JULY 2024

Strengthening the S in ESG

GUIDELINE

02 Use indicators that offer insight into the quality of a company's due diligence.

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.

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. This instalment presents our findings regarding the evaluation of companies' due diligence practices concerning risks to people across their operations and value chains.

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 TWO

USE INDICATORS THAT OFFER INSIGHT INTO THE QUALITY OF A COMPANY'S DUE DILIGENCE.

FINDINGS:

Finding #1: Risk identification indicators are not adequately equipping investors to assess whether a company is robustly identifying the most significant risks to people in its operations and value chains. Effective risk identification indicators focus on companies' governance of social performance, and on the presence of robust corporate-level risk identification and prioritization practices.

Finding #2: There is an opportunity to strengthen the S in ESG by focusing indicators on the quality of a company's actions to mitigate risks to people and related risks to business. There are already some promising approaches that can, and should, be refined and more widely used.

Finding #3: There is an opportunity to introduce indicators that focus on whether companies are evaluating the extent to which their risk mitigation activities are delivering the knowledge, mindsets and behavior change necessary to improve outcomes.

BACKGROUND

Investors need to know whether a company is anticipating and effectively addressing the most significant risks to people that are connected to its business model, operations and value chain: are they identifying the right risks; are their processes capable of mitigating them effectively; and is there evidence that they are working? This is also the basis for insight into whether the company is managing related financial, legal and reputational risks to the business.

In seeking to provide investors with the data to inform judgements across a large and diverse investment universe, it is not enough to focus on a small number of topical issues (for example, safety, diversity or child labor). Companies managing a limited, externally determined list of issues does not equate to robust management of impacts on people and risks to business. It is now understood that effective, risk-based due diligence, not issue management, is the only way for companies to be on top of the existing and emerging social impacts particular to their own diverse operational contexts and value chains. This is the consensus reflected in international standards, reporting requirements, due diligence legislation and in the expectations of investors that are experienced in addressing human rights risks in their portfolios.[1]

Investors and other stakeholders are also increasingly focused on the effectiveness of a company's actions to manage the impacts on their workforce, value chain workers, communities and consumers/end-users that the company has identified. As we discuss in Guardrail 3, simply evaluating a company's intentions – in the form of documented policies or plans – does not meet this need. Our research and findings show that ESG data providers are already taking this view on some S topics: for example, by evaluating whether companies are implementing accepted industry standards or best practices. The urgent task now is to use such approaches more consistently across the S data landscape.

The good news is that the international standards of responsible business conduct (the UN Guiding Principles on Business and Human Rights and OECD Guidelines on Responsible Business Conduct) and the growing due diligence legislation that reflect these standards are clear about what constitutes robust due diligence. ESG data providers do not need to, and should not, reinvent the wheel. And, helpfully, recent developments in reporting standards look set to increase the volume and completeness of corporate disclosures on risk identification and management processes and practices (see below, *The Rising Bar for Disclosure. Making Better S Indicators Feasible*).

THE RISING BAR FOR DISCLOSURE.

MAKING BETTER S INDICATORS FEASIBLE.

In recent years, reporting standard setters have sought to capture companies' impact management processes with a level of detail that demonstrates their scope, quality and effectiveness. Data providers will benefit from the increasing disclosure by companies of information regarding these different elements of impact and risk management.

The **European Sustainability Reporting Standards** require companies to describe how they "identify and assess material impacts, risks and opportunities" (ESRS 2, IRO-1), with specific information on how these processes focus on issues of heightened risk, are applied across the company's value chain, and refer to severity and likelihood when determining which impacts to prioritize. Furthermore, the ESRS also include disclosure requirements that show whether risk identification and mitigation measures lead to improvements in the practices of a company.[2]

The **Global Reporting Initiative's** (GRI) General Disclosures standard also underlines the embedding "of each of [the company's] policy commitments for responsible business conduct throughout its activities and business relationships" as a disclosure requirement (GRI 2-24). This includes information on how the company "integrates the commitments into organizational strategies, operational policies, and operational procedures" and "implements its commitments with and through its business relationships". Furthermore, under GRI, companies are also required not only to report on their "commitments to provide for or cooperate in the remediation of negative impacts that the organization identifies it has caused or contributed to" but also to describe the processes and approach to remedy they have in place (GRI 2-25).

The **IFRS Sustainability Disclosure Standard** (IFRS-S1) includes disclosure requirements for a company's risk management systems and would apply to any material social risk that results from a social impact. Disclosure requirements include the risk identification and risk mitigation processes the company has in place, specifying "the processes and related policies the entity uses to identify, assess, prioritize and monitor sustainability-related risks, including information about: i) the inputs and parameters the entity uses (for example, information about data sources and the scope of operations covered in the processes); (ii) whether and how the entity uses scenario analysis to inform its identification of sustainability-related risks (...)" (Paragraph 43).

RESEARCH FINDINGS

01

Risk identification indicators are not adequately equipping investors to assess whether a company is robustly identifying the most significant risks to people in its operations and value chains. Effective risk identification indicators focus on companies' governance of social performance, and on the presence of robust corporate-level risk identification and prioritization practices.

Our research identified that 5% (37) of the 725 social indicators used by data providers focus on people-related risk identification and assessments. 16 of these 37 indicators focus on supplier audits and supplier non-compliance. As we outline in Guardrail 1, this incentivizes practices that evidence has shown do little to improve outcomes for workers. Beyond that, the formulations of indicators focused on risk identification vary. For example, some focus on whether companies disclose risks they have identified related to a specific issue (usually for employee or customer health and safety) and some on whether companies are implementing impact assessments to identify project/site level impacts on local communities or product-related impacts on customers.

These kinds of indicators can only offer investors a small window into a company's risk identification practices, and only for one aspect of that company's activities. They say nothing about whether a company is identifying and prioritizing the most severe risks to people, and related risks to business, across its operations and value chains. In short, current risk identification indicators do not appear to be evaluating the extent to which companies are implementing the foundational steps of due diligence.

Some governance indicators (the G in ESG) that are relevant to social issues focus on on a company's overall business and sustainability risk assessment and management practices.

Our research found three governance indicators (out of the 200+ we reviewed) that look for:

1. evidence of "consideration of ESG factors in management discussions",
2. "disclosure of approaches to measuring ESG materiality", and,
3. that a company's risk management framework "specifically covers ESG risks".

This represents a fraction (0.3%) of the social-related G indicators we reviewed. And, even for this fraction, data analysis may be focused solely on whether companies are attentive to risks to business, regardless of whether that analysis has been informed by an assessment of the most significant risks to people, which are typically the source of business risk. It is also impossible to know whether analysts are scoring a company highly for attention to all three components of ESG, or just one or two of them.

There are two ways to address current deficiencies in the evaluation of companies' risk assessment practices. Firstly, investors and data analysts can focus on companies' governance of social performance. As we note in Guideline One, when boards, executives and other senior committees are receiving updates about an issue or risk, and scrutinizing a company's approach to it, this generally signals that company-wide attention and motivation to track and act on those issues is strong. As such, indicators that evaluate the governance of a company's social performance in broad terms can offer investors insight into the likelihood that a company is holistically and routinely identifying and assessing the most significant risks to people particular to the company. For practical recommendations, see Guideline One, Part A: Assessing Companies' Governance Processes.

Secondly, indicators can be designed to evaluate the existence of robust corporate-level risk identification and prioritization practices. This would mean focusing on whether a company has prioritized those impacts on people that are most severe in terms of their scale, scope and remediability, regardless of whether those impacts are in the company's own operations, or in its value chain.[3] It would be equally, if not more, helpful to give investors insight into the quality of a company's process for risk identification and prioritization. Example indicators might look for evidence of: the company using credible sources of data and information to inform its identification of risks; a company reviewing its visibility of risks to people on a regular basis or in light of significant business decisions/transactions or changes to operational contexts; or the company integrating the perspectives of affected stakeholders into their risk analysis.

RESEARCH FINDINGS

02 There is an opportunity to strengthen the S in ESG by focusing indicators on the quality of a company's actions to mitigate risks to people and related risks to business. There are already some promising approaches that can, and should, be refined and more widely used.

23% (219) of the social indicators and social-related governance indicators reviewed for this research focus on evidence of action by companies to address impacts on people connected to their operations and value chains. This suggests that data providers are seeking to provide investors with insight about the management of specific impacts on people, and related risks to business.

However, **most of the identified indicators fall foul of the Guardrails in this series.** For example, approximately 25% of the risk management indicators fail to offer insight into whether a company's intentions are being followed through in practice (see **Guardrail 3**) since they focus solely on the existence of policy commitments, supplier expectations, codes of conduct etc. Beyond that, many create perverse behavioral consequences (see **Guardrail 1**) or encourage unjustified conclusions (see **Guardrail 2**). This could be easily resolved by avoiding certain indicators, and therefore focusing on a smaller number of higher value S indicators.

That said, there is an opportunity to build on some existing indicator formulations that look beyond company commitments and focus on the quality of a company's efforts to mitigate risks. Our research identified almost 30 indicators that take this approach: for example, looking at whether a company's risk mitigations

- reflect industry best practice,
- address commercial practices that can increase risks to people,
- include incentives for business partners to improve their conduct, or
- build the capacity of local institutions to enhance protection of human rights.

This suggests that data analysts are, in some instances, evaluating far more than companies' commitments to address impacts on people or evidence of actions or initiatives to do so. Making more of this approach to interrogate the quality of company actions would offer far greater insight to investors about the likelihood of risks to people, and related financial, legal, and reputational risk to business, being managed by investee companies.

The following are excerpts from indicators that integrate attention to the quality of a company's actions, by assessing...

- a company's effectiveness in implementing privacy management controls that reflect global trends in privacy law and best practices.
- a company's formal process to apply environmental and health standards in new product design...whether this process is aligned to clearly defined industry standards.
- a company's initiatives to ensure that its employees practice ethical conduct in direct and indirect interactions with healthcare professionals and avoid improper marketing practices.
- a company's programs to verify compliance with policies, and introduce incentives for compliance among suppliers.

A BLIND SPOT IN ESG ANALYSIS: STAKEHOLDER ENGAGEMENT

Across the several hundred indicators that we had access to for this research, **we found only one indicator evaluating whether a company engages with credible experts and affected stakeholders** or their legitimate representatives as part of its risk identification. We found no indicators focusing on whether such engagement is occurring as part of companies' actions to mitigate risks to people, and related risks to business. Addressing this glaring blind spot in S in ESG analysis would offer significant additional insight to investors about the quality of a company's due diligence.

RESEARCH FINDINGS

03 There is an opportunity to introduce indicators that focus on whether companies are evaluating the extent to which their risk mitigation activities are delivering the knowledge, mindsets and behavior change necessary to improve outcomes.

Company executives, investors, regulators and civil society organizations are increasingly interested in the effectiveness of company actions to address risks to people and so tackle related risks to business. As noted above, this is a crucial part of the most recent reporting standards.

Companies are now designing KPIs that go beyond monitoring the reach of activities, programs and initiatives, to evaluate the results of those activities. These KPIs may be simple in nature, for example whether efforts to improve stakeholders' awareness of a grievance mechanism are increasing the number of grievances received. Other efforts are more complex, for example using social science methods to evaluate whether community engagement activities and impact management programs at operational sites are improving levels of trust between the company and community.

This trend suggests that over time, S data analysis will be able to integrate indicators that evaluate whether companies are using quantitative and qualitative feedback loops to evaluate the effectiveness of their due diligence. By way of illustration, S indicators could look for evidence of...

- a company measuring changes in knowledge from training through pre- and post-training tests
- a company tracking whether programs or processes designed to advance equitable recruitment are translating into changes in managers' hiring and/or promotion decisions.
- a company gathering input from business partners about whether contractual clauses, capacity building or other measures are in fact supporting improvements in business partners' own practices.
- a company working with relevant experts to measure progress in embedding responsible purchasing practices in its own operations.
- a company seeking input from workers to ascertain whether training about workplace harassment and well-being are translating into managers and supervisors being more respectful in day-to-day interactions.

- a company seeking input from community members about their experience of grievance mechanisms that are designed to identify and remedy harms, alongside quantitative data about the nature and speed of remedy provided.

In Shift's experience, there are a growing number of examples in which companies are implementing evaluative practices that the above types of indicators would recognize.[4]

To be clear, this recommendation is ***not*** that data analysts should judge the nature, scale or speed of results that companies are achieving, which would likely lead to perverse behavioral consequences. Instead, **it is a recommendation that analysis of the S in ESG should include attention to whether companies are themselves evaluating the effectiveness of their due diligence,** using sound and reasonable methods.

ENDNOTES

1 See What Investors Need to Manage Human Rights Risk (2022) report by the Principles for Responsible Investment.

2 See ESRS Social topical standards, particularly S1, S2, S3 and S4-4 (on taking action on material impacts on value chain workers, and approaches to managing material risks and pursuing material opportunities related to value chain workers, and effectiveness of those actions).

3 The international standards of business conduct (the UN Guiding Principles on Business and Human Rights, and the OECD Guidelines for Responsible Business Conduct) state that where it is not feasible for a company to address all identified risks simultaneously, it should prioritize impacts for initial attention based on the factors of (a) the scale of an impact – meaning how grave it is; (b) the scope of an impact – how widespread it is; and (c) the irremediable character of the impact – how hard it would be to put right. The European Sustainability Reporting Standards require attention to these same factors as part of the impact materiality process. This assessment of material impacts sets the foundation for companies to identify financially material matters. For more information about please see: Double Materiality: What you need to know, part of Shift's CSRD Reporting Series.

4 See, for example: Diversity and Inclusion at Ericsson: A Behavioural Science Story in which the company worked with an expert organisation and academics to "conduct multiple randomised controlled experiments to improve their inclusive culture, de-bias their people decisions, and critically, contribute to our collective understanding of 'what works' by engaging with the scientific community"; The Better Buying Initiative that – through the Better Buying Purchasing Practices Index and the Better Buying Partnership Index – enables apparel companies to evaluate their own progress in adapting purchasing practices which is a critical feature of due diligence in this sector. A growing number of BBI's subscriber companies are making their scores available on their corporate websites; and Best Buy's measuring the effectiveness of a factory training program in collaboration with labor rights experts and an academic institution. The training program aimed at improving how supervisors managed conflict with workers, listened to them, and dealt with workplace stress.

Strengthening the S in ESG
Guideline 2: Use indicators that offer insight into the quality of a company's due diligence.
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ABOUT SHIFT

Shift is the leading center of expertise on the UN Guiding Principles on Business and Human Rights. Shift's global team of experts works across all continents and sectors to challenge assumptions, push boundaries, and redefine corporate practice, in order to build a world where business gets done with respect for people's dignity. Shift is a non-profit, mission-driven organization, headquartered in New York City.

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