Focusing on Reporting the ‘S’ in Environment, Social & Governance

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Stakeholders and regulators are increasing their focus on the “social” element of ESG, which involves a company’s impact on its employees, workers, and community, explain Morgan Lewis attorneys. They discuss what employers need to know about these new reporting requirements, which includes a push for more human capital disclosures.

Environmental, social, and governance has become one of the biggest buzzwords in corporate America, transcending industries and markets. But up until this year, many investment managers, funds, and corporate boards have focused on the environmental, or the E, of ESG.

The pivotal social movements and continued impact of Covid-19 over the past few years have brought the S of ESG more to the forefront. In particular, employers, stakeholders, and regulators are increasingly focused on the “social” element of ESG, which concerns a business’s impact on its employees, workers, contractors, and the wider community.

As this area continues to develop, employers should be mindful of the potential challenges and implement policies and practices to mitigate risk.

The ‘S’ in ESG

ESG is a wide-ranging term that encompasses sustainability and social goals of a company. While there are currently no set metrics or prescribed areas of focus on the social limb, or S of ESG, there are a number of key areas that businesses tend to focus on, including civil and human rights; health and safety; diversity, equity, and inclusion; equal pay; and stakeholder and community engagement.

Many employers view the focus on these issues as not just the “right” thing to do, but as a business imperative with a significant impact on long-term profitability and reputation. The following are examples.

Reputation and Value

Sexual harassment or racial discrimination issues have a negative impact on share price and market value. Conversely, strong ESG programs increase a company’s value and attract investments.

Productivity and Retention

Employers with a diverse and inclusive workforce and policies addressing harassment, anti-discrimination, equal pay, and respect in the workplace have better productivity, including higher revenue growth, greater innovation, and increased employee morale and retention rates.

Legal Compliance

With the rapidly changing regulatory environment, organizations with good ESG policies will be in a better position to comply with current requirements and future regulatory developments, and avoid penalties.

Increased Voluntary Employer Reporting

While employer reporting on ESG factors remains largely voluntary, it has nevertheless increased substantially. The Center for Audit Quality reported that, by August 2021, approximately 95% of S&P 500 companies had made detailed ESG information publicly available.

Increased shareholder proposals are a key driver behind many disclosures. A majority of the proposals focus on DEI. Several public companies, for instance, received proposals that sought reporting on EEO-1 (requirement to submit certain demographic workforce data) and the effectiveness of programs to recruit, retain, and promote protected classes, and most of the proposals asking companies to provide more information on workforce diversity received majority support.

There is also an increase in shareholder support for human capital disclosures, with an average of 45% of shareholders in favor of these proposals, up from 28% in 2020.

Also tied to this increase for more transparency in workforce DEI efforts is a push for the removal of “concealment clauses,” which has pushed many companies to remove harassment and discrimination from the scope of non-disclosure and non-disparagement agreements.

Changing Regulatory Expectations

Regulation of ESG seems likely to increase as US regulators have started to formalize diversity and inclusion reporting standards. The SEC's spring 2021 unified agenda of regulatory and deregulatory actions included proposed and final SEC rulemaking areas, including disclosures related to human capital such as "workforce diversity and corporate board diversity," which fits with the Biden-Harris administration's larger focus on diversity and inclusion rulemaking.

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.

Challenges and Promising Practices

As the focus on the S by employers and stakeholders grows, companies should be thinking about the potential challenges and risks associated with ESG and ways to address them going forward.

First, because this is a relatively new area of focus, company boards should be educated on the social aspect so they can provide effective oversight. They should develop specific processes for identifying and addressing ESG risks and opportunities and ensuring alignment with corporate strategy. Some boards also assign responsibility for ESG matters to a specific committee.

Second, a challenge faced by many employers is the lack of uniform standards for ESG reporting. Companies should determine appropriate frameworks and processes for collecting, analyzing, and disclosing ESG information.

For example, with respect to diversity data, companies should have standardized processes and expectations for data sources, quality, and metrics. Companies should also ensure coordination and alignment between the various groups involved in ESG, including legal, HR, IT, and groups with significant reporting experience such as communications, finance, and investor relations.

Finally, ESG disclosures should be accurate and consistent. Though independent audits of ESG reporting are not required in most jurisdictions, these 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.

In May 2021, the Institute of Internal Auditors Global published a white paper concerning the role of internal audits in ESG reporting and recommendations on what internal audits should provide to offer appropriate assurance on ESG risk management, including ESG reporting. In the paper, the IIA stated that as “ESG reporting becomes increasingly common, it should be treated with the same care as financial reporting.”

Regulators, investors, employees, and other stakeholders increasingly expect companies to report on how they impact the world around them. As value creation beyond financial performance is becoming a critical issue, organizations should continue to enhance their ESG efforts while implementing processes to address any challenges and potential regulatory requirements going forward.

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