JUNE 2024

Strengthening the S in ESG

GUIDELINE

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

B Focus on Stakeholder Engagement indicators.

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 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.

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 stakeholder engagement indicators. Part A looks at indicators related to governance and Part C at those related to 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). Shift recognizes that the underlying methodologies used to reach a judgement on a company's performance against an indicator may offer more nuance than we were could not access for our research.

GUIDELINE ONE

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

PART B: FOCUS ON STAKEHOLDER ENGAGEMENT INDICATORS

Finding #1: Indicators can be strengthened by evaluating whether companies are engaging with all relevant affected stakeholder groups across their operations and value chains, and the extent to which this engagement is aligned with international standards.

Finding #2: Some data providers are beginning to focus on the quality of a company's stakeholder engagement, but most focus on companies' commitments to engage or the existence of engagement mechanisms. We found no indicators in use for evaluating stakeholder feedback about company engagement.

BACKGROUND

Why evaluate stakeholder engagement? Company engagement with the perspectives of affected stakeholders - workers, communities and people that may be harmed by product use - is critical to anticipating and addressing risks to human rights connected to a company's operations and value chain. This is reflected in the authoritative international standards of business conduct with regard to impacts on people – the UN Guiding Principles on Business and Human Rights (UNGPs) and the OECD Guidelines for Responsible Business Conduct, and now in mandatory due diligence legislation and reporting requirements [see page 5].

The UNGPs define stakeholder engagement as an ongoing process of interaction and dialogue between an enterprise and its stakeholders that enables the enterprise to hear, understand and respond to their interests and concerns, including through collaborative approaches. Priority should be given to affected stakeholders whose human rights are adversely impacted by business operations. The UNGPs provide that organisations should "seek to understand the concerns of potentially affected stakeholders by consulting them directly in a manner that takes into account language and other potential barriers to effective engagement."[1]

Where business leaders regularly hear from internal and external stakeholders who may be impacted by the business to understand how they view the company and its actions, they are more likely to identify human rights risks and impacts early so they can be addressed effectively. Where a company informs these stakeholders of how issues they raise are being addressed, it is more likely that they will feel it is safe and worthwhile to raise issues.

For investors and other stakeholders seeking to evaluate a company's social performance, evidence of such practices signals a corporate culture that considers how people's lives are affected by the business, reinforces day-to-day decision-making and behaviors aimed at avoiding or mitigating negative impacts, and understands that this is important to the success of the company.

Overview of ESG Stakeholder Engagement Indicators:

- We found only 35 indicators in use that in some way touch on hearing from potentially affected stakeholders (less than 5% of the total ESG indicators we reviewed).
- Of these, 20 focus on employees, 9 on communities, 4 on customers and 2 take a broader view by focusing on "Stakeholder engagement to verify human rights risks and impacts" and "Grievance mechanisms in place for individuals impacted by business activities"
- Beyond welcome attention to freedom of association and collective bargaining, the indicators used skew heavily towards evidence of mechanisms for assessing employees' job satisfaction, customer satisfaction with product/services, or surfacing complaints from these groups. These indicators focus on whistleblowing mechanisms, hotlines, surveys and consumer grievance channels.

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 their engagement with affected stakeholders. 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.

Within the **European Sustainability Reporting Standards** (ESRS) stakeholder engagement is a recurring theme. This starts with the materiality assessment, where section 3.1 of ESRS 1 clarifies that engagement with affected stakeholders is meant to be conducted in the context of a company's due diligence process "to understand how they [affected stakeholders] may be impacted". In addition, various ESRS require disclosures on stakeholder engagement beyond the materiality assessment, for instance, as part of processes to remediate negative impacts and channels to raise concerns; in relation to actions taken on material sustainability matters; and in tracking the effectiveness of policies and actions.

The **Global Reporting Initiative** sets the expectation that companies report on their engagement with stakeholders in various ways, and defines "stakeholder" as an "individual or group that has an interest that is affected or could be affected by the organization's activities" [GRI 3 Material Topics Standard]. GRI General Disclosures (2-29) state that companies shall "Describe its approach to engaging with stakeholders, including: the categories of stakeholders it engages with, and how they are identified; the purpose of the stakeholder engagement; and how the organization seeks to ensure meaningful engagement with stakeholders."

Additionally, a number of the GRI topical standards, including GRI 411 on Indigenous Peoples Rights, require companies to report on their management of impacts on people with reference to GR3 which includes that "companies shall describe how engagement with stakeholders has informed the actions taken and how it has informed whether the actions have been effective" (GRI 3-3).

RESEARCH FINDINGS

01 Indicators can be strengthened by evaluating whether companies are engaging with all relevant affected stakeholder groups across their operations and value chains, and the extent to which this engagement is aligned with international standards.

As noted above, data providers currently place an outsized focus on company engagement with certain stakeholders (notably employees) at the expense of others.

Better indicators would focus on the extent to which:

- A company recognizes which stakeholders in which situations across its operations and value chain are most likely to be at risk of experiencing negative human rights impacts, and/or whether there is evidence that the company undertakes stakeholder mapping to understand this.
- A company commits to engaging with affected stakeholders beyond one-off risk and impact assessments to include engagement at times when business decisions are made that could impact those stakeholders.
- A company's employee, community or consumer hotlines, complaints or grievance mechanisms align with the effectiveness criteria established in the UNGPs and OECD Guidelines. Principle 31 of the UNGPs states that to be effective, grievance mechanisms should be: legitimate; accessible, predictable, equitable, transparent, rights-compatible, a source of continuous learning and based on engagement and dialogue.

In relation to this last point, some indicators already used by ESG data providers are focused on evaluating the existence of grievance mechanisms. Examples include indicators that are seeking evidence of "mechanisms in place for managing community incidents, complaints, or grievances" or whether a company's approach to local community engagement "includes grievance mechanism reporting". But these indicators do not interrogate the quality of such processes.

Our research did identify two indicators designed to assess some features of these mechanisms. One looks at whether **"A company's grievance mechanisms for individuals impacted by business activities covers human rights explicitly, is confidential/anonymous, and is available to internal and external stakeholders."** Another looks at whether **"A company has systems and policies in place for the reporting of internal ethical compliance complaints without retaliation or retribution, including but not limited to access to confidential third-party ethics hotlines or systems for confidential written complaints."** This shows that looking at the quality of mechanisms is feasible, even if no currently used indicators are designed to evaluate against the effectiveness criteria laid out in international standards.

RESEARCH FINDINGS

02

Some data providers are beginning to focus on the quality of a company's stakeholder engagement, but most focus on companies' commitments to engage or the existence of engagement mechanisms. We found no indicators in use for evaluating stakeholder feedback about company engagement.

Our research identified only a handful of indicators designed to offer insight into the quality of a company's engagement with affected stakeholders. The good news is that the indicators model how well-designed indicators can offer investors and other stakeholders (including executives and managers inside of a company) clearer insight into this critical aspect of corporate conduct.

Examples of better indicators in use include those that look for evidence of:

1. Executive level accountability for initiatives to consult with and maintain relations with communities that may be impacted by the company's business activities.
2. Board-level oversight, management-level committee oversight, or a formal monitoring group for customer complaints.
3. Managers being trained on the handling of reports or instances of abuse, alongside whether reporting channels exist.
4. Community engagement prior to developing operations in new locations.

5. Initiatives to consult with and maintain relations with communities that may be impacted by the company’s business activities, including early stage and ongoing consultation initiatives.
6. Disclosure of the actions taken based on reports received.
7. Results from engagement being used to inform a company’s decision-making and practices.

Our research uncovered no existing indicators capable of assessing stakeholder groups’ experience of engagement processes and grievance mechanisms. By way of illustration, indicators could assess:

- the percentage of stakeholders participating in engagement activities who feel the process is fairly conducted, or that it would be worthwhile continuing or repeating in the future, **or**
- the percentage of stakeholders who feel channels for raising grievances are accessible, fair and worth using.

Such evaluation would of course require companies to use social science expertise to gather qualitative feedback in ways that avoid skewing the results or suppressing honest responses, to engage with a representative sample of stakeholders, and to disclose the statistically relevant results of their evaluations. This would mirror the practice of companies that routinely use survey methods to gather such qualitative feedback from employees about their work environment and from customers about their levels of satisfaction with a company’s products and services.

ENDNOTE

1 Commentary to Principle 18 of the UN Guiding Principles on Business and Human Rights, 2011