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Environmental, social and governance considerations for responsible global employers: Focusing on the 'S'

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The past several years have presented global employers with a challenging, rapidly-changing landscape. With the advent of social movements such as #MeToo and Black Lives Matter and the impact of the covid-19 pandemic, the priorities and concerns of global employers have started to shift significantly.

These morphing priorities are clearly visible in the growing emphasis now placed by many global businesses on environmental, social and governance (ESG) issues. Employees, regulators, investors, clients and other stakeholders are increasingly interested in the potential for businesses to have positive impacts beyond making financial returns. Many employers have responded by developing responsible commercial practices through the adoption of strategies to help them address the ESG issues they face across the jurisdictions in which they operate. Global employers have become aware that abiding by robust ethical business standards is beneficial on many levels, not least because research shows that businesses that adopt and prioritise ESG standards financially outperform their competitors over time.

In recent months, a growing focus has been placed on the 'social' element of ESG, which concerns a business's impact on its employees, workers, contractors and the wider community. Although measuring and reporting on the 'S' in ESG is, in many ways, still in its nascent stages, there was considerable growth and development in this area in 2021.

The broad landscape

ESG is an umbrella term for the tools used to measure the sustainability and ethical impact of a business.

Although ESG factors are largely non-financial, potential investors, customers and employees often have regard to a business's ESG performance when deciding whether to invest money or time in a given business. Organisations are now being scrutinised for their ability to implement policies that promote or encourage a positive workforce culture and environment.

In 2021, ESG factors were increasingly incorporated into organisational governance and compliance frameworks across the globe. In particular, businesses have started to focus on the social limb, or 'S', of ESG, covering, broadly, how businesses treat their workforce, interact with their local communities, behave in business relationships, and even how supply chains are composed and operated.

Although there are currently no set metrics or prescribed areas of focus, there are a number of key areas that businesses tend to pinpoint when measuring the 'S' in ESG. These areas include:

- Human rights (including modern slavery and child labour): Certain businesses are required to identify the steps that they have taken to prevent any involvement in human rights violations, such as modern slavery or human trafficking. Beyond required reporting, many organisations are making significant efforts to prove to potential investors or employees that they are neither complicit in nor associated with any human rights violations.
- Health and safety: The covid-19 pandemic has thrown into sharp relief the significance of safe working environments, including the importance of employee mental health and wellbeing. Global employers are recognising that raising awareness of and placing emphasis on employee mental health and wellbeing contributes to employee productivity and engagement, and improves the sustainability of their operations.
- Diversity and inclusion: Businesses may be required to comply with certain legal requirements relating to topics such as inclusion and non-discrimination. Additionally, global employers are beginning to recognise the benefits of a diverse and inclusive working environment, as well as its positive impact on employee attraction, retention and development.
- Equal pay: Certain employers operating in particular jurisdictions are required to report on their gender pay gaps and the measures they take to achieve equal pay between men and women and, increasingly, between different racial and ethnic groups. There is also increasing pressure on employers to undertake voluntary reporting on their ethnicity and disability pay gaps, prompting many employers to undertake global pay equity audits to understand and address the distribution of compensation among their workforce.
- Stakeholder and community engagement: Businesses are aware that stakeholders often have a keen interest in whether and how businesses contribute to causes that stakeholders value. Accordingly, many employers have robust corporate responsibility programmes by which they can demonstrate their commitment to positive social impact.

Why the 'S' in ESG is important

Focusing on the 'S' in ESG is not simply the 'right' thing for employers to do. Examples abound demonstrating that employers who recognise how ESG factors affect their workforce and implement strategies to deal with potential problems and shortcomings, will be more profitable and reputationally secure in the long term. There are several key reasons why focusing on social issues is important for employers:

- Reputation and value: Businesses that fall below expected ESG performance standards will suffer reputationally. Over the past few years, there have been numerous examples of poor social standards, such as sexual harassment or racial discrimination allegations, having a negative impact on the share price and market values of certain companies. Demonstrating a commitment to social issues can help employers avoid costly reputational damage. Strong ESG policies also attract investments, because most investors are now aware of the importance of ESG factors and their broad significance.
- Productivity: Having robust policies addressing 'S' factors has more than an external impact. Employers that maintain a diverse and inclusive workforce, policies addressing equal pay and similar strategies have better productivity, including higher revenue growth, greater innovation and increased employee morale and retention rates.
- Legal compliance: As discussed in more detail below, the regulatory environment is changing rapidly, and many jurisdictions are on the cusp of implementing additional and more comprehensive reporting duties for global employers. Those organisations that demonstrate good ESG policies now will be far better placed to comply with future regulatory developments and avoid penalties.

Measuring the 'S' in ESG

Despite a clear appetite amongst employees and other stakeholders for employers to demonstrate their commitment to social issues and the obvious benefits to employers who do so, a key challenge faced by many global businesses is the lack of uniform standards for ESG reporting, in addition to the rapidly evolving regulatory environment. These challenges are often exacerbated by the fact that ESG reporting varies depending on an organisation's industry, geography, size, demographic makeup and governance structure.

Nevertheless, employer reporting on ESG factors increased in 2021, and significant emphasis has been placed on the role of internal audits in assisting employers to make informed decisions about integrating ESG measures across organisations. Furthermore, regulators across the globe are gearing up to implement additional rules on ESG disclosures.

Employer reporting

Reporting related to social issues remains largely voluntary in many places worldwide. There are, however, some mandatory reporting requirements in certain jurisdictions. For example, in the UK, large private and voluntary sector employers (employers with 250 or more employees) are required to analyse their gender pay gap each April. As set out further below, the UK government has consulted publicly in relation to the potential extension of the pay reporting regime to ethnicity pay data, and further developments in this respect are anticipated soon. Additionally, large commercial organisations that carry on business in the UK and have a total turnover of £36 million or more must publish an annual modern slavery statement on the actions they have taken to ensure their business and supply chains are slavery-free.

In France, companies with 50 or more employees are required to analyse and publish their gender pay gap every year on 1 March. Further, all companies headquartered in France and employing more than 5,000 employees in France, or headquartered in France or abroad and employing more than 10,000 employees worldwide, must implement vigilance plans. A vigilance plan sets out reasonable measures to identify risks and prevent serious violations of human rights and fundamental freedoms, and health and safety of persons and the environment, resulting from the activities of a company and any companies it controls, either directly or indirectly, as well as the activities of subcontractors or suppliers with whom an established business relationship is maintained. In addition, companies must verify the registration of their subcontractors with the tax and social security authorities and their compliance with various French social security and labour law obligations.

In Germany, corporate employers with more than 500 employees are required to report every three or five years on the actions they have taken to advance gender equality, the effect of such actions, and the actions taken to establish gender pay equity.

In the EU more generally, a new regulation on sustainability-related disclosures in the financial services sector, Regulation 2019/2088 (the Sustainability-related Financial Disclosures Regulation (SFDR)), came into force on 10 March 2021. SFDR aims to ensure that asset managers, financial advisors, and other financial market participants consider sustainability and other ESG factors in their decision-making regarding investments and include such details in the information provided about those investments. It also requires those market participants and advisers to identify and publish information about how they account for 'sustainability risks' in their investment advice or decision-making.

In the United States, increased shareholder proposals are a key driver behind many disclosures. A majority of the proposals focus on workplace equity related to workforce diversity, equity and inclusion. Several public companies have received proposals to provide EEO-1 reporting and related reporting on the effectiveness of programmes concerning the recruitment, retention and promotion of protected classes, and a majority of the proposals ask companies to provide more information concerning the diversity of their workforces received majority support. Proposals on human capital management received an average of 45 per cent shareholder support in 2021, as opposed to 28 per cent in 2020. All proposals asking for more information on mandatory arbitration policies that went to a vote received majority support. There is also a focus on 'concealment clauses', which is pushing companies to remove harassment and discrimination from the scope of non-disclosure and non-disparagement agreements. This drive has led to an exponential rise in the number of chief diversity officers. Increasingly, directors are in favour of taking steps to improve diversity, such as following the 'Rooney Rule' of always interviewing a diverse slate of candidates and requiring search firms to always offer a diverse slate of candidates.

Although reporting relating to social issues throughout the Middle East, North Africa (MENA) and in much of Asia is still voluntary, there have been some legislative changes. Specifically, within the Gulf Cooperation Council, both the United Arab Emirates and Saudi Arabia have released legislation governing gender pay gap issues and ensuring the law creates more equity across genders. Following the enactment of legislation in early 2022, United Arab Emirates employers are prohibited from pay discrimination on the basis of gender, race, nationality, etc.

Notably, in China, the principle of 'equal pay for equal work' is enshrined across multiple laws and regulations, and the country continues to introduce greater protections for female workers. The Law on Protection of Women's Rights and Interests was promulgated in 1992 and last amended in 2018. The latest draft, if adopted in its current form, would, among many other provisions to protect and enhance the role and experience of females in the workplace, require companies to include information regarding gender equality in their annual reports, such as the promotion of the recruitment of females, the gender ratio in management, and the gender ratio across the company's workforce.

Beyond mandatory reporting, many businesses have taken steps to offer voluntary disclosures and set goals related to social issues. For example, the Centre for Audit Quality reported that, by August 2021, approximately 95 per cent of S&P 500 companies had made detailed ESG information publicly available. Usually, this information was outside of any US Securities and Exchange Commission (SEC) submissions and contained in a standalone report.

Additionally, since 2004, 26 EU member states have put in place diversity charters. These charters support and encourage good practice in diversity management among thousands of multinationals, public bodies and non-profit organisations. The European platform of diversity charters now includes the 26 national diversity charters, representing more than 12,000 signatory organisations and more than 16 million employees. The EU strategy for diversity and inclusion focuses on four main target groups: women, people with disabilities, people from the LGBTI community, and seniors. It includes both cross-sectional and specific measures to address the concerns of each of these groups:

- for women: specific management programmes and support for existing and new women's networks;
- for people with disabilities: involvement of people with disabilities in the planning of access and mobility facilities in Commission buildings;
- for people from the LGBTI community: awareness-raising activities and training for managers and other staff members to dispel any unconscious prejudices; and
- for senior staff: follow-up to establish whether they are discriminated against when applying for a new position.

Further, Directive 2014/95/EU, also called the Non-Financial Reporting Directive (NFRD), provides that certain large companies and groups should report on their ESG policies and their performance as measured against key performance indicators. Companies should also provide a description of the main ESG risks they have identified, and how they manage them.

Although the process is voluntary, each EU member state has its own specific requirements in light of the way the NFRD has been transposed locally. For example, under French law, certain ESG reporting obligations are mandatory for certain categories of companies (the thresholds assessed at the closing date of the financial year are set at €100 million for the balance sheet total, €100 million for the net sales figures, and 500 for the average number of permanent employees during the year).

A non-financial performance statement must present for the most relevant environmental and social risks:

- a description of the main risks related to the company's activity;
- a description of the policies applied by the company, including, where applicable, the due diligence procedures implemented to prevent, identify and mitigate the occurrence of these risks; and
- the results of these policies, including key performance indicators.

The non-financial statement or extra-financial performance declaration should be published in a company's annual management report prepared by the board of directors or the management board at the same time as the financial statements to which it relates. The statement or declaration must also be made public on a company's website within eight months of the end of the financial year and remain available for five years.

In the MENA region, although there is currently no legal mandate for reporting, companies throughout the region are voluntarily taking steps to adhere to the UN Sustainable Development Goals. There is a developing trend amongst investors (specifically within the Gulf Cooperation Council) to push companies to be more ESG compliant, with investors choosing to invest in companies based on their ESG benchmarks. This has resulted in employers being more voluntarily ESG focused.

Internal audits

Many businesses have turned to internal audits to provide organisational leadership with reliable assurance on the effectiveness of ESG management, including ESG governance, risk assessment, monitoring and reporting.

Currently, independent audits of ESG reporting are not required in most jurisdictions. Regardless, internal audit functions are becoming a key tool for assessing internal frameworks, validating the completeness and accuracy of data used in reporting, and providing assurance and advice around ESG reporting.

Accordingly, many jurisdictions are seeing increased emphasis placed on the processes and methods by which businesses measure and assess progress on ESG issues. In May 2021, the Institute of Internal Auditors Global (IIA) published a white paper concerning the role of internal audits in ESG reporting. In the paper, the IIA expressed its view that as 'ESG reporting becomes increasingly common, it should be treated with the same care as financial reporting'. It further added that organisations 'need to recognize that ESG reporting must be built on a strategically crafted system of internal controls and accurately reflect how an organization's organization's ESG efforts relate to each other, the organization's finances, and value creation'.

The IIA report contained recommendations on what internal audits should provide in order to offer the requisite assurance on ESG risk management, including ESG reporting. In particular, it noted that internal audits should:

- review reporting metrics for relevancy, accuracy, timeliness and consistency;
- review reporting for consistency with formal financial disclosure filings;
- conduct materiality or risk assessments on ESG reporting; and
- incorporate ESG factors into audit plans on a more regular basis.

Additionally, the paper pointed out that internal audits can perform an advisory function, highlighting that they can:

- help to build an ESG control environment and recommend appropriate frameworks to manage and mitigate risks;
- recommend reporting metrics; and
- advise on ESG governance.

It is expected that employers will continue to rely on internal audits to support and bolster their ESG regimes.

Changing regulatory expectations

Although reporting on social issues remains largely voluntary, regulation in these areas seems likely to increase. 2021 saw regulatory environments across the globe (particularly in the financial services sector) place greater emphasis on ESG disclosures, with many jurisdictions taking steps to make more ESG disclosures mandatory. This trend is expected to continue.

United States

US regulators have started to emphasise the importance of reporting around diversity and inclusion. The US SEC has indicated that rulemaking around diversity and inclusion is a priority for the Biden administration. In June 2021, the SEC's Office of Information and Regulatory Affairs released its Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions. The report included notable proposed and final SEC rulemaking areas, including disclosures related to human capital, 'including workforce diversity and corporate board diversity'. Also, in August 2021, the SEC approved Nasdaq Stock Market LLC's rule changes related to board diversity and disclosure, which will require each Nasdaq-listed company (subject to certain exceptions) to have at least two diverse board members, or to explain why it does not. In approving these rule changes, the SEC was clear that there is 'more work to be done in improving both diversity and transparency at public companies and in our capital markets more broadly', and expressed the hope that Nasdaq's new rules are 'a starting point for initiatives related to diversity, not the finish line'.

United Kingdom

In the UK, diversity and inclusion reporting is also taking centre stage. Although there is currently no requirement to carry out diversity and inclusion monitoring in the UK, this seems likely to change. For example, in July 2021, the Financial Conduct Authority, the Prudential Regulation Authority and the Bank of England published a joint discussion paper, entitled 'Diversity and inclusion in the financial sector – working together to drive change', aimed at engaging financial firms and other stakeholders in discussions around how to accelerate meaningful changes in diversity and inclusion within the financial sector. The paper clearly stated the regulators' intentions to build on existing requirements to support and monitor diversity and inclusion progress in the UK financial sector, and it is expected that additional diversity and inclusion metrics will soon become part of how the regulators operate, and how they expect the UK financial services sector to operate.

Additionally, many organisations are increasingly reporting on any pay gap due to race and ethnicity. Although such reports are not yet mandatory, many anticipate that mandatory reporting requirements in these areas are imminent. The government held an ethnicity pay reporting consultation in 2018 that closed in 2019, and, although a response is yet to be published, one is expected soon.

Conclusion

It is clear that ESG considerations are now top of mind for the world's leading organisations, as regulators, investors, employees and other stakeholders increasingly expect companies to report on how they impact the world around them. Allowing such stakeholders to understand an organisation's value creation beyond its financial performance is becoming a critical issue, and by doing so, companies are likely to be attractive to the best and brightest talent.

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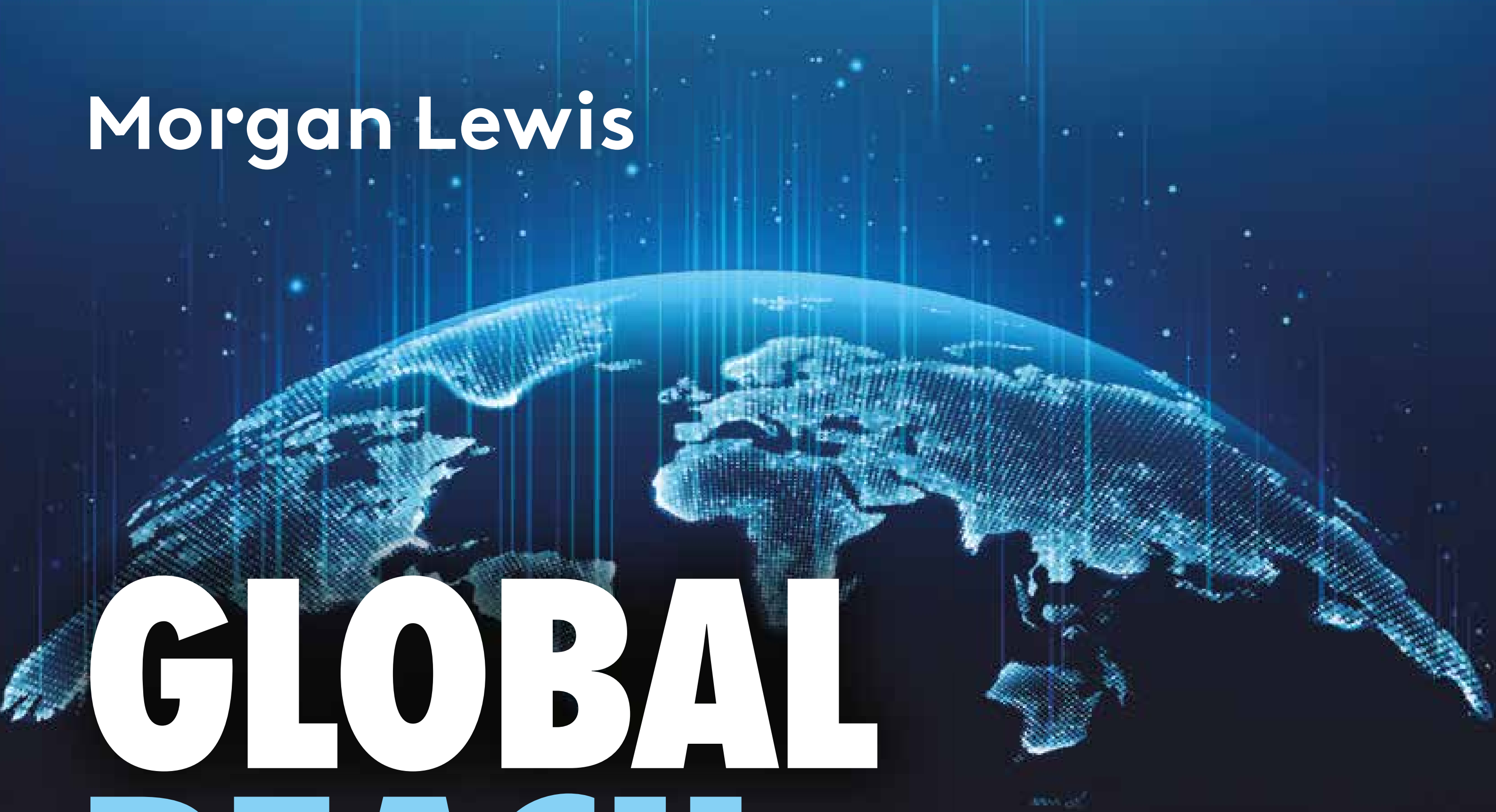

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