JUNE 2024

Strengthening the S in ESG

GUIDELINE

01 Use indicators that are strong predictors of business decision-making and behavior.

A Evaluating companies' governance practices

Shift

INTRODUCTION

This is part of Shift's series Strengthening the S in ESG, focused on designing better social indicators and metrics. It is based on our analysis of over 1300 indicators and metrics used in ESG data providers' products or reporting requirements. Of the almost 1300 indicators and metrics we researched: approximately 700 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.

This resource is one part of our research into indicators that are strong predictors of business decision-making and behavior (**see here for an overview of this guideline**). This instalment presents our findings on **Governance** indicators. In the next pieces we'll be looking at **Stakeholder Engagement** and **Targets**.

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.

GUIDELINE ONE

USE INDICATORS THAT ARE STRONG PREDICTORS OF BUSINESS DECISION-MAKING AND BEHAVIOR.

PART A: GOVERNANCE INDICATORS

Finding #1: Only a small number of social-related Governance indicators in use evaluate board-level scrutiny and oversight of sustainability commitments or programs. None offer insight as to the level of attention to social impacts and risks.

Finding #2: There is evidence that it is feasible, though not yet common, to evaluate whether there is board oversight of risks to people typically impacted by the company's industry - some existing ESG indicators do address board attention to specific sustainability issues.

Finding #3: Data providers are not evaluating board members' "S" competence, nor evaluating the existence of efforts to inform the board of the company's management of social risks.

BACKGROUND

Why evaluate board-level and executive engagement? It is widely accepted that the "tone at the top" is highly determinant of day-to-day decisions and behaviors of people across an organization that shape its impact on employees, workers, communities and consumers. For example, if leaders reinforce a strategy and culture that reward and celebrate the minimization of costs in sourcing practices, procurement teams are unlikely to prioritize addressing human rights risks and impacts with their suppliers, even if the company has committed publicly to doing so.

This underpins the growing focus in sustainability reporting standards (see overleaf) on board oversight and scrutiny of a company's management of sustainability impacts and risks. When an issue is taken up by the governance body with the highest decision-making authority, or by executive and other senior committees, this generally signals that it is being taken seriously and seen as relevant to the company's success. In sum, where the board pays attention to these issues, it is likely that leaders' attention, motivation, and allocation of resources to address risks to people and related business risks will be higher.

THE RISING BAR FOR DISCLOSURE

MAKING BETTER S INDICATORS FEASIBLE

In recent years, reporting standard setters have been substantially raising the bar for company reporting on the nature of board-level engagement in sustainability matters. This is good news for data providers and investors seeking to gain more insight into companies' practices in this area: better information in disclosure makes the use of better indicators at scale more feasible.

The **European Sustainability Reporting Standards** now mandate an explanation of: "the sustainability-related expertise that the [governing] bodies, as a whole, either directly possess or can leverage, for example through access to experts or training" (ESRS 2 GOV-1); "whether, by whom and how frequently the administrative, management and supervisory bodies, including their relevant committees, are informed about material impacts, risks and opportunities, the implementation of sustainability due diligence and the results and effectiveness of policies, actions, metrics and targets adopted to address them, as well as any other sustainability- related concern that may arise and would require their attention" plus "a list of the material impacts, risks and opportunities addressed by the administrative, management and supervisory bodies, or their relevant committees during the reporting period" (ESRS 2 GOV-2).

The **Global Reporting Initiative's General Disclosures** include a focus on the "Role of the highest governance body in overseeing the management of impacts" (GRI 2-12) including that companies should "describe the role of the highest governance body in overseeing the organization's due diligence and other processes to identify and manage the organization's impacts on the economy, environment, and people including whether and how the highest governance body engages with stakeholders to support these processes". GRI 2-13 goes on to state that, among other items, companies shall "describe the process and frequency for senior executives or other employees to report back to the highest governance body on the management of the organization's impacts on the economy, environment, and people."

The **IFRS Sustainability Disclosure Standard** (IFRS-S1) includes disclosure requirements about the role of governance bodies, including "how and how often the body(s) or individual(s) is informed about sustainability-related risks and opportunities," and "how the body(s) or individual(s) takes into account sustainability-related risks and opportunities when overseeing the entity's strategy, its decisions on major transactions and its risk management processes and related policies..." (paragraph 27).

RESEARCH FINDINGS

01 Only a small number of S in ESG indicators in use evaluate board-level scrutiny and oversight of sustainability commitments or programs. None offer insight as to the level of attention to social impacts and risks.

This weak focus on the basics of board oversight is problematic for any investor seeking to understand whether a company is serious about anticipating and addressing its impacts on people and planet, and the related business implications.

That said, there are some promising indicators in this area which evaluate:

1. Whether the board specifically oversees a code of conduct or ESG risks.
2. Whether a company has assigned board or executive level responsibility for oversight of ESG issues.
3. Whether there is an executive director on the board with responsibility for corporate social responsibility (CSR)/sustainability, but beyond responsibility for health and safety alone.
4. Whether the company has a committee (at board and/or management level) in place that is formally responsible for sustainability, and if so, whether it consists only of board members, or is not a formal board committee but includes at least one board member etc.

However, the format of these indicators makes it impossible to tell whether a board is overseeing "only" environmental performance, "only" social performance, or a small subset of issues (for example, health and safety, diversity and inclusion and/or climate).

In order to provide timely oversight of a company's sustainability performance, **board-level discussions need to be sufficiently regular**: at least annual and more frequent if there are alterations to the business model, operating contexts, acquisitions or other factors that suggest a significant change in the company's social risk profile. **Our research found no such indicators** – yet it appears to be accepted practice for data providers to evaluate the number of times that the board, audit and/or compensation committees have met over the reporting period, and the level of attendance at meetings.

RESEARCH FINDINGS

02 There is evidence that it is feasible, though not yet common, to evaluate whether there is board oversight of risks to people typically impacted by the company's industry; some existing ESG indicators do address board attention to specific sustainability issues.

It is reasonable to expect the board or relevant sub-committees to have a holistic understanding of how a company addresses risks to people across the stakeholder groups that are typically vulnerable to significant harm due to the nature of the company's business strategies and activities. For example, for boards of mining companies there should be insight into the management of impacts on local communities, not only workforce health and safety; for boards of telecommunications companies, into abuses of freedom of expression, not only privacy; and for boards of high-street fashion brands, into impacts on supply chain workers, not only employee diversity and inclusion. All of these issues, where poorly managed, have been shown to generate financial, reputational and/or other risks to the business.

Indeed, some indicators already seek to capture board oversight of specific topical issues, such as for:

1. Health and safety, by looking for: a) Evidence of board or board committee oversight of management of health and safety risks; b) Named position responsible at Board level.
2. Privacy and data security, by looking for: The existence of an executive body responsible for privacy and data security; Indication of the executive body (board-level committee, c-suite or executive committee, or special task for or risk officer) responsible for the company's privacy and data security strategy and performance.
3. Anti-corruption, by looking at the nature of oversight of business ethics and corruption issues (board-level committee, c-suite or executive committee, or special task force or risk officer).
4. Whether the company has a committee (at board and/or management level) in place that is formally responsible for sustainability, and if so, whether it consists only of board members, or is not a formal board committee but includes at least one board member etc.

However, the focus of these indicators is often restricted to issues of legal compliance. It appears that data providers are not evaluating the extent to which boards have a holistic oversight of the most significant risks across a company's operations and value chains. **Indicators could be crafted to offer investors and others improved insight into this, for example by assessing board-level oversight of how a company addresses risks to the stakeholder groups typically vulnerable to harm in its industry.**

RESEARCH FINDINGS

03 Data providers are not evaluating board members' "S" competence, nor evaluating the existence of efforts to inform the board of the company's management of social risks.

Our research suggests that **none of the major ESG data providers are evaluating whether executive or non-executive members of boards have the expertise to scrutinize a company's evaluation and management of social impacts** and related risks to the business. Existing indicators focus on general board-level risk management competence (e.g., board expertise in enterprise risk management and training for non-executive directors on risk management) and independent financial expertise on the audit committee (e.g., whether at least one or a majority of members of the audit committee are financial experts). By contrast, several data providers appear to assess whether a company trains it employees on ESG writ large or on specific social issues (such as safety, diversity, privacy or human rights), and the amount of money spent on such training. This begs the question as to why attention to executive and board-level expertise and training on sustainability is so low by comparison.

Board discussions and oversight need to be based on adequate information with regard to incidents or allegations of harm to people inside or outside the company, as well as leading practices in the industry against which the company may be compared. But our research identified only one indicator evaluating "whether the company has a corporate social responsibility (CSR)/sustainability (or equivalent) committee that reports directly to the board". Even with this indicator, it is unclear whether the term 'CSR' in this indicator is interpreted to mean social impacts and risks associated with the business, or would include more old-school philanthropic social projects. This absence of indicators focused on how information on social risks and impact reaches the board is problematic.