Overseeing Environmental, Social and Governance (ESG) Matters: A Framework for Boards of Directors

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Preface

The Corporate Oversight and Governance Board (COGB) of the Chartered Professional Accountants of Canada (CPA Canada) has commissioned *A Practical Framework for Oversight of Environmental, Social and Governance (ESG) Matters by Boards* to help directors oversee organizational performance of ESG matters.

The focus on ESG matters is continuing to grow, with increased attention being paid by a wide variety of stakeholders. Boards need to be knowledgeable and engaged in the oversight of ESG matters. Recognizing that this is a vast and complex area, this document provides a practical step-by-step approach and related resources that boards at any stage of their ESG oversight journey can benefit from.

CPA Canada would like to thank the COGB board members and staff who provided input to this project. We would also like to acknowledge Mr. John E. Caldwell, CPA, CA for generously sharing his time and expertise in advising on this project.

Corporate Oversight and Governance Board

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Executive Summary

This document provides a practical step-by-step framework for the boards of directors of public companies to follow for their oversight of environmental, social and governance (ESG) matters, and includes examples of the types of matters that are relevant in each of the ESG categories. The ESG oversight framework is designed for boards of large, medium and small companies. In fulfilling their oversight role, we expect that boards will need assistance from management, for example to determine what ESG matters are important for the company, to develop relevant goals and standards and to conduct assessments of progress against those goals and standards. As a result, this framework can also serve as an important resource for management when engaging in discussions with boards regarding their oversight of ESG matters.

The Growing Importance of ESG in the Boardroom

Canada's net-zero emissions target, civil society's response to our systemic social justice issues, and the economic and social impacts of COVID-19 have raised the awareness of ESG matters, and they have become an important focus for companies. The global pandemic has brought many of these issues to the forefront, amplified their impact and created the impetuses for change. Investors, governments, the media, special interest groups and civil society have clearly signaled that a concerted focus on ESG has become foundational for the resilience and benefit of any organization.

In response to the challenges related to sustainability reporting, there has been increased momentum towards global standardization. The IFRS Foundation confirmed their intent to establish an International Sustainability Standards Board (ISSB) with the following strategic direction:

- Focus on information that is material to investors, lenders, and other creditors.
- Initially focus effort on climate related matters, while working toward meeting the information needs of investors on other sustainability matters.
- Build on well-established work of the Task Force on Climate-related Financial Disclosures (TCFD) and alliance of other frameworks and standard setters.
- Work with standard setters from key jurisdictions, to provide a globally consistent and comparable sustainability reporting baseline.

The formal announcement of the new board is planned for November 2021 at the United Nations COP26 Conference.

What Is the Role of the Board in ESG Oversight?

ESG matters present both risks and opportunities to companies. From a board's perspective, it can be challenging to understand how to carry out its oversight role in this area. Primarily boards are responsible for ensuring ESG matters are considered in the organization's strategy and for exercising effective governance of ESG matters.

The Board's ESG Journey

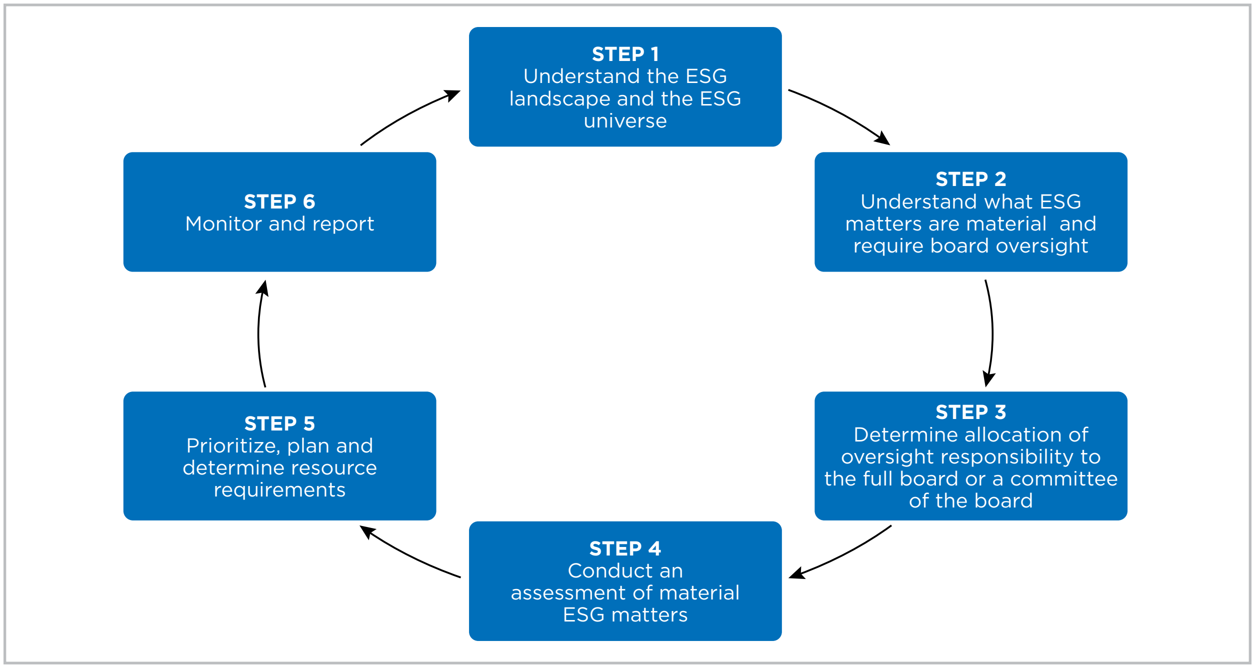
Each board (and individual board member) will be at a different stage in their ESG journey, including having different levels of maturity and resources with respect to its oversight of ESG matters. For example, boards at an earlier stage of their ESG journey, may not yet have the appropriate data available to effectively assess the company's performance with respect to certain ESG matters. As a result, it may take time to complete all the steps set out in the ESG oversight framework. Nevertheless, the ESG oversight framework provides a useful tool for boards at all stages of their ESG journey.

The ESG Oversight Framework

An Overview

The ESG oversight framework (as summarized in **Diagram 1**) provides a step-by-step approach to the oversight of ESG matters by boards, from how to develop an understanding of what types of ESG matters may be relevant to the company, to setting targets, measuring progress and thinking through considerations related to reporting.

DIAGRAM 1: SUMMARY OF THE ESG OVERSIGHT FRAMEWORK



ESG matters and their related oversight can be far-reaching and complex. Therefore, there is no one-size-fits-all approach. Each board may want to adapt the ESG oversight framework to suit its needs and those of the organization (for example, by performing the steps in the order that makes the most sense in their current circumstance).

The execution of the ESG oversight framework is not a one-time exercise. Rather, it is an iterative process occurring over time. As the organization and the board evolves in its engagement and oversight of ESG matters, it should periodically revisit and update prior assessments to ensure relevancy. "*Materiality is dynamic: factors that are initially not material may become material over time*," (CPA Canada, 2020) which highlights the need to periodically revisit previous materiality assessments conducted in **Step 2** of the ESG oversight framework. The dynamic nature of materiality is discussed in more detail in Canadian Securities Administrators' Staff Notice 51-333 *Environmental Reporting Guidance*.

Step 1: Understand the ESG Landscape and the ESG Universe

At the outset, boards should first recognize that ESG consists of three distinct categories. As a first step for ESG oversight, the board should gain a broader understanding of the landscape for each category and the current and emerging trends.

The board, with the assistance of management, and potentially external subject matter experts, should identify the broad universe of topics for each category – environmental, social and governance. We will refer to the numerous topics that may fall under these three categories as the "ESG universe."

As a starting point to assist board members, we have provided examples of the types of topics that may fall under each of these categories (as shown in **Diagrams 1 to 3**).

Key considerations

The ESG universe is expansive and the matters that are relevant may differ from company to company. For each example provided in the sample ESG universes below, there may be other categories and sub-categories that have not been identified in this document. If a particular matter is relevant or important to the company, then the board, with the assistance of management and experts, should use available resources to "drill-down" and develop a deeper understanding of the topic.

Consider environmental and social impacts and dependencies across the value chain from product design to delivery, use and end-of-life disposal. For example, in the fashion industry, you may consider how the company's products are being designed to limit water usage and to incorporate the use of sustainable fabrics.

DIAGRAM 2: ENVIRONMENTAL MATTERS – A SAMPLE UNIVERSE

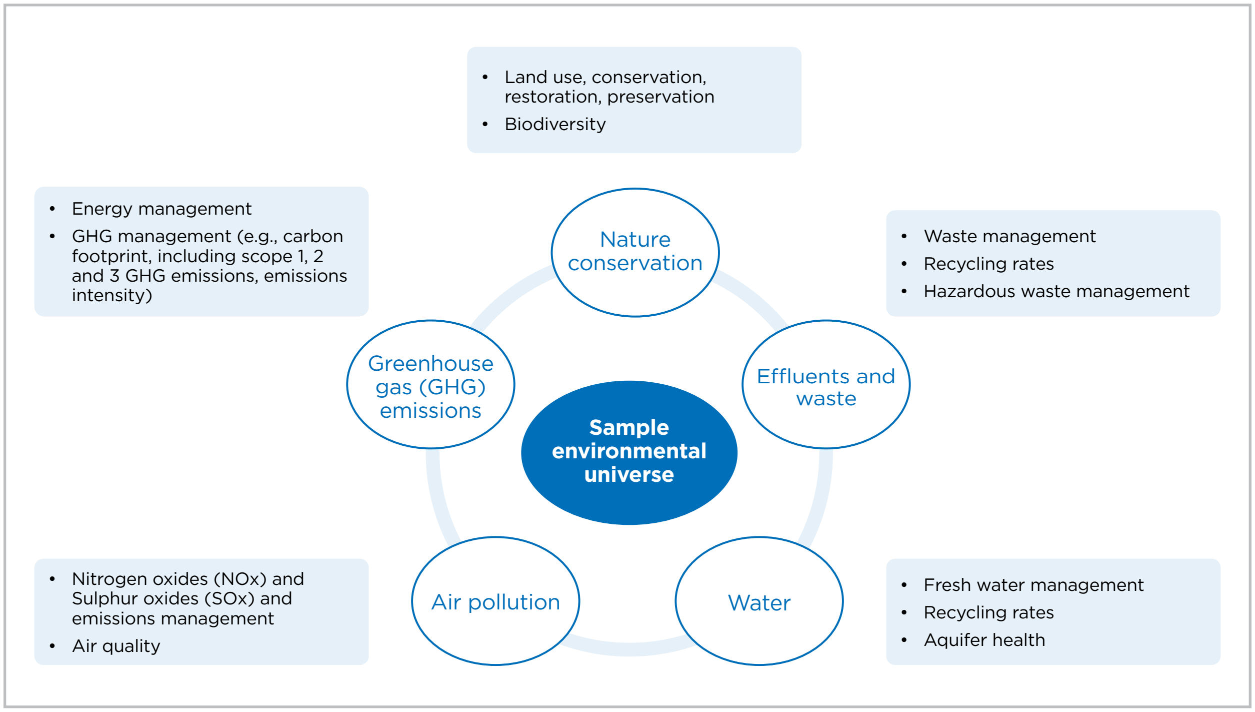


DIAGRAM 3: SOCIAL MATTERS – A SAMPLE UNIVERSE

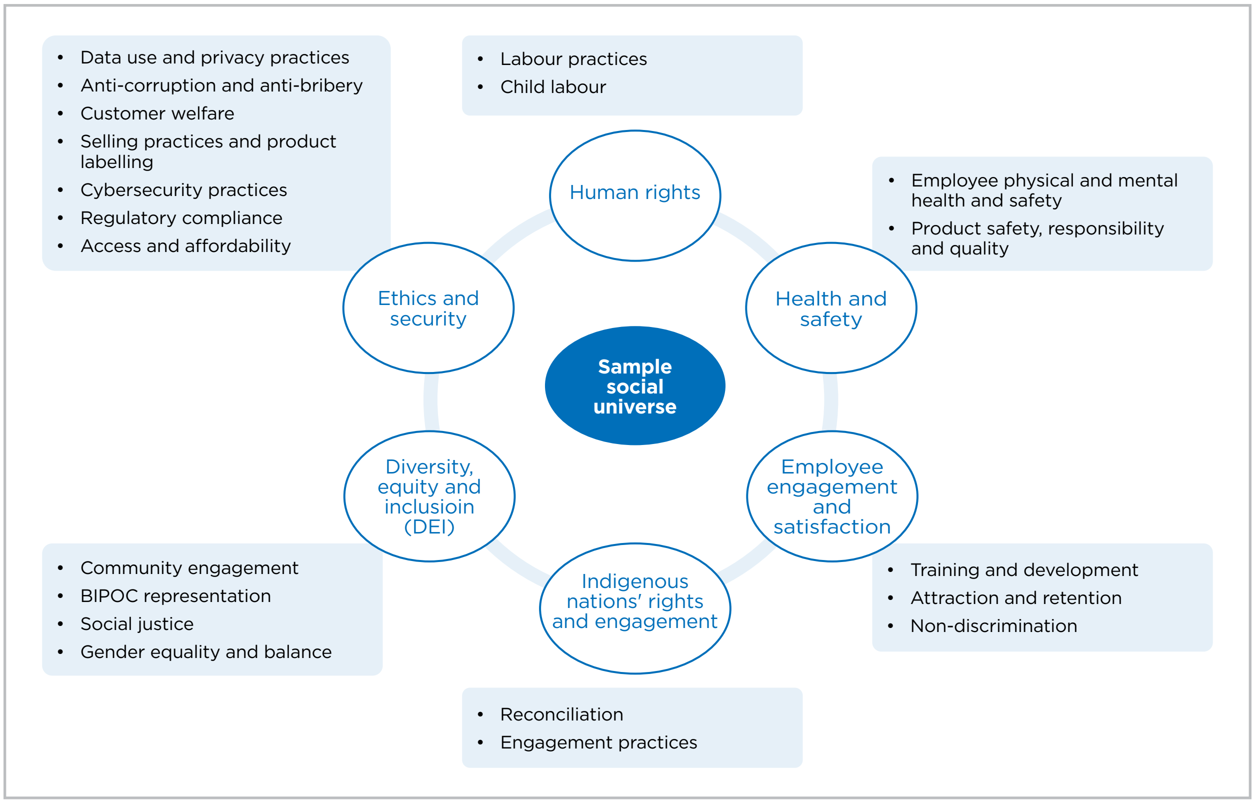
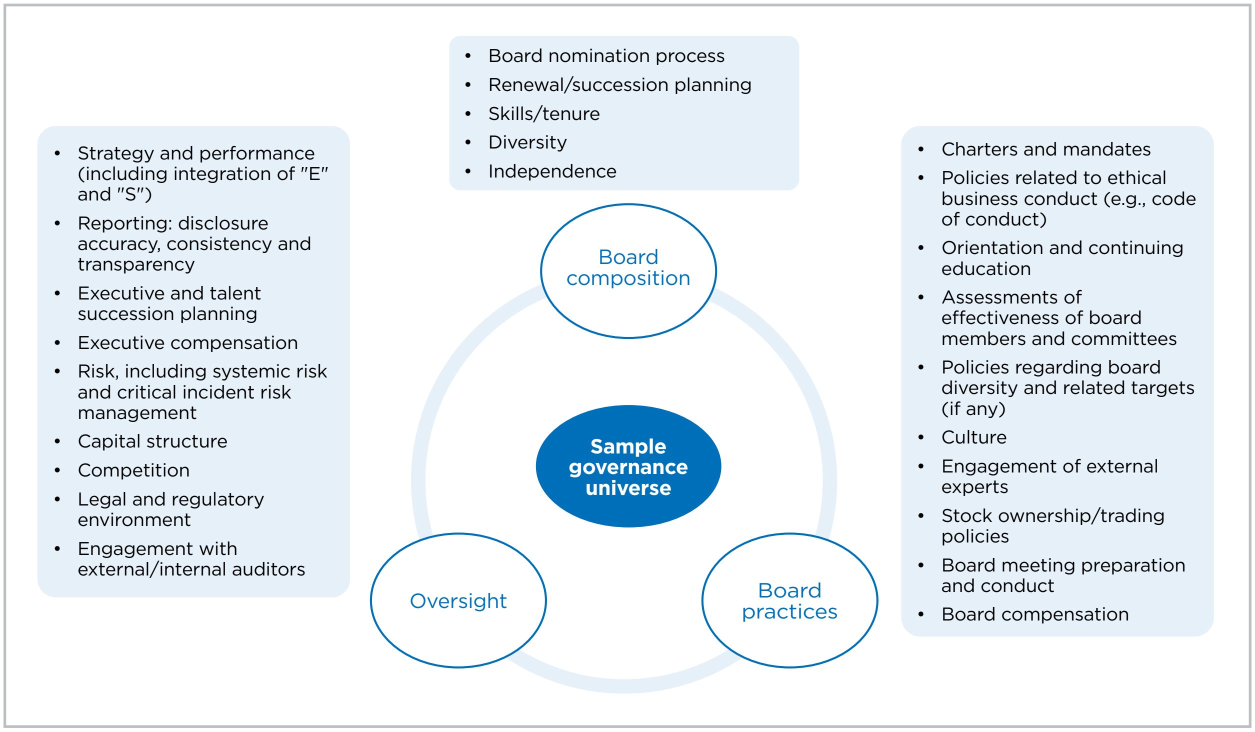
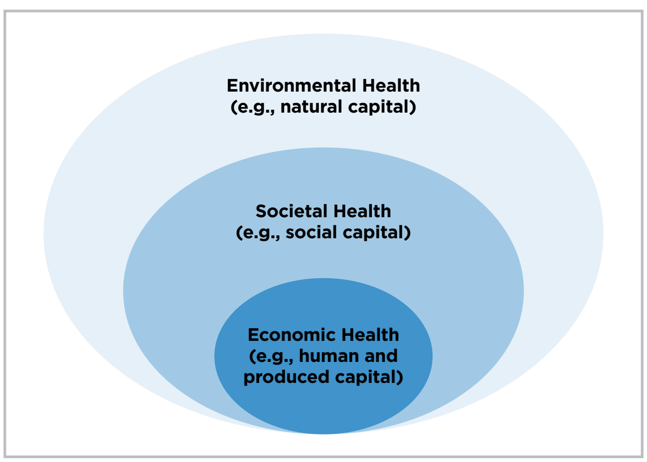


DIAGRAM 4: GOVERNANCE MATTERS – A SAMPLE UNIVERSE



Understanding how it's all related

DIAGRAM 5: INTERDEPENDENCE OF ENVIRONMENTAL, SOCIAL, AND ECONOMIC WELLBEING



The health of our environment (e.g., natural capital) and the trust and cooperation built across the value chain with stakeholders such as customers, business partners and regulators (e.g., social capital), underpin our economic wellbeing and prosperity (Eltobgy & Guillot, 2021; Locke et al., 2021), as shown in **Diagram 5**. Due to the interdependence of our environmental, societal and economic wellbeing, organizations are seeing and experiencing overlapping risks and opportunities. For example, climate change is not only an environmental issue that has resulted in economic risks; it is also a human rights and social justice issue. Racialized communities and low-income communities bear the greatest health impacts and financial risks associated with climate change (Levy & Patz, 2015). To address social injustice alongside climate change, these communities and their interests should be included in the identification of climate-change risks and in the development of mitigation and adaptation solutions. Additionally, while governance may have historically been seen as distinct from "E" and "S," there is increasing recognition that "G" is in fact critically intertwined with "E" and "S" matters. For example, to make meaningful progress with respect to climate change, it is imperative to have the foundation of a strong governance structure.

As another example, Indigenous Peoples have deep knowledge and unique perspectives on the interconnected nature of ESG matters. As stated in the *First Nations Major Projects Collation ESG Primer*: "Indigenous people are the multi-generational stewards of the lands, waters, and resources that are now known as Canada. [They] are a vital part of, and have a vested interest in, building an environmentally and socially responsible future that will benefit all Canadians, Indigenous and non-Indigenous alike. The inclusion of Indigenous standards, knowledge, values and aspirations at all levels in both corporate decision-making, and in ESG frameworks, data collection and evaluation, will improve company performance, investment stability and social outcomes." (Podlasly, Lindley-Peart & von der Porten, 2021)

ESG matters cannot be viewed and managed in silos. Organizations need to account for intersectionality when developing their ESG strategy and process for board oversight. This will allow for holistic value creation and organizational resilience.

Step 2: Understand Which ESG Matters Are Material and Require Board Oversight

The next step is to scope and prioritize the board's involvement in the oversight of ESG matters. With the assistance of management and, potentially, external experts, the board needs to:

1. Obtain an understanding of which ESG matters identified in **Step 1** are material to the company.
2. Obtain an understanding of the relevance or relationship of the ESG matters to the company's risks and strategy (i.e., how does the ESG matter relate to the key risks, value statement, strategic pillars and objectives that drive the organization's strategy?).
3. Determine which of these matters the board will be involved in overseeing, and which will be assigned to management.

Key considerations

1. **Keep the context in mind**
   Determining materiality is a complex and dynamic process, and it may be more challenging when dealing with matters that are perceived as intangible and difficult to quantify (e.g., certain social matters). There are also differing definitions and thresholds depending on the context in which the materiality assessment is being made. Management and the board (with the support of experts as needed) will have to determine which ESG matters are material in the specific context. As examples, a few definitions of materiality have been included in **Appendix A**, however the information provided is not intended as a comprehensive overview of materiality.

   Further, when determining which ESG matters to focus on, boards may want to go beyond the traditional lens of materiality. This could be the case when a particular matter may not be material from a traditional perspective but is an area that the company (or its stakeholders) otherwise value, or that the company wants to be a leader in, and therefore it warrants the board's attention.

   For example, some factors that may be considered include risks and opportunities related to operational performance, access to capital, brand and reputation and asset value.

2. **Engage Indigenous Peoples and key stakeholders early and often**
   It is critical for management, and potentially the board, to engage with Indigenous Peoples and key stakeholders, such as investors, customers, suppliers, relevant communities and governments to determine which ESG issues are material, or otherwise important, for the company. Management should consider the communities and stakeholders on which the company has the largest impact (e.g., minority groups, including Indigenous Peoples), and include all divisions within the company in these discussions. In particular, boards should consider the recommendations of **Truth and Reconciliation Commission of Canada: Calls to action** (Truth and Reconciliation Commission of Canada, 2015).

   This process is to ensure broad stakeholder perspectives are considered leading to a robust, inclusive and comprehensive analysis. Engagement with stakeholders and Indigenous Peoples should be conducted early and often in this process.

Step 3: Determine Allocation of Oversight Responsibility to the Full Board or a Committee of the Board

Once the board has determined which ESG matters will be a priority for board oversight (as identified in **Step 2**), the board, with the assistance of management, should determine whether the full board, or alternatively, a committee of the board, will take primary responsibility for oversight of the matter.

Key considerations

In determining how to allocate oversight to the full board or a committee of the board, the board should consider the nature of the ESG issue, the depth of expertise required, the time involved in oversight, and the mandates of existing board committees. For example, labour practices could be reviewed by the human resource and compensation committee, but certain environmental matters may require full board participation. For matters that haven't previously been addressed by the board or committee of the board there may be a significant learning curve.

The board may also want to consider whether there are certain critical ESG matters for the organization that would benefit from having an executive sponsor. Assignment of an executive sponsor may signal to those inside and outside the organization that the matter is a priority.

As previously noted, there is an inherent interconnection between the "E," "S" and "G," so it is important to avoid strict silos that may impede effective oversight. Board committees should regularly provide updates to the full board to ensure a cohesive and integrated approach to oversight.

Step 4: Conduct an Assessment of Material ESG Matters

Conduct a gap analysis of the current state versus desired state

The next step in the ESG oversight framework is to get a firm grasp on where the organization currently stands, and what its goals or standards are on each ESG matter. To conduct this analysis, the board (or committee of the board as determined in **Step 3**) should complete the following assessment for each ESG matter that is subject to its oversight:

1. Determine the current state for each matter using appropriate quantitative metrics or qualitative considerations.

Key considerations

- The method of determination will vary depending on the nature of the issue. Some can be easily quantified, while others may be more subjective.
- What information is required to determine the current state and how might it be measured?

2. Establish goals or standards for each ESG matter.

Key considerations

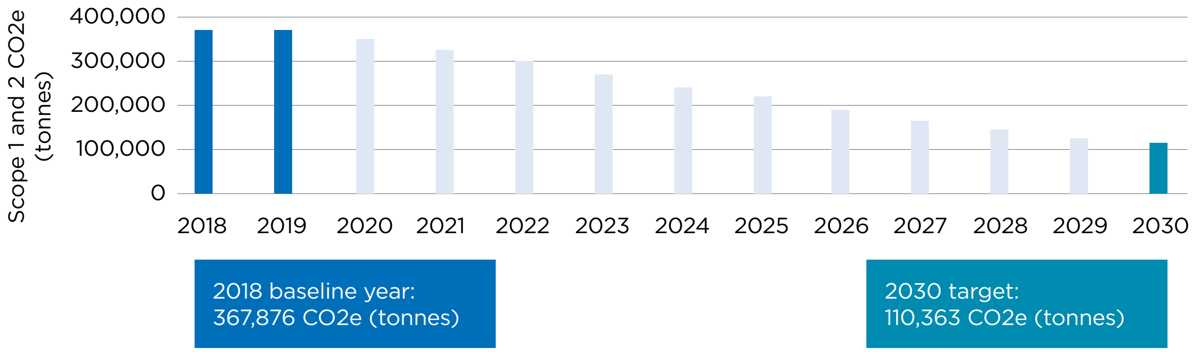
- Management should be tasked to establish the goals or standards for each matter for the board's review.
- Such goals or standards may be informed by industry or peer benchmarking, externally imposed requirements and/or stakeholder engagement.
- Consider the appropriate period to realistically meet the goals or standards. Companies that are earlier in their ESG journey may not yet have historical or current data available, and the board may instead focus on the company's process or approach to begin to capture this data.

An example: Setting science-based greenhouse gas emissions targets

Several Canadian companies have now set science-based, greenhouse gas (GHG) emissions targets.[1] In other words, these companies have set GHG emissions reduction targets for their company operations that are aligned with the Paris Agreement to limit global warming to 1.5°C, compared to pre-industrial levels. Below is an example of science-based emissions targets set by a Canadian food and beverage company for their scope 1 and scope 2 emissions:

1 For further information refer to ***Companies Taking Action*** by Science Based Targets.

Company A commits to a 30% absolute reduction for Scope 1 and 2 GHG emissions from a 2018 baseline year by 2030.



Scope 1: All direct GHG emissions under Company A's operational control
Scope 2: Indirect GHG emissions from consumption of purchased electricity, heat, or steam

Note: The 2020-2029 Scope 1 and 2 CO2e have been estimated for illustrative purposes.

3. Gain an understanding of the gap that exists between the current state and the goal or standard, including considering relevant metrics.

Key considerations

- This assessment can assist in prioritizing and allocating resources. For example, if the gap analysis reveals that there is a significant deficit between the current state and the goal or standard for a critical matter, the board may decide to allocate more resources to quickly close the gap.
- A large deficit may also signal the need to engage external experts to better understand the reason for the gap, and steps required to meet the goal or standard.

Understand the strategy and actions to close the gap

Given the exposure identified by the gap, management should develop and present a plan, including strategy, actions, resources and timelines needed, to close the gap.

Step 5: Prioritize, Plan and Determine Resource Requirements

While all ESG matters can be significant, with the benefit of **Steps 1 through 4**, the board or committee should prioritize the issues identified for the purpose of monitoring, as set out in **Step 6**.

Step 6: Monitor and Report

Monitoring and reporting are critical components of the iterative nature of the ESG oversight framework. To effectively monitor the company's progress on ESG matters, the board in conjunction with management should determine the depth of review, the frequency of reporting and the appropriate metrics. This may include, for example, reporting the status of current and planned initiatives and performance against goals or standards.

Certain ESG matters may require reports from external advisors such as environmental assessments.

To meet the rising interest in ESG matters, companies will not only have to report on issues required by regulation but will also have to consider periodic voluntary disclosures when there is key stakeholder interest.

Conclusion

In this rapidly evolving landscape, companies are experiencing heightened scrutiny over their management of ESG matters. Modern and effective boards must be actively engaged in these critical matters to assist in managing risk and fostering long-term sustainable value creation. The framework outlined above provides boards with a step-by-step tool to maintain effective oversight and governance of ESG matters.

Additional Resources

CPA Canada resources

- CPA Canada and TMX Group, *A Primer for Environmental & Social Disclosure*
- CPA Canada, *Environmental and Social Risks and Opportunities: Questions for Directors to Ask*
- CPA Canada, On the Radar, *The Business Impact of Environmental and Social Issues*
- CPA Canada, *Climate Change Briefing Questions for Directors to Ask*
- CPA Canada, *Climate Risk – Is it on Your Radar?*
- CPA Canada, *Disclosing the Impacts of Climate Change: A process for assessing materiality*

Voluntary reporting standards and frameworks for disclosure of ESG factors

- SASB Standards[2]
- TCFD Recommendations & Implementation Guidance
- TCFD Knowledge Hub
- GRI Standards

2 On June 9, 2021, the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) officially announced their merger to form the Value Reporting Foundation.

Appendix A: Examples of Materiality Definitions

The following is a simple overview of materiality definitions in a few different contexts and does not represent a comprehensive overview of materiality in these or other contexts. The information presented is current as of the publication date.

Canadian Securities Law – For the purposes of *Management's Discussion and Analysis* and the *Annual Information Form*, information is likely material if a reasonable investor's decision whether to buy, sell or hold securities in an issuer would likely be influenced or changed if the information in question was omitted or misstated.[3] As noted in Canadian Securities Administrators' (CSA) Staff Notice 51-358 *Reporting of Climate Change-related Risks*, securities legislation imposes a different test for materiality in certain other contexts, and issuers should consider the applicable test when preparing disclosure for those other purposes. Staff of the CSA have also provided guidance on materiality in CSA Staff Notice 51-333 *Environmental Reporting Guidance*. Issuers can also find guidance on assessing materiality in National Policy 51-201 *Disclosure Standards*.

International Financial Reporting Standards – Under International Accounting Standard 1 *Presentation of Financial Statements*, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about the specific reporting entity.

Toronto Stock Exchange (TMX) – Under section 407 of the *TSX Company Manual*, "Material information is any information relating to the business and affairs of a company that results in or would reasonably be expected to result in a significant change in the market price or value of any of the company's listed securities."

Sustainability Accounting Standards Board (SASB)[4] – For the purpose of SASB's standard-setting process, a topic is financially material if omitting, misstating or obscuring it could reasonably be expected to influence investment or lending decisions that users make on the basis of their assessments of short-, medium-, and long-term financial performance and enterprise value (SASB, 2020). Additionally, the SASB Materiality Map™ identifies sustainability issues that are likely to affect the financial condition or operating performance of companies within an industry.

GRI – Material topics are topics that reflect the organisation's most significant impacts on the economy, environment, and people, including impacts on human rights (CDP et al., 2020).

3 For further information, refer to Part 1(f) of Form 51-102F1 *Management's Discussion and Analysis* and Part 1(e) of Form 51-102F2 *Annual Information Form*.

4 On June 9, 2021, the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) officially announced their merger to form the Value Reporting Foundation.

There may also be materiality definitions for a particular ESG topic, for example:

Task Force on Climate Related Disclosure (TCFD) – Organizations should determine materiality for climate-related issues consistent with how they determine the materiality of other information included in their annual financial filings.

References

Canadian Securities Administrators. (2010, October 27). CSA Staff Notice 51-333 *Environmental reporting guidance* [PDF].

Canadian Securities Administrators. (2019, August 1). CSA Staff Notice 51-358 *Reporting of climate change-related risks* [PDF].

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