MAY 2024

Strengthening the S in ESG

GUARDRAIL

01 Avoid indicators that create perverse behavioral consequences.

Shift

INTRODUCTION

This is Part I of Shift's Strengthening the S in ESG Series focused on designing better social indicators and metrics. It is based on our analysis of almost 1300 indicators and metrics used in ESG data providers' products or reporting requirements. Approximately 700 of these are social indicators used by five major ESG data providers[1], 225 are governance indicators used by these same providers and 350 are social indicators used in global or regional reporting frameworks. Shift's findings are structured around three guardrails (what to avoid in indicator design) and three guidelines (what to aim for in indicator design) to support the use and design of effective social indicators and metrics. For an introduction to the series, **please visit our webpage.**

1 Shift was unable to verify whether the non-public indicators and metrics that we used for our analysis are the most up to date versions used by data providers at the time of writing (April 2024). We also recognize that the underlying methodologies used to reach a judgement on a company's performance against an indicator may offer more nuance that we could not access for our research.

GUARDRAIL ONE

AVOID INDICATORS THAT CREATE PERVERSE BEHAVIORAL CONSEQUENCES.

Too many of the S in ESG indicators, metrics and approaches used by data providers and in reporting frameworks risk incentivizing companies to do the opposite of what is desired. This includes indicators that reward low numbers of incidents, the practice of social auditing, and outmoded notions of Corporate Social Responsibility (CSR). Our analysis uncovered the use of:

1. Indicators focused on the number of complaints, grievances or incidents as recorded by a company, potentially incentivizing issues to be hidden or under-reported.
2. Indicators that reward practices that have, at best, been shown to lead to limited positive results.
3. Indicators that reflect outdated understandings of corporate responsibility, so orienting companies away from identifying and addressing the most significant risks to people within their operations and value chains.

Some of the indicators we identified as problematic should simply be taken out of circulation. Others could be adapted to avoid crossing the guardrail.

8% of the ~700 'S' indicators in use fail to avoid creating perverse behavioural consequences.

THE GUARDRAIL EXPLAINED

This guardrail is anchored in well-understood economic and social science principles that address the limitations and unintended consequences of using certain metrics and targets for policymaking and evaluation. The first is Goodhart's law, articulated by British economist Charles Goodhart, which is often summarized as "when a measure becomes a target, it ceases to be a good measure". The second is from Donald Campbell, an American social scientist who posited much the same but with a focus on the risks of using singular quantitative indicators to inform public policy. Campbell's Law posits that the more "a quantitative social indicator is used for social decision-making, the more it will be subjected to corruption pressures and likely to distort the social processes it aims to monitor".

These “laws” highlight the risk that certain indicators or metrics, once used as a target for policy or evaluating third-party conduct, can lose their reliability as entities may manipulate them or alter their own behavior to meet that target. A commonly used example is a law enforcement agency using the reduction of reported crime numbers as a primary measure of their effectiveness. In practice, this incentivizes the reduced reporting of crimes by police, or a downgrading of the severity of incidents. Consequently, while the reported crime numbers go down, they cease to be a reliable indicator of the true level of safety in the community or the effectiveness of law enforcement efforts. In healthcare, measuring doctors’ performance based on patient outcomes might make sense on the surface but is problematic if it encourages doctors to only take the easy cases and decline the hard ones. An example from a business context would be a company setting sales targets to boost profitability, resulting in salespeople offering discounts or engaging in unethical sales practices to reach their monthly goals – which could ultimately undermine profitability.

At present, too many of the S indicators and metrics being used to drive disclosure and evaluate companies’ social performance risk leading to the type of unintended consequences that Goodhart and Campbell warned about.

RESEARCH FINDINGS

01 There is a prevalence of indicators focused on the number of complaints, grievances or incidents as recorded by a company, potentially incentivizing issues to be hidden or under-reported.

A high number against these kinds of indicators will invariably be seen by companies as signalling poor social performance to investors and other stakeholders. Ideally, this would lead to business leaders taking action to reduce harms within their operations or across their value chain, even seeking ways to tackle the root causes of risks to people’s human rights.

However, equally likely is that companies will seek to “improve” their performance against these indicators by other means. For example, managers might be incentivized to downgrade incidents to less severe categories or to log complaints as merely “feedback”. They might feel pressure to suppress significant complaints through pressure or outright intimidation such that workers and communities do not feel safe to speak up. Clearly, this undermines the ability of those with complaints or grievances to be properly heard and access remedy commensurate with any actual harms experienced. It also obscures leaders' insight into the existence of bad practices and prevents the possibility of addressing them early, before they escalate into bigger issues.

Another example of indicators in this category are those that focus on supply chain audit non-compliances. Aside from the inherent problem of signalling that social audits are an effective means to identify and address risks (see below), constructing an indicator in this way can encourage companies not to find problems, assuming that this will be rewarded by data analysts and investors.

EXAMPLE INDICATORS WITH POTENTIAL UNINTENDED CONSEQUENCES

1. **Number of customer complaints** reported by the company.
2. **Total number of identified incidents of violations involving the rights of indigenous peoples.**
3. **Number of social audit non-compliances** found or violations of the company's code of conduct.
4. **Number of work-related incidents and/or complaints and severe human rights impacts and incidents** within the company's own workforce and any related material fines or sanctions for the reporting period.

TIP

FOCUS INDICATORS ON THE QUALITY OF COMPANY RESPONSES – AND INTEGRATE EVALUATION OF OUTCOMES FOR PEOPLE.

In the area of complaints and grievances, rewriting indicators to minimize unintended consequences may be possible – for example, by focusing on the quality of company responses. The Global Reporting Initiative has moved in this direction with some of its indicators, for example by including whether remediation plans related to an incident are in place.[1] It would be even better to integrate evaluation of the outcomes for people achieved through complaints processes. But that will require appetite and capacity to handle more qualitative information.

RESEARCH FINDINGS

02 A substantial number of indicators reward practices that have, at best, been shown to lead to limited positive results.

A typical example here would be emphasis on the number of people receiving training in diversity, equity and inclusion (DEI), or the number of hours of such training delivered, given the largely mixed evidence in terms of outcomes that this achieves.[2] Another is the strong prevalence of indicators focused on companies conducting social audits in supplier factories: for example, the number of supply chain audits implemented, numbers of suppliers' facilities audited, the percentage of suppliers audited, or whether companies disclose the results of audits. These indicators reinforce a policing approach to supply chain issues that has been shown to be largely ineffective. Given most suppliers' overriding desire to ensure they retain their customers' business, there are strong incentives for suppliers to game the audit system (for example, keeping double books or clearing children out when audits happen) and for auditors (who are often paid by the suppliers they audit) to downplay concerns or engage in outright corruption.[3]

Evidence has long shown both that many such audits therefore fail to pick up on significant issues and that 'corrective action plans' based on audit results rarely lead to enduring improvements for workers. Yet their prevalence as a metric in the evaluation of corporate performance incentivizes further investment in these processes, while distracting attention and resources from a company's own purchasing practices or other root-cause issues of human rights harms in global value chains. The cycle is self-reinforcing: the behavioral distortion of doubling down on social audits to improve the company's reported numbers further fuels the behavioral incentives for the audit process to show (false) positive results.

EXAMPLE INDICATORS WITH POTENTIAL UNINTENDED CONSEQUENCES

1. **Number of suppliers audited.**
2. **Percentage of suppliers audited to the company's code of conduct.**
3. **Number of a company's suppliers certified to an external labour/social standard.**
4. **Disclosure of the results of external supplier inspections or audits.**
5. **Physical inspection audits, assessments are carried out.**

TIP

LOOK FOR EVIDENCE OF SUSTAINED CHANGES IN SUPPLIER PRACTICES

Focusing on evidence of sustained changes in supplier practices could provide greater insight and does not need to be predicated on audits at all: for example, the quality of management engagement with workers. Such evidence will likely not come at the same scale as simple numbers of audits conducted. But having some data that offers meaningful insight must surely trump having lots of data that offers little or none.

RESEARCH FINDINGS

03

There is an over-use of indicators that reflect outdated understandings of corporate responsibility, so orienting companies away from identifying and addressing the most significant risks to people within their operations and value chains.

Indicators of this ilk include those focused on a company's corporate philanthropic spending, investment in community programs, and numbers of staff volunteering hours. They include indicators regarding initiatives to support healthcare or education or specific social causes (e.g., water, veterans' affairs, HIV/Aids) that the data provider has deemed to be valuable regardless of the industry or business concerned. These types of company programs can be worthy and deliver positive social impacts, but they give no insight into whether a company is addressing negative impacts on people that are connected to its core business. The exception would be where a company clearly makes this connection, for example, if it discloses that an investment in a community's access to water is responding to an impact of the company on local water resources, as agreed with the community. Moreover, rating and ranking companies based on "CSR" investments can syphon executive attention and company resources away from what is actually material, so leaving risks to people unaddressed, and increasing the resulting risks to the business and its investors.

EXAMPLE INDICATORS WITH POTENTIAL UNINTENDED CONSEQUENCES

1. **Total number of volunteering hours.**
2. **Programs or initiatives to facilitate (community) access to education or healthcare.**
3. **Money spent by the company on community-building activities.**
4. **Total amount of donations/community investments made to registered not-for-profit organisations.**
5. **Value of investments in community development.**

TIP

REMOVE OUTDATED PHILANTHROPY-BASED INDICATORS

Avoiding indicators that bring risks of perverse behavioural effects does not need to be a complicated task. For example, one easy step would be to simply remove outdated philanthropy-based indicators altogether. It can be clarifying to simply get rid of those metrics that do not help evaluate relevant aspects of performance.

LOOKING AHEAD

Improving the S in ESG requires two actions from data providers and standard setters. First, to be bold enough to remove indicators that are inherently flawed. Second, to use design principles that will deliver indicators and metrics that can bring greater value to both the measurement and assessment of progress. In this series, we will propose the following three design principles or Guardrails:

1. Indicators should focus on strong predictors of business decision-making and behaviour;
2. Indicators should focus on the quality of due diligence processes, and
3. Indicators should offer insight into outcomes for people that the company can reasonably be judged to have contributed to.

ENDNOTES

1 One GRI Indicator formulation that integrates attention to action by the company to address incidents identified is: “The reporting organization shall report the following information: a. Total number of identified incidents of violations involving the rights of indigenous peoples during the reporting period. b. Status of the incidents and actions taken with reference to the following: i. Incident reviewed by the organization; ii. Remediation plans being implemented; iii. Remediation plans that have been implemented, with results reviewed through routine internal management review processes; iv. Incident no longer subject to action.” Source GRI Topical Standard: Rights of Indigenous Peoples, Disclosure 411-1 (2016)

2 See: Chang, Bonet et al, Incorporating DEI into Decision-Making, Harvard Business Review [accessed: 16 April 2024]; and Chang, Milkman et al, The mixed effects of online diversity training [accessed: 16 April 2024];

3 See: Human Rights Watch Obsessed with Audit Tools, Missing the Goal: Why Social Audits Can’t Fix Labor Rights Abuses in Global Supply Chains, November 2022 [accessed: 16 April 2024]