Sustainability & compliance: Understanding the social pillar

A primer for compliance officers.

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Executive summary.

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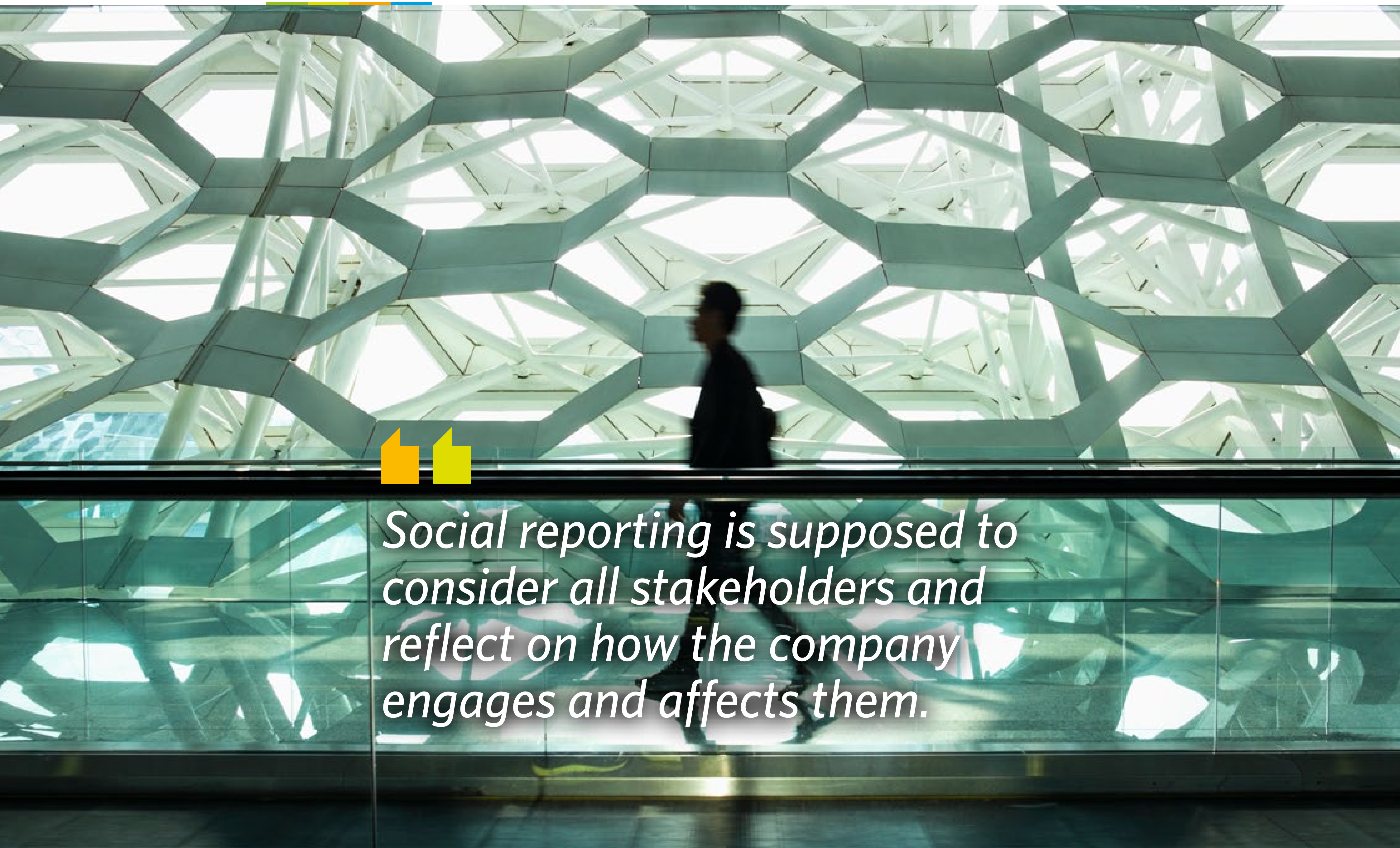
Environmental, social and governance (ESG) issues have rapidly risen up the corporate agenda in the last few years (and, more recently, to the top of newsfeeds). Five years ago, almost nobody was thinking or talking about them. This year, research by Deloitte found that every company surveyed was reporting on these issues[1].

However, **the ubiquity of ESG and sustainability reporting does not mean there is consensus about what matters**. When you dig deeper, it seems that for most companies, the priority is environmental issues—not surprising given the global impact of climate change, and the direction of government interest. There is much less focus on, or understanding of, the ‘S’ of ESG: the social aspects of sustainability reporting and activity.

Reporting on this social pillar isn’t exactly straightforward. **Social issues can be harder to measure and quantify than environmental matters**. There are many more challenges in collecting information, and considerably less standardization. It’s also harder to know what to prioritize, because issues may vary by business, sector or country. This resource describes some of the issues, challenges and solutions in reporting on social sustainability issues

1) www2.deloitte.com/us/en/pages/audit/articles/esg-survey.html



Social reporting is supposed to consider all stakeholders and reflect on how the company engages and affects them.

What is the social pillar of sustainability reporting?

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The social pillar of sustainability targets the relationships between a company and its employees, consumers, local communities, and a broad range of stakeholders that might be connected to the company's operations, including the workers in its supply chain. Social reporting is supposed to consider all stakeholders and reflect on how the company engages and affects them.

The social pillar is therefore extremely broad when considered as a whole. However, paradoxically, it's also highly specific to the organization. This makes it very hard to set standards for reporting, because **what matters for one organization may be irrelevant for another**. What, therefore, should be included?

There is currently no standardized approach to social reporting. There are also **very real differences between the approaches taken to social reporting** by different organizations that provide sustainability reporting standards. For example, the Global Reporting Initiative (GRI) includes disclosures related to employment, occupational health and safety, training and education, diversity and equal opportunity, child labor, security practices and rights of indigenous peoples. The Sustainability Accounting Standards Board (SASB), however, requires disclosures on customer privacy, data security, customer welfare, employee engagement, diversity, and inclusion. There is some overlap between the two, but also some clear areas of difference.

For the majority of organizations, information on **human rights, health and safety, impacts on local communities, and labor practices are the main social issues to be reported on**. However, there is considerable scope for variation even within categories with robust regulatory frameworks. For example, the Universal Declaration of Human Rights has a list of 29 rights that encompass freedom, liberty, right to asylum, and nationality. What's more, the United Nations Guiding Principles on Business and Human Rights (UNGPs) mention that businesses can have an impact on most of the internationally recognized list of human rights. Covering everything could lead to some very long reports.

We suggest some particularly hot topics that companies might wish to consider are **diversity, equity and inclusion, occupational health and safety, mental health and well-being, and social impacts on global supply chains**. These issues are relevant to most companies, and we are also seeing increasing regulatory activity in these areas.

Crucially, companies need to understand the risks faced by their industry, the jurisdictions where they operate, and their products or services.

Reporting on the social pillar.

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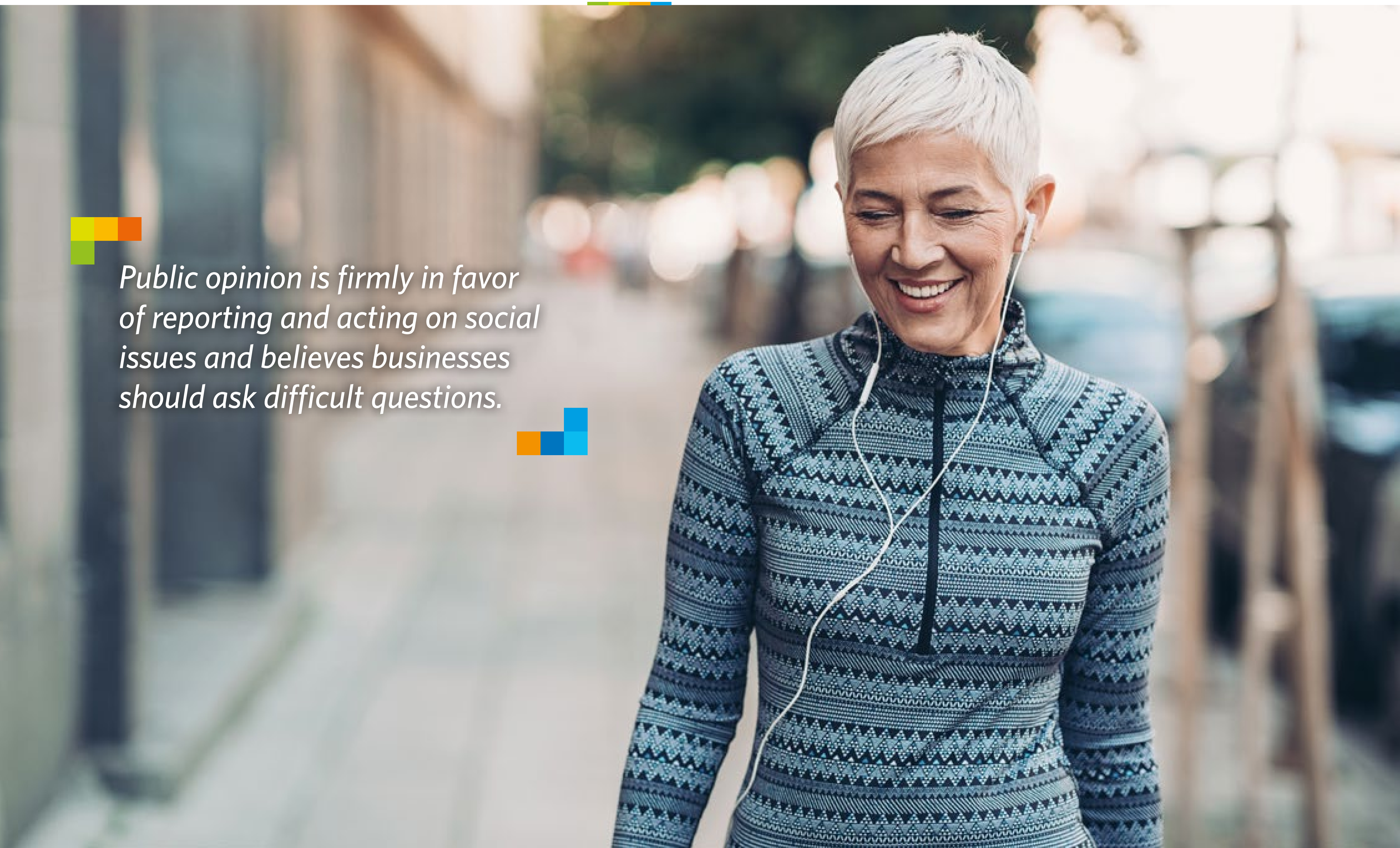
How should organizations prioritize what to report under the social pillar? The key is that **reports should reflect what is relevant to the company and its stakeholders**, and particularly the risks and effects on the company's long-term stability. For example, an office-based company might want to focus its attention on diversity and inclusion, especially if it has a gender imbalance or lack of policies supporting LGBTQ employees. However, manufacturing companies, especially those who have offshored manufacturing activities, may be more focused on issues of avoiding forced labor.

The crucial word to consider is *materiality*. Material sustainability issues are economic, environmental, or social issues that the company has an impact on or is impacted by.

Considering the adoption of double materiality criteria by reporting standards and regulations (including in the recently adopted Corporate Sustainability Reporting Directive – CSRD - in the European Union), the company must consider how sustainability issues can create financial risks for the business, along with the business own impacts on people and the environment. It's a matter of **being transparent and providing information that accounts for the risks and opportunities** that implementing sustainable measures can provide to the organization.

The materiality assessment helps the company to identify its impacts and to support the inclusion of information in sustainability reports. When it comes to social issues, the sustainability report must provide information that is relevant to the organization and its employees, consumers and communities impacted by its operations.

Crucially, companies need to understand the risks faced by their industry, the jurisdictions where they operate, and their products or services. It's also important to consult stakeholders when deciding what and where to report. Together, these will affect decisions about priorities. However, **it's hard to see reports being 'wrong' if they show an understanding of risks and what is important to the business** and make commitments beyond profit and shareholders while considering their workers, users, and the community affected by their activities.



Public opinion is firmly in favor of reporting and acting on social issues and believes businesses should ask difficult questions.

Public interest in the social pillar.

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Reporting and acting on the social pillar aren't simply a matter between a business and its immediate stakeholders. We are increasingly seeing global businesses held to account by customers and the mainstream media for violations related to social issues. These include violations by their suppliers, where ignorance isn't seen as a defense. This suggests that **public opinion is firmly in favor of reporting and acting on social issues** and believes businesses should ask difficult questions.

Bad publicity travels fast in our globalized world and can cause considerable reputational damage. Combined with the bewildering array of social issues to consider, **organizations need a comprehensive system to be able to identify, track and manage the social issues that are relevant**. A good place to start is with a dialogue with a broad range of stakeholders, to reach a better understanding of the relevant social risks and opportunities.

Companies must ensure that their business strategy reflects their social priorities and **treat reporting on social aspects as equally important as environmental or financial issues**. This means being clear about any regulatory requirements that may affect them, across all the jurisdictions in which they operate.

One of the major areas of regulatory requirements that impact the social pillar is human rights, which are put in place from a jurisdictional perspective and protected by several international conventions.

Looking back: The history of human rights and the social pillar.

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One of the major areas of regulatory requirements that impact the social pillar is human rights, which are put in place not only from a jurisdictional perspective, but also protected by several international conventions. Regarding social rights, **the major international treaty is the International Covenant on Economic, Social and Cultural Rights (ICESCR)**, adopted by the United Nations in 1966. Along with the Universal Declaration of Human Rights and the International Covenant on Civil and Political Rights, they form the International Bill of Human Rights.

The ICESCRC set a firm foundation for the right to work, which must be freely accepted, carried out in safe and healthy working conditions, be compensated with a fair wage, and provide a decent living.

The covenant also guarantees the rights to:

- join and form trade unions
- strike
- access social security
- maternity protection
- an adequate standard of living
- a high standard of physical and mental health
- education.

The ICESCR also prohibits child labor, in Article 10, item 3. The Covenant states that

"Children and young persons should be protected from economic and social exploitation. Their employment in work harmful to their morals or health or dangerous to life or likely to hamper their normal development should be punishable by law. States should also set age limits below which the paid employment of child labour should be prohibited and punishable by law."

Several governments, both national and regional, have since adopted legislation to protect human rights and ensure that businesses are held accountable for human rights violations in their operations.

Regulatory changes in the social pillar.

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More recently, the United Nations Guiding Principles on Business and Human Rights (UNGPs) have **established a corporate responsibility to respect human rights**. They also set out that this responsibility refers to all internationally recognized human rights. This includes the rights listed in the International Bill of Human Rights, referred to above. It also includes the principles concerning fundamental rights in the International Labor Organization's (ILO) core conventions.

These principles were endorsed by the United Nations Human Rights Council in 2011. Since then, there has been **growing pressure on companies to implement measures that would make the responsibility to respect human rights into a reality**. Several governments, both national and regional, have since adopted legislation to protect human rights and ensure that businesses are held accountable for human rights violations in their operations. **Crucially, this also applies to their supply chains**.

Some of the first instruments focusing on business responsibility throughout their supply chains are the California Transparency in Supply Chains Act, 2012, and the United Kingdom Modern Slavery Act, 2015. These pieces of legislation were mainly focused on the ban on modern slavery. However, **the scope of regulations is now broadening to human rights violations in general**, making recent regulations broader and more protective.

Additionally, even though the main focus of the early instruments focusing on modern slavery and human rights violations was on reporting and ensuring transparency in supply chains, most of them lacked enforcement mechanisms and were accused of "lacking teeth." **Recent legislation, however, has made a stronger attempt in this direction**, but it's too soon to say if it will be effective.

It's important to remember that **these regulations are set nationally, but they apply to global supply chains**. Their reach is therefore supranational and affects global suppliers. This is a very good starting point for global action, creating an urgent need for enterprises to prepare and to increase their understanding of social issues impacting their operations and supply chains, in order to avoid fines for non-compliance as well as reputational risks. Perhaps the point to note is that governments and international bodies are working hard to better protect human rights. Companies would do well to take note.

Other examples of recent regulations on the protection of human rights across global supply chains include:

The German Act on Corporate Due Diligence in Supply Chains

This aims to enhance the protection of international human rights and the environment by setting mandatory standards for large companies and their value chains. **The human rights risks identified by the Act include child and forced labor, disrespect of labor standards and freedom of association, inequality, and withholding an adequate wage**. The Act also refers to environmental-related obligations arising from the Stockholm Convention on POPs regarding the prevention of persistent organic pollutants, the production and disposal of mercury under the Minamata Convention, and the control of transboundary movements of hazardous waste and their disposal under the Basel Convention.

Companies are required to monitor and act upon violations in their operations and the operations of their direct suppliers and ensure compliance to the best of their ability in their supply chain. For indirect suppliers, **if companies obtain substantiated knowledge of a possible violation of human rights or environmental standards, they must conduct a risk analysis** to address these violations. Companies can be fined for non-compliance depending on the severity of the violation and may be excluded from public tenders for up to three years. Companies with an annual global turnover of more than 400 million euros can be subject to fines of up to 2% of their annual global turnover.

The Norwegian Transparency Act

This promotes corporate respect for human rights and decent working conditions in producing goods and providing services. The Act **defines decent working conditions as work that safeguards fundamental human rights and health, safety, and environment in the workplace and provides a living wage**. The Act applies to all larger companies domiciled in Norway, regardless of whether they offer their products or services within the Norwegian borders. It also applies to foreign corporations selling their products or services in Norway and with tax obligations to the Norwegian government.

Companies are expected to carry out human rights due diligence in line with the OECD Guidelines for Multinational Enterprises. The due diligence process **must identify and assess actual and potential adverse impacts on fundamental human rights and decent working conditions** that they have caused, contributed to, or are directly linked with the business operations, products or services via the supply chain or business partners. The assessment therefore covers the company itself, its supply chains, and business partners, and must be reported on each year via the company's website. Sanctions may be imposed for non-compliance, although it's not yet clear what these may be.

The European Union (EU) Corporate Sustainability Due Diligence Directive (CSDDD)

This supports the EU's transition towards a sustainable financial system. It aims to promote sustainable and responsible business conduct in the EU. Its adoption is also **designed to create a level playing field across Europe**, and it's therefore another element that will close the enforcement gap in this field. The proposal of the CSDDD has been subject of a deep analysis on our blog, by Enhesa's European Union expert.

When adopted, the CSDDD's **due diligence obligations will apply to both EU and non-EU companies operating in the single market**, depending on their size and number of employees. The application depends on the number of employees and turnover in the last financial year. Technically, the CSDDD only applies to large companies. However, small and medium-sized enterprises are also likely to be affected indirectly as suppliers to large companies.

The directive requires companies to incorporate due diligence into their business ethic, policies, and actions. They **must develop, publish and update yearly a corporate due diligence policy**. They must also identify, mitigate, and try to neutralize actual and potential negative environmental and human rights impacts resulting from their activities or within and related to their value chains. Companies must establish a complaints procedure so that anyone affected has an effective way to raise concerns. Finally, they need to publish an annual report on the outcome of their due diligence.

Overall, the **legislative framework requiring mandatory human rights due diligence is growing**. There is no question that companies are expected to be more transparent. There is also no doubt that they will be held accountable for both their direct activities and for the activities of their supply chains and business partners.

Due diligence is crucial to every company, regardless of size and location. Even though regulations are largely targeted at bigger businesses, they will also have a knock-on effect on others.

The importance of transparency and robust reporting on the social pillar.

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Reporting on the social pillar is very much not a 'tick-box' exercise, any more than reporting on the environmental aspects. **Reports must be evidence-based**, and the data used to support them must clearly show the impact on suppliers and communities affected by the company's operations.

It's also important to note that **even though regulations are largely targeted at bigger businesses, they will also have a knock-on effect on small and medium-sized businesses**. Many of these smaller businesses supply larger ones—and will therefore be caught as part of the supply chain. Falling below the regulatory threshold doesn't give any business a free pass to ignore measures that otherwise would be required. We are moving towards a system in which businesses that wish to continue placing products and services on the market must recognize that **transparency is key**. Due diligence is crucial to every company, regardless of size and location.

Building on success: The Sustainable Development Goals

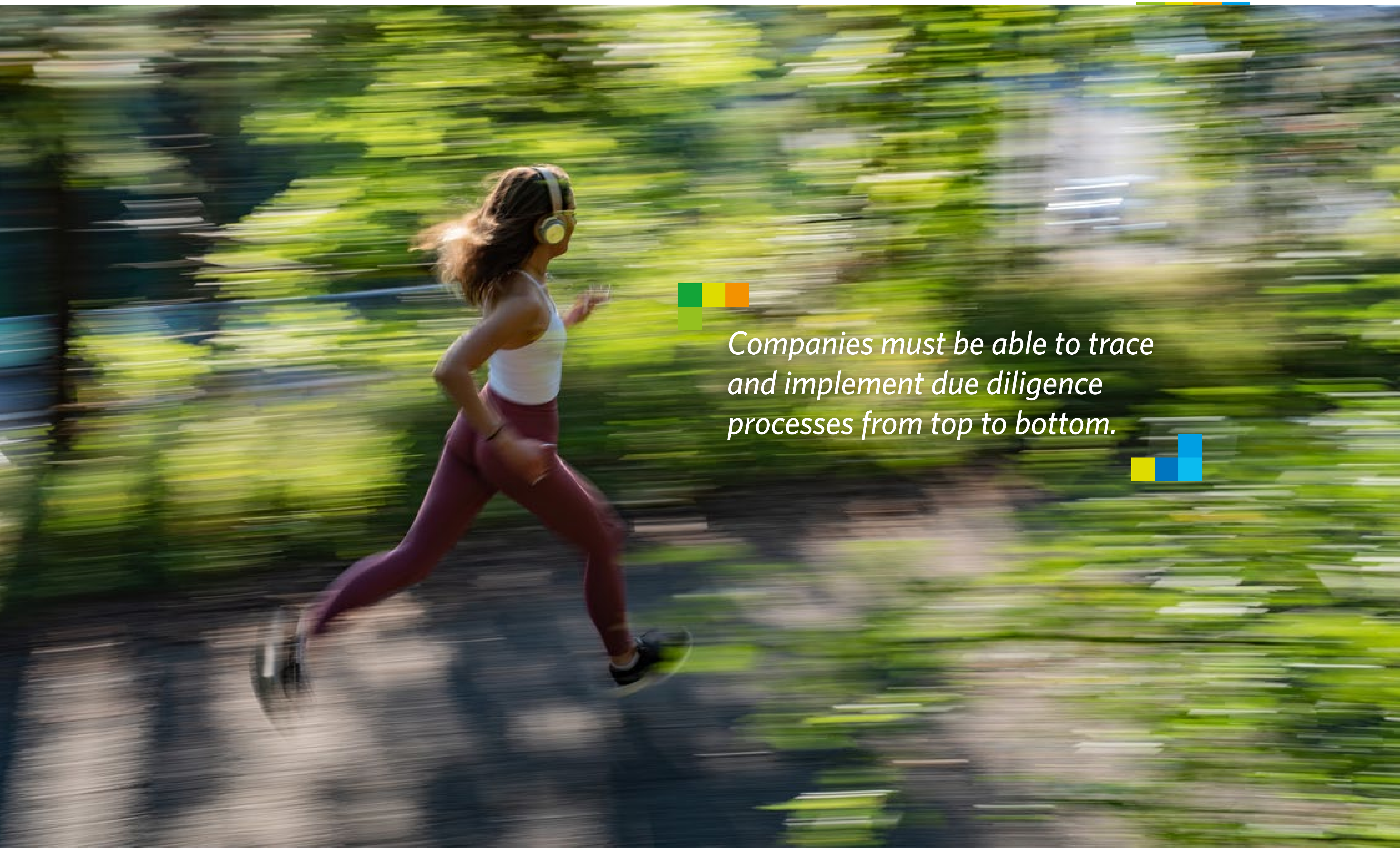
The UN's Sustainable Development Goals were developed in 2015 by the UN General Assembly. They have a clear and solid focus on all issues relating to sustainability, including modern social issues. They can therefore be used as a **strong guide for ESG and sustainability reporting** across all three pillars.

Under the social pillar, for example, the fifth goal on Gender Equality has a target focusing on "Ensure women's full and effective participation and equal opportunities for leadership at all levels of decision-making in political, economic and public life." This is included in several sets of ESG reporting requirements or standards as a material aspect enshrined as board diversity. In the Netherlands, for example, **companies are required to comply with female quota provisions applicable to supervisory boards and non-executive directors**.

Another extremely ambitious target, under the eighth goal on Decent Work, is "**by 2030, achieve full and productive employment and decent work for all women and men**, including for young people and persons with disabilities, and equal pay for work of equal value."

The eighth goal also covers the ambition to end forced labor, or modern slavery. This is no small aspiration. Last year, the International Labor Organization (ILO) released a report **estimating that around 49.6 million people in the world were subject to modern slavery conditions** on any given day of 2021. This includes people being forced to work against their will or in a forced marriage. This is nearly one in every 150 people in the world. It's important to reflect that one of the major reasons for the persistence of modern slavery is that many companies source goods from places with the lowest costs. That usually means low labor costs, which may in turn mean the use of forced labor.

We advise manufacturing companies to **have a clear oversight of their production processes, including the workers employed in their value chains**. They need to be able to report with confidence that they and their suppliers are not complicit in modern slavery. As mentioned, there's a lot of recent regulatory activity addressing transparency in global supply chains and imposing mandatory human rights due diligence. The German and Norwegian legislation covering supply chains, and the European Union Directive on corporate sustainability due diligence are part of this movement. We foresee several regulatory changes in the coming years, with stronger liability to business, **and companies need to be prepared to answer for their own activities and suppliers**.



Companies must be able to trace and implement due diligence processes from top to bottom.

An ambitious remit.

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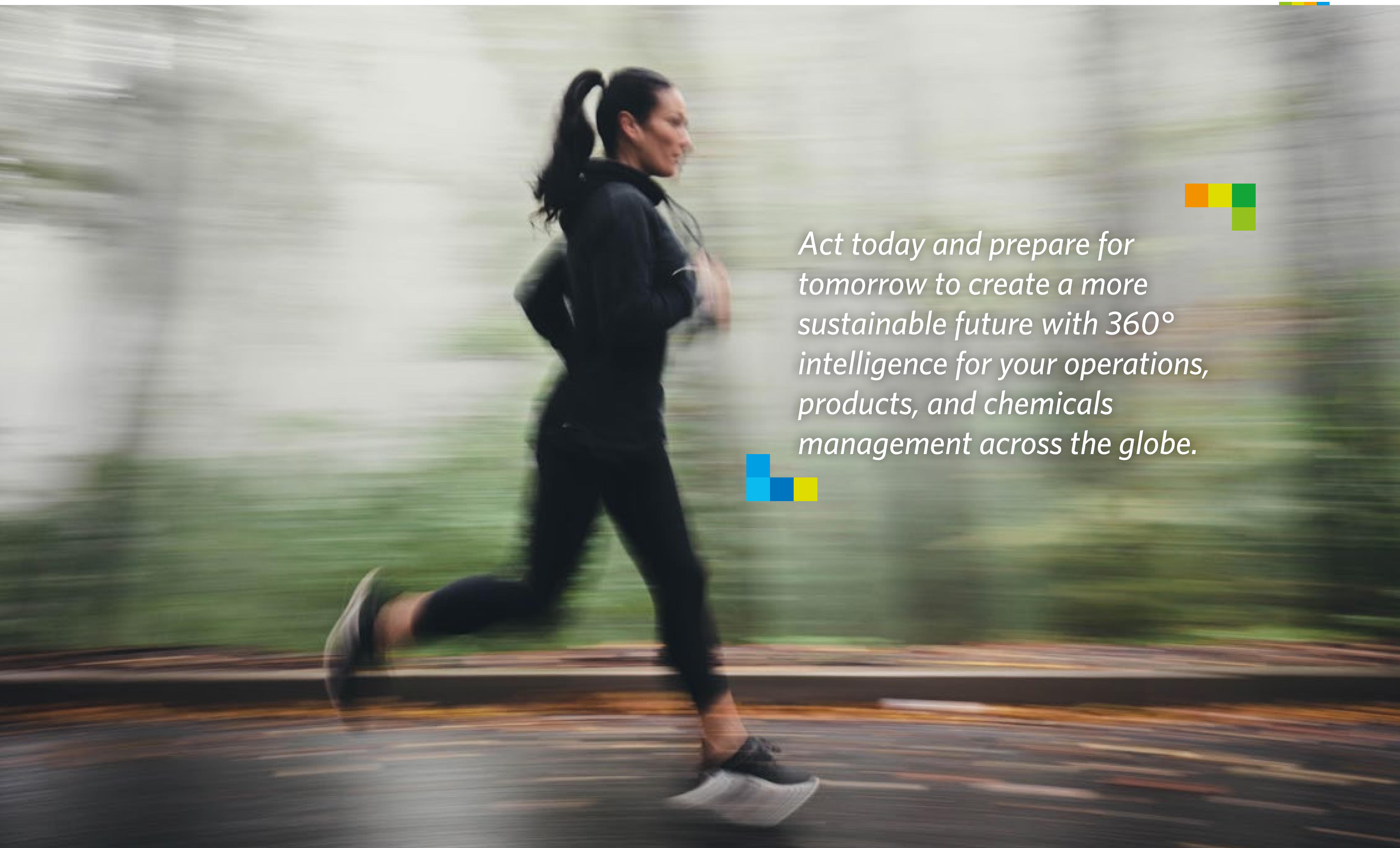
The SDGs set a very ambitious agenda reflecting a commitment of all the 193 member states of the United Nations. They provide a clear blueprint for the future of corporate sustainability reporting across environmental, social and governance issues. They also highlight that action on environmental issues isn't enough. **For true sustainability, companies must cover all three pillars, plus financial success**.

In a globalized world, supplies come from many different parts of the world. It's therefore essential that businesses are clear on, take responsibility, and are held to account for assessing and addressing human rights issues.

Supply chains may be complex and carry high risks and many points of vulnerability. However, **companies must be able to trace and implement due diligence processes from top to bottom**. Where necessary, they must use their leverage to influence business relationships to ensure respect for human rights and the guarantee of fundamental social rights. Companies must seek to transform their business model and ensure that living wages are guaranteed, and labor standards are respected, wherever they operate and in every business relationship.

There is a very real case for ethical production. That means production that is both consistent with environmental principles, and that guarantees decent working conditions for all the workers in the value chain. **Consumers increasingly want to know more about the goods that they are buying** – and that means that businesses can't afford to avoid asking difficult questions. Alongside this, **the legal framework is rapidly changing and increasing companies' accountability** throughout their operations and business relationships.

Implementing due diligence across supply chains is key to every business to guarantee their sustainability and existence. **Scrutiny is only going to increase from all stakeholders: customers, shareholders, and regulators**, and companies need to address all areas to achieve success.



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