CSRD REPORTING SERIES

IV. GOVERNANCE, STRATEGY AND BUSINESS MODELS

Four highlights from the European Sustainability Reporting Standards

AUGUST 2023

Shift

GOVERNANCE, STRATEGY AND BUSINESS MODELS:

Four highlights from the European Sustainability Reporting Standards

What you will learn:

Historically, sustainability reporting standards have often sought high-level disclosures on the governance of 'sustainability matters.' And, frequently, the term 'sustainability' has been applied almost exclusively in relation to climate change and environmental issues; with diversity and inclusion occasionally featuring as the sole 'social' issue. This is no longer the case.

This article highlights four disclosure requirements of the ESRS that are vital to the governance of social matters:

1) The expertise of governing bodies
2) The issues escalated (or not) to governing bodies
3) The integration of incentives
4) The relationship between impacts and a company's business model

1. THE EXPERTISE OF GOVERNING BODIES

ESRS 2 GOV-1 requires disclosures on the composition, roles and responsibilities of a company's administrative, management and supervisory bodies (collectively, their 'governing bodies') with regard to sustainability matters. Companies must describe "how [those] bodies determine whether appropriate skills and expertise are available or will be developed to oversee sustainability matters."[1] This includes disclosing whether their governing bodies already possess the requisite sustainability-related expertise, or whether this is something they can leverage externally; and how this expertise relates to their material impacts, risks and opportunities.

Expertise on human rights issues – in contrast to expertise on environmental issues – has often been lacking in internal functions, particularly at the highest levels of governance; so it's noteworthy that the ESRS make explicit the link between a company's material impacts, risks and opportunities and their sustainability related expertise. This should encourage companies to engage with their governing bodies on 'people'-related impacts, including by

1 ESRS 2 GOV-1, para. 23.

offering meaningful and effective training. At a minimum, C-suites and boards should be aware of international standards on human rights and responsible business conduct and the typically salient human rights issues in their industry. And, ideally, at least one C-suite or board member should have business and human rights expertise. For more information, see this **five-step guide for company boards.**

2. THE ISSUES ESCALATED (OR NOT) TO GOVERNING BODIES

ESRS 2 GOV-2 requires companies to disclose how their governing bodies "are informed about sustainability matters and how these matters were addressed during the reporting period." There are two key points of note here:

Firstly, **a lack of social issues being elevated to governing bodies – particularly when significant risks are known – will be telling.** This is a critical opportunity to engage the board on the company's most severe social risks. The **ESRS provides a clear architecture for Social standards** which covers an array of potentially material social issues for companies. And, there are extensive, publicly available examples of how such issues arise in different industries, that can help companies spot material human rights issues that relate to their own employees, workers in the value chain, communities or consumers.[2]

Secondly, while there is some value to simply listing the high-level material impacts discussed by the governing bodies, such as "modern slavery in our supply chain" or "diversity in our workforce", as required in ESRS 2 GOV-2 (c), it's not particularly useful information at that level of aggregation, or without additional context. Instead, companies should aim to be specific about the issues discussed by their Boards and how they are being considered, including in the context of their strategy and risk management procedures. **This can help demonstrate the extent to which the Board understands and is effectively overseeing the appropriate management of material social impacts.** For some inspiration on relevant information to include, see the UNGP Reporting Framework and question **A2 - What kinds of human rights issues are discussed by senior management and by the Board, and why?**

2 For examples of potentially material social issues, see Human Rights Guidance Tool for the Financial Sector by UNEP, Human Rights Translated 2.0 by Monash University, The Relationship between Business and Human Rights by Shift and Mazars, Doing Business with Respect for Human Rights by Shift, Oxfam and Global Compact, sector-specific due diligence guidance by the OECD and the website of the Business and Human Rights Resource Center.

3. THE INTEGRATION OF PERFORMANCE INCENTIVES

To tackle negative business impacts, it is vital that people within businesses – including top management and boards – are made aware of the ways in which respect for human rights should inform their actions and decisions. One means of encouraging such awareness is through performance incentives. ESRS 2 GOV-3 sets a welcome requirement for companies to “disclose information about the integration of its sustainability-related performance in incentive schemes” for members of their governing bodies.

In practice, incentives can take many forms, including internal recognition, performance metrics, performance evaluation, linking evaluation to remuneration, and promotion opportunities. Companies should carefully consider whether existing commercial incentives may be at odds with sustainability incentives and consider disclosing any actions taken to align incentives in their disclosures. UN Guiding Principle 16 highlights the need to strive for coherence between companies’ responsibility to respect human rights and policies and procedures that govern their wider business activities and relationships.

4. THE RELATIONSHIP BETWEEN IMPACTS AND A COMPANY’S BUSINESS MODEL

ESRS 2 SBM-3 asks companies to disclose how they understand and address the relationship between material impacts on people and their business model(s). With this, **EFRAG set a ground-breaking requirement, reflecting not only that sustainability matters such as climate change or systemic inequality can put a business model at risk, but also that aspects of a business model can generate material sustainability impacts, often leading to financial risk as well.**

When assessing and addressing impacts and risks, it's vital to examine which impacts originate from, or are connected to, a company’s business model. Companies attempting to tackle negative impacts within specific business activities will never truly ‘fix’ the issues if they are embedded into the business model. As Shift’s work has shown, this may occur:

- Through the value proposition (what the company offers and to whom) e.g., lowest cost goods or services in ways that put pressure on labor rights;
- Through the value chain (how the company delivers value) e.g., speed in developing products or services, or delivering projects, with risks to health and safety;
- Through the cost structure and the revenue model (how the business model is profitable) e.g., using gig workers or other precarious labor.

Shift

For more examples of how businesses across a range of sectors could be wired to put people at risk, see Shift's set of **Business Model Red Flags**.

In many ways, disclosures on a company's governance, strategy and business model can reveal how seriously it treats social impacts and risks. As such, **they provide valuable reference points for an internal audit function to identify whether a company's top management and governing bodies possess the intent, skills and information required to effectively manage human rights risks and impacts.** These same insights will be relevant to future implementation of the Corporate Sustainability Due Diligence Directive as national enforcement agencies look to understand whether due diligence and its governance are adequate.

INSIGHTS FROM THE CS3D

Addressing business model-related impacts as part of mandatory due diligence

Negotiations on the EU's Corporate Sustainability Due Diligence Directive (CS3D) also reflect growing recognition of the need for companies to pay attention to impacts originating from or connected to business models. The positions adopted by the European Commission, Council and Parliament on the CS3D would all require companies to consider their business models and strategy in developing appropriate climate transition plans. The Parliament goes further by requiring that companies' broader sustainability due diligence include attention to how business models may heighten human rights and environmental risks, and how these could be mitigated through key activities like sales and purchasing practices. As the CS3D negotiations move forward, there is an opportunity to more closely align the text with the ESRS on this point, which would help set harmonized expectations for companies to tackle human rights impacts in a meaningful way.

GOVERNANCE, STRATEGY AND BUSINESS MODELS: FOUR HIGHLIGHTS FROM THE EUROPEAN SUSTAINABILITY REPORTING STANDARDS
Shift, New York. August 2023

ACKNOWLEDGMENTS

This resource was authored by Michelle Langlois with valuable input from Caroline Rees.

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. Visit **shiftproject.org** and follow us at **@shiftproject.**

shiftproject.org

@shiftproject

shift-project

CSRD REPORTING SERIES

For other items in this series please visit **the webpage**.