An aerial photograph of a dense forest with a road running through it. The trees are mostly green, with some lighter green and some bare trees. The road is a dark grey asphalt road that curves slightly to the right. The background is a dark green gradient.

A CORPORATE BOARD MEMBER/EY RESEARCH REPORT

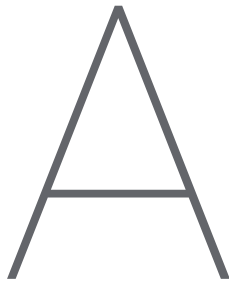
# FOUR OPPORTUNITIES FOR ENHANCING ESG OVERSIGHT

Steps public company boards can take to strengthen their effectiveness and meet stakeholder expectations

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growing number of companies are embracing environmental, social and governance (ESG) matters as a strategic business imperative. They recognize ESG's potential to build long-term competitive advantage, enhance resiliency to accelerating sustainability risks and attract socially and environmentally conscious investors, talent and customers. In view of the surge in sustainable investing and evolving investor stewardship practices, companies also see ESG's value in accessing capital and proactively addressing matters that could attract hedge fund activists.

The journey to integrate ESG into strategy and risk management, however, can be challenging. Companies—and individual directors—are at different points of travel. Some companies are advancing existing ESG strategies with the full support of the board. Others are at the starting point of identifying the ESG factors that are most salient to their business and working to understand how various investing and social trends are shaping the business context in ways that strengthen ESG's relevance.

Further complicating the journey, markets are still in the process of defining how to effectively measure and report ESG performance, with ongoing market-driven and regulatory developments accelerating the pace of change and impacting stakeholder expectations.

To better understand where companies are on this journey and how boards are integrating matters of ESG into their overall governance of risk and strategy, Corporate Board Member worked with the EY Center for Board Matters to survey nearly 400 public company directors in February and March of 2021 on their perspectives, practices and forecasts for ESG.

Data from the survey shows that most directors are approaching ESG as a compliance matter rather than as a strategic opportunity, and a number of them lack confidence in their understanding of shareholders' expectations related to environmental and social factors. Understanding which ESG issues are material to the business is somewhat challenging for many directors, particularly for those who say their companies have not yet performed a sustainability materiality assessment. While most directors confirmed that their companies are reporting ESG information externally, only about a third of them say their company has controls in place around the collection and disclosure of material ESG information.

This report examines these findings and offers four opportunities for boards to consider as they enhance their ESG oversight.

■ **Four opportunities for enhancing ESG oversight:**

- 1. Shift from a compliance to a strategic mindset
- 2. Know the ESG factors that matter most to the business
- 3. Consider expanding key board committee responsibilities to include ESG
- 4. Oversee how the company is telling its ESG story

## SHIFTING FROM A COMPLIANCE TO A STRATEGIC MINDSET

A growing number of companies view ESG through the lens of strategic opportunity and risk mitigation. They are using carefully defined ESG priorities to shape an ESG strategy that drives long-term business value. This forward-looking approach positions them to capitalize on ESG investing trends and competitively differentiate their firms. This approach is triggered by their recognition of the profound shifts impacting their business, such as climate impacts and the energy transition, the transformation of work, changing consumer sentiments, and investor and employee preferences.

Yet, data from the research shows that many directors are approaching ESG largely as a compliance matter. On average, 53 percent<sup>1</sup> say they are considering ESG issues only because compliance, disclosure obligations and shareholder pressure compel them to do so—and another 21 percent say they don't believe these issues materially impact their business value. Only 25 percent view ESG as an area that presents risks and opportunities for the business.

Our survey also found that while directors are confident about their shareholders' expectations when it comes to governance, they are less so in regard to environmental and social factors. When asked to rate their understanding of their shareholders' ESG expectations, directors rated their understanding of governance expectations a 4.1 out of 5 (with 5 indicating greatest understanding) and their understanding of social and environmental expectations a 3.4/5.

Shifting from a compliance to a strategic mindset will require deepening the board's ESG knowledge. Bringing external insights into the boardroom through board education programs can help the board understand ESG-related trends that may affect the company's business, including market-driven and regulatory developments, evolving stakeholder expectations and megatrends.

Investors are looking to understand how the board is obtaining this external view and enhancing their fluency on ESG. In EY conversations with more than 60 institutional investors in the fall of 2020, a point heard consistently is the opportunity for boards to access more external expertise to help management look forward and see how business trends and stakeholder expectations are changing over time, especially around fast-developing issues such as ESG.<sup>2</sup> Of course, engaging shareholders directly is also a valuable way for management teams and directors to better understand investor perspectives on the company's ESG profile and leading market practice.

<sup>1</sup> Average proportion of directors across the environment, social and governance areas.

<sup>2</sup> What investors expect from the 2021 proxy season, EY Center for Board Matters, February 2021

### Which of the following best describes your view of ESG?

	Environment	Social	Governance
I don't believe it materially impacts our company's business value	26%	16%	21%
Compliance, disclosure obligations and shareholder pressure compel us to consider it	55%	57%	46%
I believe it presents risks and strategic opportunities for the business	20%	27%	33%

### On a 1-5 scale, please rate your understanding of your company's shareholders' expectations as they relate to ESG matters: [1 = Low understanding/5 = Great understanding]

Shareholder expectations on **G: 4.1**

Shareholder expectations on **S: 3.4**

Shareholder expectations on **E: 3.4**

## KNOWING THE ESG FACTORS THAT MATTER MOST TO THE BUSINESS

Shifting to a more strategic ESG mindset will also require a deeper understanding of the ESG issues that matter most to the business. ESG is an incredibly broad topic whose definition continues to evolve and expand as developments related to technology, society and the planet generate new and changing risks and opportunities for business. But not every ESG factor will be relevant to the business model and value proposition of every company. The key to unlocking ESG's value is to identify and prioritize the specific set of ESG factors that intersect with the business.

Our survey found that determining which environmental and social issues are truly material to the company and its stakeholders—and that may present untapped opportunities—is somewhat challenging for many directors. For example, while 83 percent of directors say they are very confident in their understanding of the material governance issues facing their company, less than half feel that level of confidence in their understanding of the company's material environmental issues.

A fundamental step in determining what environmental and social factors matter most is having management conduct, and the board oversee, a sustainability materiality assessment. This assessment involves engaging with a company's most important stakeholders to identify and prioritize the ESG topics that are most relevant to the business and where the company can make the most meaningful impact. This is a critical early step as it helps companies filter the excessive number of ESG issues into a more manageable set upon which to focus.

Using the ESG topics identified by the materiality assessment, the board can then oversee an ESG strategy that addresses opportunities while managing risks related to the company's ESG profile. These opportunities may relate to innovation and creating products and services with sustainability attributes; considering ESG in capital allocation, supply chain, partner choice and investment decisions; enhancing brand reputation; building better relationships with stakeholders; and achieving competitive market differentiation.

Data from the research shows that many companies either had not performed a sustainability materiality assessment to identify and prioritize ESG topics

### How confident are you in your personal understanding of the material ESG issues facing your company?

#### GOVERNANCE



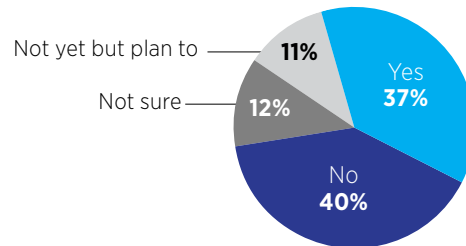
#### SOCIAL



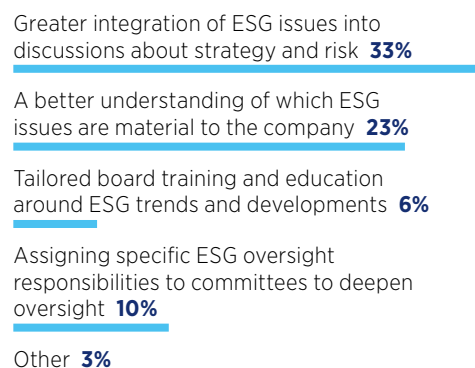
#### ENVIRONMENT/SUSTAINABILITY



### Has your company performed a sustainability materiality assessment to identify and prioritize the ESG topics that are of highest priority to the company and its stakeholders?



### Which of the following would most enhance your board's current oversight of ESG matters?



\* Respondents were asked to select only one. 17 percent of respondents said no change was needed. Percentages may not add up to 100 due to rounding.

(40 percent) or the directors were unsure if such an assessment had taken place (12 percent).

Directors' views on what would improve their oversight of ESG matters reflects the potential value of a materiality assessment. When asked what would most enhance their board's current oversight of ESG matters, the top two answers were greater integration of ESG issues into discussions about strategy and risk (33 percent) and developing a better understanding of which ESG issues are material to the company (23 percent)—both of those actions are enabled by a robust materiality assessment.

### SPOTLIGHT ON CLIMATE RISK AND WORKFORCE DIVERSITY

Climate risk and workforce diversity, equity and inclusion (DEI) are among the top investor stewardship priorities for 2021. When EY researchers spoke with more than 60 institutional investors in the fall of 2020, around two-thirds of them said they will ask their portfolio companies for robust diversity disclosures inclusive of the workforce and boards, calling DEI central to a company's ability to innovate and embrace change.

Additionally, around two-thirds of investors said they are pressing for corporate action and disclosures on climate change, citing it as a systemic risk that will broadly impact sectors and markets in different ways across the globe. Further, as part of its increased focus on disclosures related to ESG matters, the SEC will be assessing compliance with and updating the Commission's 2010 guidance on climate-related disclosures. Taken together, these developments are bringing increased scrutiny of how boards are executing related oversight of these areas.

The 2021 board survey shows that most directors feel they have an excellent or adequate understanding of company-specific risks and opportunities related to climate and DEI. However, given the increasing level of stakeholder scrutiny, for many directors these topics are still ripe for enhancing competence and confidence. For example, only 30 percent of directors feel they have an excellent understanding of company-specific risks and opportunities related to climate change and the energy transition, and around half say the same about risks and opportunities related to DEI. These are also areas where more directors acknowledged a need for improvement.

	EXCELLENT	ADEQUATE	NEEDS IMPROVEMENT	NOT A RELEVANT ISSUE FOR THE COMPANY
Stakeholder views on core governance practices (e.g., voting structure, director election practices)	61%	32%	5%	2%
Stakeholder views on board composition and refreshment	54%	39%	6%	2%
Other workforce issues beyond DEI (e.g., workforce stability, health & safety, training & development, labor relations)	43%	48%	8%	1%
Workforce diversity, equity and inclusion (DEI)	49%	37%	12%	2%
Other environmental issues (e.g., natural resource management, recycling, circular economy)	25%	52%	17%	7%
Climate risk/energy transition	30%	47%	15%	9%

## CONSIDERING EXPANDING KEY BOARD COMMITTEE RESPONSIBILITIES TO INCLUDE ESG

How boards exercise their environmental and social oversight responsibilities varies across companies. Tailoring the board's approach to the company's specific circumstances is important. Committees can play a vital role in deepening board focus and directing appropriate attention to various environmental and social areas, which can supplement the full board's oversight of how these matters are integrated into strategy, talent and risk management.

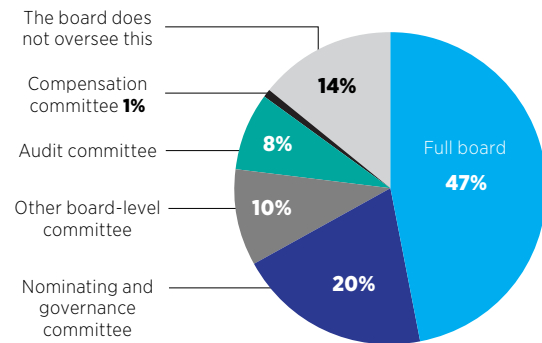
Data from the survey shows that some companies are starting to expand the mandates of the nominating and governance committee and the compensation committee to include environmental and social oversight responsibilities. For example, 20 percent of directors say oversight of climate-related risks and opportunities primarily resides with the nominating and governance committee. Similarly, 27 percent say workforce DEI oversight responsibilities primarily reside with the compensation committee.

These findings generally align with EY research from 2020, which found that 37 percent of Fortune 100 companies assigned oversight of human capital to the compensation committee, and 47 percent assigned oversight of environmental sustainability to the nominating and governance committee (often more broadly encompassing both environmental and social matters).

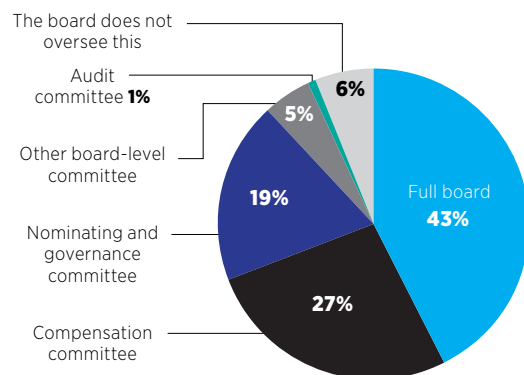
Expanding the purview of the board's key committees aligns environmental and social oversight responsibilities with the core work of those committees and may better integrate related matters into overall governance. For example, the nominating and governance committee can focus on addressing the expectations of stakeholders and making sure that material environmental and social issues are integrated into the full board and committee responsibilities and areas of expertise.

Notably, the research shows that an impressive 82 percent of the boards represented discuss ESG as a part of board composition, refreshment and evaluation discussions. The compensation committee can oversee the alignment of environmental and social goals to executive pay to drive strategic progress and align executives to the long-term focus of the organization. This should include overseeing

### Where does oversight of climate-related risks and opportunities primarily reside within your board?



### Where does oversight of broader workforce diversity, equity and inclusion primarily reside within your board?



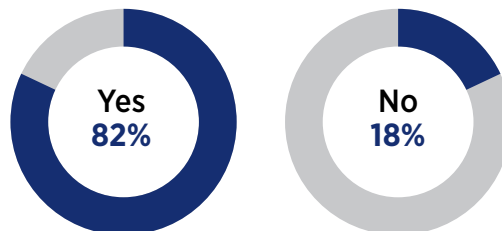
\*Percentages may not add up to 100 due to rounding.

that proxy materials provide a clear rationale for how ESG goals are incorporated into the executive pay program or, if they are not incorporated, why.

The audit committee can oversee ESG disclosure processes and controls and obtain internal and external assurance over ESG reporting. This work at the committee level supports full board oversight of ESG integration into strategy and risk management.

While expanding the mandates of the key committees may more effectively integrate environmental and social matters into the work of the board, some boards may choose to create a separate sustainability committee or an environmental, health and safety committee to explicitly focus on ESG risks and opportunities. The most effective structure may change over time based on the advancement of the company's sustainability journey and changes in its business. The board assessment process can help provide a regular check on whether committee responsibilities or structure should change and can uncover opportunities for strengthening environmental and social governance through full board and committee agendas and the board education program.

**Is ESG discussed as part of board composition, refreshment and evaluation discussions?**



## OVERSEEING HOW THE COMPANY IS TELLING ITS ESG STORY

ESG reporting provides stakeholders a more comprehensive view into how companies are delivering and protecting value. ESG disclosures are also becoming an increasingly important data set for mainstream investors that are integrating related factors into their investment and stewardship decisions.

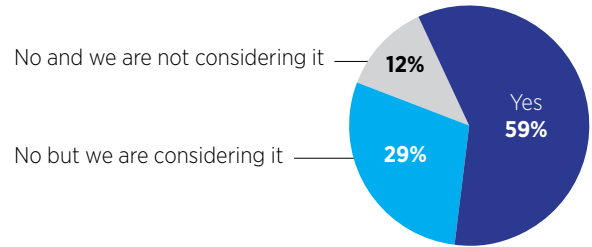
Among the directors participating in our research, 59 percent say their company reports ESG information externally, which shows a recognition among most companies of the value of telling their ESG story. Nevertheless, this still leaves opportunity for many companies to tell a more comprehensive, long-term value story to the market. Absent companies telling their story, third-party ESG data and ratings providers will do it for them, often using estimates for unreported data and thereby penalizing companies for the lack of disclosure. Companies must own their ESG narrative.

Among the directors who say their companies are already reporting on ESG externally, 58 percent say their companies provide a stand-alone ESG/sustainability report, with others relying on the annual report, company website or proxy statement to make ESG disclosures. Twenty-eight percent of directors say their companies are incorporating ESG communications into earnings calls.

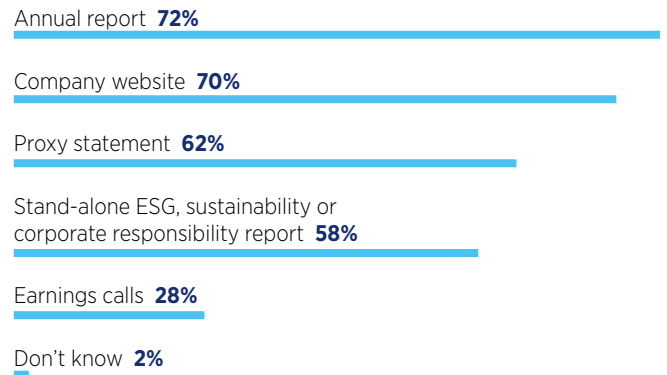
While different company communications will target different audiences and have different objectives, all communications should articulate a clear, consistent, long-term strategy for value creation. ESG disclosures should tie into the narrative coming from the rest of the company's external reporting. Companies may ask themselves, for example, how the risk factors in the 10-K align with the ESG risks discussed in the sustainability report, or how the sustainability report aligns with what companies are highlighting on earnings calls. The board can play an important role in overseeing the consistency and clarity of the company's ESG narrative.

Disclosures should align to investor expectations and needs, and what investors have stressed most is that they want ESG disclosures to focus on what is material and align to external frameworks. They seek a baseline level of standardized data to support relevance, objectivity and comparability. Nearly all

### Does your company report ESG information externally?

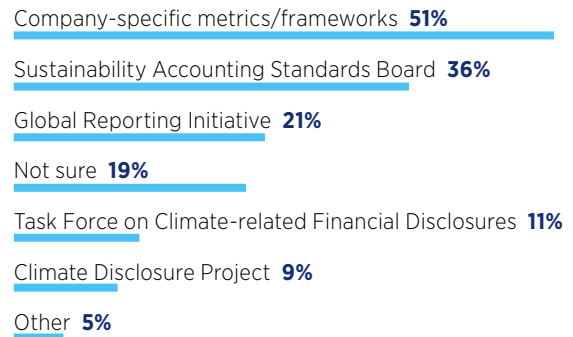


### Which of the following channels does your company use for ESG reporting?



\* Respondents were asked to select all that apply.

### If your company currently reports ESG information externally, which framework(s) or metrics do you use?



\* Respondents were asked to select all that apply.



the investors contacted by EY researchers in a recent investor outreach cited the Sustainability Accounting Standards Board (SASB) as a decision-useful framework. Notably, SASB's standards are geared to help companies disclose sustainability information based on their sector that is financially material.

However, the 2021 research indicates that company-specific metrics are the most popular disclosure approach across our survey group. Notably, 19 percent of the directors participating in the study say they aren't sure what frameworks or metrics are used.

Another critical consideration for ESG reporting is that companies need to have robust disclosure processes and controls in place, including those related to data quality. Sustainability reports are often created by a different part of the organization from where financial reporting is done, so the controls and discipline might not be of the same rigor and the sustainability report may not receive the same level of attention. Involving internal audit and obtaining internal and external assurance will help the company provide credible, quality ESG data to the marketplace and build stakeholder confidence in the reliability of this information.

Among the surveyed directors who say their companies are already reporting on ESG, 35 percent note that their companies currently have controls in place around the collection and disclosure of material ESG information, and 21 percent say the company is obtaining external assurance over its ESG reporting. Notably, 74 percent of these same directors say their companies are integrating ESG information into regulatory filings.

With stakeholders increasingly relying on ESG data to make informed decisions, it is paramount that companies develop robust governance policies regarding this information. Our survey shows that a majority of companies that are reporting on ESG are in the process of developing such policies. Boards, and particularly audit committees, can play a crucial role here through their oversight.

### Where is your company in its development and implementation of controls around the collection and disclosure of material ESG information?

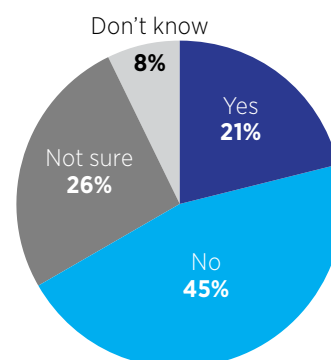
We have them in place **35%**

We are in process **59%**

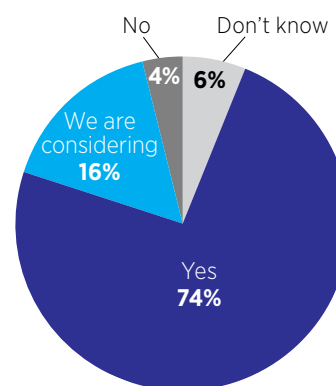
We have not started **3%**

Don't know **3%**

### Does your company obtain external assurance over its ESG reporting?



### Does your company integrate ESG information into its regulatory filings?



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## GOING FORWARD

It would be difficult to overstate the level of stakeholder interest in company ESG practices and performance. The topic has largely dominated much of the discourse around corporate governance in the past year, with near-continuous market-driven and regulatory developments accelerating the pace of change and shaping stakeholder expectations. This context has created a steep learning curve for directors, executives, investors and other stakeholders who are navigating this new landscape. The survey results reflect opportunities for boards to continue to deepen their knowledge and enhance their oversight of ESG to help guide their companies through these dynamic, disruptive times.

### Questions for boards to consider

- How is the company's strategy and risk management meeting the needs of key stakeholders, addressing financially material environmental and social factors, and driving competitive advantage?
- How is the board learning about ESG-related trends and developments that could impact the business and affect shareholder support for the board and management?
- How would a sustainability materiality assessment help inform the company's strategy and strengthen relationships with key stakeholders?
- Would assigning ESG oversight responsibilities to board committees enhance the board's governance?
- How do company communications increase the brand value of ESG initiatives and meet investor needs for decision-useful ESG information?
- Is the company taking the same approach to nonfinancial data as it is to financial data in terms of disclosure processes, controls and obtaining external assurance?

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