosure committee involved in the process?
• What is internal audit’s involvement? What are their findings and recommendations?
On the horizon

Financial statement impacts

As companies invest in technology, research, and development to meet their ESG objectives, it will impact their cash flow and financial statements. For example, as car companies make net zero commitments, they may need to develop new or transform existing manufacturing plants to build electric vehicles.

Initiatives of that size would require approval from the full board. But once the board has signed off, it’s the audit committee that needs to pay close attention to the details of these investments and how they might get reflected in the financial statements.

How will these projects be financed? Is management taking advantage of the tax credits and incentives provided by federal, state and local governments to encourage companies to integrate ESG into their strategy? Those are just a few of the questions the audit committee should be asking.

Another issue the audit committee will need to monitor is how management is accounting for new types of assets, like carbon offsets, that aren’t covered by US GAAP rules.

The audit committee can also ask:

• How will the company’s ESG commitments impact its financial statements?
• Has management communicated, through disclosure, its forecasted projections and necessary investments in financial statements?
• How is management keeping up with regulatory changes in these areas?
• What is the plan for evaluating the return on sustainability investments?
• Has management considered the impact of strategy changes on the useful lives and valuations of existing assets?
To better oversee ESG assurance, the audit committee may want to ask the following questions:

- Have investors or other stakeholders requested assurance over the ESG reporting? If so, have they indicated what level of assurance they prefer?
- If the company includes ESG information in its SEC filings, how has management considered the impact some level of assurance might have on stakeholder confidence in the disclosures?
- How is management keeping abreast of new and emerging regulatory assurance requirements?

Overseeing ESG assurance

Obtaining some level of independent assurance (either reasonable or limited assurance) builds confidence that the information disclosed is accurate and reliable. Yet in 2020, 44% of S&P 500 companies had some or all of their sustainability information subject to some sort of third-party assurance. More recently, the European Commission adopted a proposal that requires companies subject to its Corporate Sustainability Responsibility Reporting Directive to have the ESG data they disclose subject to an independent limited assurance engagement.

Because the EU has generally been ahead of the US in its ESG reporting requirements, it could signal what’s on the horizon for other jurisdictions. So although nearly 70% of US directors think the current system of voluntary ESG reporting and disclosure is preferable, it might be prudent to prepare for mandatory reporting, especially given the SEC’s proposed rules on climate change and cybersecurity. With the increasing global focus on climate change and investor pressure for better ESG reporting, we anticipate a shift to mandatory reporting that may require some level of assurance.

Don’t forget the charter

When an audit committee begins to oversee ESG processes, controls, disclosures, and assurance, it should update its charter to reflect the new responsibility.
Conclusion

As companies continue to integrate ESG into their strategies, they will need input from the full board. Boards that leverage the audit committee’s financial disclosure oversight expertise by assigning them the responsibility to oversee ESG disclosures can get ahead of the growing demand for this information. Enhanced ESG disclosure is a trend that’s only going to intensify in the coming years as regulators respond to rising concerns about the impact of environmental and social issues on business operations and performance.

Contacts

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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