# ESG in the Supply Chain:

## Understanding Opportunities & Managing Risks

# Introducing ESG Risk in the Supply Chain

ESG (Environmental, Social, and Governance) is a framework that has evolved from Corporate Social Responsibility (CSR) approaches and financial risk assessments to become integral to modern business practices. ESG is a risk management and value creation tool that focuses on companies' environmental impact, social responsibility, and governance structures.

While some form of social or philanthropic focus has existed in business for decades, there has been an increased spotlight on ESG and sustainability in recent years for multiple reasons:

- Various global regulations introduced new requirements for businesses to meet, with continued legislation expected
- Many investors[1], stakeholders, and customers expect companies to focus on ESG to combat climate change and ensure universal human rights
- Sustainable practices make smart business sense and increase operational efficiency over time
- Protecting the environment, practicing business ethics, and safeguarding workers are necessary for business and supply chain sustainability in rapidly evolving marketplaces

There is a common misconception that ESG practices are costly and offer little return on investment, leading to a lot of cynicism about the need for such business practices. However, the opposite is true when a company looks at ESG as an investment. For example, managing emissions and adopting renewable energy sources require a cost upfront, but will pay off midterm by reducing operational costs and enhancing the company's reputation.

So where does the supply chain fit in? For companies to fulfill ESG regulations, policies, and expectations, they must ensure the same rigor is applied to their entire supply chain. For example, 80-90% of a company's carbon footprint[2] exists in their supply chain.

ESG risks can have profound implications for the hiring company, but they also matter deeply for suppliers and contractors. Understanding these risks and addressing them proactively is essential for all parties involved.

SECTION ONE

# ESG in the Supply Chain - History, Key Terms, Trends, and Regulations

## A Brief History of ESG

The principles underpinning ESG are not new; they evolved from the earlier practices of CSR. For instance, in the late 19th and early 20th centuries, companies like Cadbury[3] and Unilever[4] were already implementing practices that would be classified under ESG today. These companies recognized the importance of improving their workers' lives and ensuring that their business operations did not harm the environment.

The term "ESG" itself emerged more recently as companies and investors sought to address the broader impact of business operations on society and the environment — and from an outside-in perspective, the risks posed by social and environmental factors on the stability of the business. Unlike CSR, which often operated on a voluntary basis, ESG is increasingly becoming a requirement for companies, driven by regulatory demands and investor expectations.

While CSR often focused on individual initiatives, ESG is a more comprehensive approach, encompassing broader environmental, social, and governance issues at the operational level. The evolution from CSR to ESG signifies a shift towards more structured and measurable practices that are now crucial to business success in multiple ways. This evolution also shifts these activities from more philanthropic endeavors and embeds them into the business DNA of a company to reduce risk and drive value.

In addition to attracting investment, satisfying compliance requirements, and improving brand reputation, ESG adoption can also increase operational efficiency and save companies money. Many organizations have realized that sustainable and ethical approaches to business have a significant positive impact on the bottom line. For example, optimizing use of resources and adopting renewable options results in waste reduction and more energy efficiency, both of which lower operational costs. Another example is in labor costs and efficiency: workers who are treated fairly tend to be more productive and stay longer with a company, and companies find it easier to attract and retain a workforce in competitive labor markets.

## Key Terms Related to ESG

Terminology related to ESG can be confusing as there is overlap in some key terms but also important distinctions.

### ESG *(i:.es'dʒi:)*

Shorthand for environmental, social, and governance, ESG is a set of standards and practices related to an organization's environmental and social impact on their local and global community. It's largely used by the investment community to determine an organization's risk and valuation.

### Sustainability *(sə-ˌstā-nə-'bi-lə-tē)*

Though the terms "ESG" and "sustainability" are often used interchangeably, there is an important distinction. The goal of corporate sustainability is conducting responsible business practices to minimize harm to the environment or society. ESG, meanwhile, is a broader concept that encompasses not only sustainability but other criteria that businesses use to create policies and measure performance.

### Governance *('gə-vər-nən(t)s)*

The system of rules, practices, and processes by which a company is directed and controlled. It encompasses the mechanisms that ensure the company's accountability to its stakeholders, including shareholders, employees, customers, and the broader community.

### Social *('sō-shəl)*

The Social aspect of ESG refers to how a company manages its relationships with its employees, suppliers, customers, and the communities in which it operates. It focuses on the impact a company has on society and the ethical standards it upholds in its interactions with people.

### Materiality *(mə-ˌtir-ē-'a-lə-tē)*

Materiality refers to ESG issues that are significant to the company and its stakeholders, considering both financial impacts on the business as well as broader social and environmental consequences. Materiality helps a business prioritize ESG programming and investments to maximize impact and mitigate core risks.

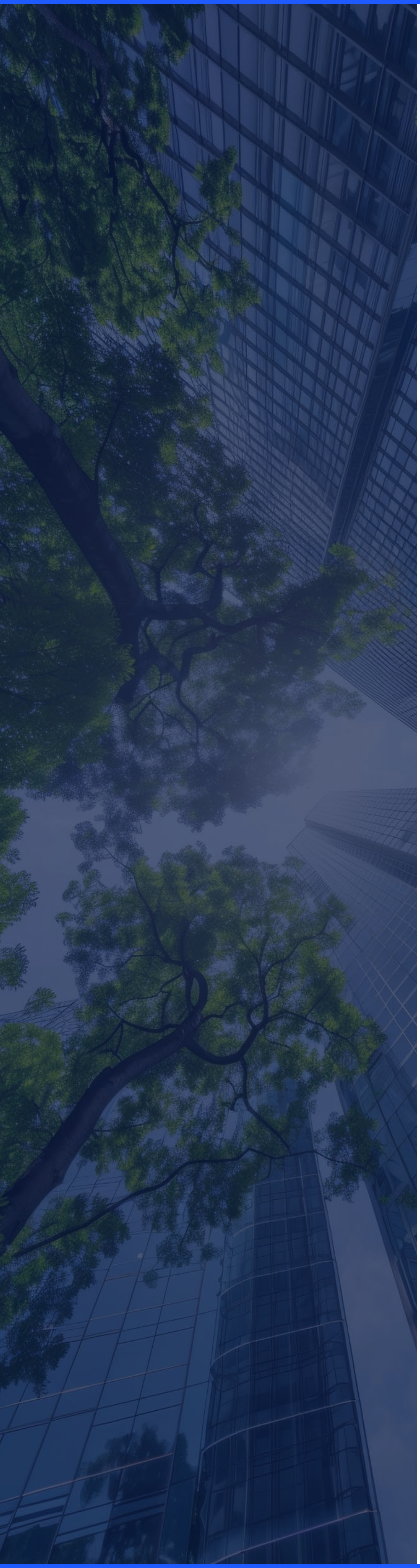
### Greenhouse Gasses (GHG) *('grēn-ˌhau̇s 'gases)*

GHGs refer to gasses like carbon dioxide, methane, and nitrous oxide, which contribute to global warming and are critical factors in environmental risk assessments. Many interchange the term "GHG" with "carbon footprint," but greenhouse gasses encompass more than just carbon. Organizations of all sizes produce greenhouse gasses, largely through the burning of fossil fuels like coal, oil, and gas. Current regulations primarily focus on carbon but are increasingly looking at methane as well, given the intensity of its environmental impact.

### Scope 1, 2, and 3 Emissions *('skōp ē-'mi-shəns)*

When evaluating an organization's greenhouse gas emissions, those emissions can be separated into different categories:

- **Scope 1 emissions** are those that a company directly produces at its location(s).
- **Scope 2 emissions** are indirect emissions from the electricity and other energy that the company buys.
- **Scope 3 emissions** are all other indirect sources of greenhouse gasses related to a company's operations, largely produced throughout the company's extended supply chain (e.g., purchased goods and services). Scope 3 emissions are particularly important to understanding the supply chain's impact on a company's environmental footprint and are the focus of many regulations.



## Emerging Trends & New Regulations

Recent trends indicate a growing emphasis on ESG due to increased awareness and demand for sustainable business practices. ESG is now seen as essential for both multinational corporations and small businesses. There is also a significant global investment in managing emissions and climate preparedness, which has become crucial for businesses seeking capital.

The "triple bottom line" concept, which considers the impact of business operations on people, planet, and profit, is gaining traction. Businesses are recognizing that sustainable practices not only help protect the environment but also create value for shareholders through energy efficiency, waste reduction, reduced material costs, fewer business disruptions, a more productive workforce, a more reliable supply chain, and more.

Furthermore, new regulations, particularly concerning forced labor, child labor, and greenhouse gas emissions, are pushing companies to adopt more rigorous ESG practices. Regulatory trends are shaping the future of ESG, particularly with the rise in forced labor due to labor shortages exacerbated by climate change and socio-political shifts post-pandemic. New and stricter anti-modern slavery laws across countries like Canada, Australia, and France are forcing companies to be responsible for and reassess their entire supply chains. Additionally, there is a heightened focus on greenhouse gas emissions, waste reduction, and carbon reporting, driving a shift towards a circular economy. In California, new laws require organizations to report on the sustainability of their supply chains[5].

These regulations are not just limited to local operations but also affect global supply chains, making compliance more complex and crucial. Companies are under increased scrutiny to ensure their operations are not only legally compliant but also ethically sound.


SECTION TWO

# Understanding ESG Risks in the Supply Chain

## Summarizing Key ESG Supply Chain Risks

ESG encompasses several environmental, social, and governance risks that can pose challenges and result in severe consequences for hiring companies. Part of what makes these risks so concerning is that they can be difficult to spot without a comprehensive risk management and due diligence program.

The following are key ESG risks that lurk in the supply chain and examples of the consequences.

### Environmental Risks

- Emissions impact of suppliers and contractors, which can equate to 80-90% of a company's full carbon footprint
- Potential damage to natural ecosystems from sourcing materials and other supply chain activities, especially from contractors using unsustainable practices
- Compliance violations with environmental regulations and standards

*EXAMPLE:* The 2010 Deepwater Horizon disaster[6] that caused a massive oil spill into the Gulf of Mexico had enormous consequences for hiring client BP, including significant brand damage and massive criminal and civil settlements.

### Social Risks

- Forced and child labor, fueled in recent years by labor shortages globally, even in developed countries
- Other human and labor rights issues, such as fair wages and safe working conditions
- Community impact and social responsibilities of material sourcing
- Workplace health and safety

*EXAMPLE*: In 2013, a building in Bangladesh that housed several garment factories collapsed,[7] killing over 1,100 workers. The building owner knew it was unsafe, yet threatened to withhold pay from workers who refused to continue working. Multiple major fashion brands used the factory for manufacturing, causing a global outcry about garment worker conditions.


### Governance Risks

- Corruption and bribery within the supply chain
- Lack of transparency and accountability in business operations
- Lack of legal compliance and adherence to global standards and regulations

*EXAMPLE:* The Petrobras scandal in Brazil[8] exemplifies the devastating impact of bribery and corruption in the supply chain. The scandal involved kickbacks from contractors to executives at Petrobras, leading to inflated contract prices and billions in losses. The hiring company's involvement in corrupt practices led to legal action and massive fines. It also caused a sharp decline in its stock value, eroded investor confidence, and damaged its reputation on a global scale.

## The Impact of ESG Risks on the Hiring Company

As illustrated by the examples above, the conduct of just one contractor or supplier can have far-reaching consequences for the companies at the top of the supply chain. These include:

### Reputational Damage

The most immediate and visible impacts of ESG-related incidents often involve reputational damage. News of unethical practices or environmental violations by a supplier can spread rapidly, leading to public backlash against the hiring company. This can result in loss of customer trust, boycotts, and significant harm to the brand's image. It can also impact a company's ability to secure loans and investments, as ESG factors are also becoming critical in financial assessments.

### Regulatory Noncompliance

Regulatory compliance is another critical area where ESG risks can manifest. Governments around the world are implementing stricter regulations around environmental standards, labor practices, and governance. A company that violates these regulations may face legal repercussions, including fines, penalties, project delays, and costly litigation. Even if the hiring company was unaware of a supplier's illicit actions, they can still be held liable under various international laws.

### Financial Implications

ESG risks can also have significant financial implications. Poor environmental practices by suppliers can lead to supply chain disruptions, such as the depletion of natural resources or damage to ecosystems that are crucial for production. Social issues, such as labor strikes or poor working conditions, can also cause public outcry and project delays. These disruptions can increase operational costs, affect product availability, and reduce company profitability.

***EXAMPLE:*** In 2015, Nestlé faced significant scrutiny when an investigation found forced labor and human trafficking[9] were prevalent in its seafood supply chain in Thailand. Following the revelations, Nestle faced legal challenges, regulatory scrutiny, consumer backlash, and significant reputational damage.

Nestlé's experience shows the importance of thoroughly vetting and monitoring suppliers to ensure compliance with ethical standards and to avoid legal repercussions and damage to the company’s reputation.

## Why ESG Matters to Contractors and Suppliers

Suppliers and contractors are not immune to the growing importance of ESG. In fact, their relationship with hiring companies increasingly hinges on their ability to demonstrate strong ESG performance. One of the primary reasons why suppliers should care about ESG is the business continuity and market access it provides. As more companies prioritize ESG in their procurement processes, suppliers that fail to meet these standards risk losing contracts or being excluded from new business opportunities.

Competitive advantage is another compelling reason. Suppliers that adopt sustainable practices and demonstrate a commitment to social and governance issues are more likely to attract and retain clients. They differentiate themselves in the market, not just by offering competitive prices but by being reliable partners that align with the hiring company's values and long-term goals.

Moreover, as discussed earlier, financial benefits can arise from ESG initiatives. For instance, energy-efficient processes and waste reduction often lead to lower operational costs. Strong governance practices minimize the risk of fraud, corruption, and legal issues, thereby safeguarding the supplier's financial health. Additionally, suppliers that excel in ESG are able to access financing more easily, as investors increasingly favor companies with strong ESG credentials.


SECTION THREE

# Seven Best Practices for Managing ESG Risks in the Supply Chain

## 1. Utilize Frameworks and Standards

A critical component of effective ESG management in the supply chain is the adoption of internationally recognized frameworks and standards. These provide a structured approach to integrating ESG considerations into business operations and ensure efforts align with global best practices.

Key frameworks include the United Nations Global Compact[10], which provides principles on human rights, labor, environment, and anti-corruption, and the Global Reporting Initiative (GRI)[11], which offers guidelines for reporting ESG performance. ISO standards[12], such as ISO 14001 for environmental management and ISO 45001 for occupational health and safety, also offer robust tools for managing specific ESG risks.

Additionally, industry-specific codes of practice, such as the Ethical Trade Initiative (ETI) Base Code[13], can provide tailored guidance for businesses operating in particular sectors. By aligning their ESG strategies with these frameworks, companies can meet regulatory requirements and enhance their credibility with investors, customers, and other stakeholders.

## 2. ESG Needs to Start at the Top

Successful ESG integration starts with strong leadership commitment. Senior management must prioritize ESG initiatives and allocate adequate resources to ensure their success. This involves more than just setting policies; it requires embedding ESG principles into the company culture and ensuring these principles guide decision-making at every level and every tier of the supply chain.

Cultural integration is vital. Organizations must foster a culture that values sustainability and safety, encouraging proactive approaches to ESG challenges throughout the company. This can be achieved by ensuring all employees feel incentivized and empowered to contribute to the company's ESG goals. Additionally, setting realistic, data-driven goals for ESG compliance and improvement is crucial. Companies should avoid greenwashing — making false or exaggerated claims about their environmental practices — and instead focus on establishing practical targets based on a thorough understanding of current capabilities and practices.

### 3. Assess ESG Risks in the Supply Chain

Effective ESG management in the supply chain requires a comprehensive risk assessment and due diligence process. Companies must utilize risk models to evaluate suppliers, identify high-risk vendors, and address issues systematically. This includes tailoring assessments and due diligence processes to account for regional laws, cultural differences, and the specific challenges of the business sector.

### 4. Start Small and Advance in Maturity

When getting started with ESG initiatives, especially measuring and monitoring within the supply chain, many companies benefit from starting small and building in maturity[14]. There are a few reasons this can be advantageous:

**A.**

**Undertaking a new ESG initiative takes time.** Any successful ESG program within an organization must touch multiple departments and operational processes, and trying to take on too much too quickly can cause friction and overwhelm.

**B.**

**Culture change also doesn't happen overnight.** To get employees, customers, investors, and other stakeholders on board, you need to set reasonable targets, communicate clearly, build trust, and create lasting change.

**C.**

**Implementing an aggressive ESG measurement program for suppliers and contractors can be overwhelming and met with pushback.** The smarter move is to start gathering data and implementing new processes slowly.

Before you start integrating ESG criteria into procurement processes and supplier contracts, you may want to simply start by gathering data. This will help ease contractors and suppliers into your new program and give you a baseline of current performance and red flags. Later, you can begin phasing in more stringent requirements and contractual obligations, and set realistic company goals.

## 5. Work Directly with Suppliers

Supplier engagement and buy-in is essential to measuring, monitoring, and managing ESG within the supply chain. Companies should work closely with suppliers to improve ESG performance through training, monitoring, and continuous support. This goes beyond mere data collection; it involves contextualizing the information gathered and taking proactive steps to address any identified risks.

## 6. Focus on Continuous Improvement

ESG is not a one-time initiative but an ongoing process of continuous improvement. Companies must stay updated on the latest ESG best practices and regulations and adjust their programs accordingly. This requires utilizing both internal and external resources, such as industry reports, regulatory updates, and expert consultations, to ensure that the company remains at the forefront of ESG strategies.

Establishing a roadmap for continuous improvement is also essential. Companies should regularly update their practices and policies based on new information, changing conditions, and stakeholder feedback. Transparency and communication, both within the organization and with external stakeholders, are vital to maintaining trust and demonstrating the company's commitment to ESG.


## 7. Stakeholder Engagement

Engaging stakeholders is a critical aspect of ESG management. This includes providing training and education on ESG principles for employees and suppliers, raising awareness about the importance of sustainability, and highlighting how individual actions contribute to broader ESG goals.


Building partnerships with non-governmental organizations (NGOs) and other organizations can also enhance ESG efforts. These partnerships provide access to external expertise and resources, helping companies address complex ESG challenges more effectively and creating economies of scale on ESG programs within region and industry.

Moreover, companies should actively engage with stakeholders, including investors, customers, and local communities, to gather feedback and foster collaboration on ESG initiatives. This not only strengthens relationships but also ensures that the company's ESG efforts align with its stakeholders' expectations and needs, building legitimacy and enhancing brand reputation.

# Conclusion

Incorporating ESG into the supply chain is no longer optional but a business imperative. As global awareness of environmental and social issues increases, companies must ensure that their supply chains are not only efficient but also sustainable and ethical. The good news is that this shift rewards those making strides to stay ahead of the curve. By adopting ESG practices, companies can increase profits, mitigate risks, enhance their reputation, and create long-term value for all stakeholders.

Understanding and managing ESG risks in the supply chain is a critical necessity for both hiring companies and their suppliers. As seen, ESG-related incidents can lead to severe reputational damage, regulatory noncompliance, and significant financial consequences for hiring companies.

By adopting recognized frameworks and standards, securing top management commitment, conducting thorough risk assessments, and engaging stakeholders, companies can effectively manage ESG risks and create long-term value. In an increasingly ESG-conscious world, companies that prioritize these efforts will be better positioned to succeed and thrive.

Avetta is a SaaS software company that provides supply chain risk management solutions. Its platform is trusted by over 130,000 suppliers in over 120 countries. Visit Avetta.com to learn more about its ESG and sustainability supply chain solutions[15], which are part of its comprehensive contractor prequalification and management platform.[16]

# Thank You to Our Authors

## Katie Martin, Director of Sustainability

Katie is a multidisciplinary leader in tech, ESG, and sustainability with over a decade of experiences leading businesses through ESG and sustainability transformations. She has designed, implemented, and assessed ESG and Sustainability programs for both Fortune 500s and startups at scale across a variety of sectors including mobility, education, civic engagement, consumer goods, and green tech.

In 2018, Katie launched the global Social Impact practice area at Boston Consulting Group's digital ventures arm, developing and applying ESG methodology to expand business' sustainability capabilities and data management. She also drafted and implemented BCG's strategic roadmap, facilitating service design through core offerings, product design, strategic partnerships, and internal programming.

Because upwards of 90% of ESG and sustainability impact occurs in supply chains, Katie joined leading global supply chain risk management firm, Avetta, in 2022. As the ESG & Sustainability Lead Principal at Avetta, Katie architects solutions to address ESG leaders' organizational goals across their supply chain from initial program development to optimization and reporting, leveraging Avetta's best in class technology platform to deliver transformative results for partners.

She received her B.S. from Cornell University and an MPA from NYU.

## Mike Ford, Global Principal - EHS & Sustainability MSc. MSc. MCIPS. CMIOSH. FIIRSM. FRSPH.

A chartered safety professional with 30 years' experience in HSEQ, ethical sourcing audits and Human Rights, Mike Ford has worked as Head of HSEQ on major infrastructure projects, utilities, mass transit, and manufacturing which included project compliance with responsibility for pre-qualifying and monitoring direct and in-direct supply chain.

Mike acts as an international subject matter expert on behalf of the prestigious Campbell Institute via the International Institute of Risk and Safety Management, reviewing annual safety award submissions. He has two post graduate master's degrees in Occupational Health and Safety Management, and Procurement and Supply Chain Management, as well as lead auditor certification in five disciplines.

His expertise includes:

- Development and delivery of global supply chain risk and evaluation programs focusing upon multi-disciplinary supplier risk (EHS / Qual. CSR / Sust.).
- Implementation and project management of global pre-qualification programs (Western Africa / APAC/Australasia / Canada / Scandinavia and UK and Mainland Europe) within a wide range of sectors: manufacturing, food, and construction (including governmental projects).

# Appendix:

Additional Supply Chain ESG Resources

## Industry Resources

There are a number of globally recognized ESG reporting frameworks that organizations may choose to align their ESG initiatives to, including:

- **United Nations Global Compact**
- **Global Reporting Initiative (GRI)**
- **ISO standards**
- **IFRS Sustainability Disclosure Standards**

There are also industry-specific ESG codes and frameworks for companies that want to tailor their ESG programs further, including:

- **Ethical Trade Initiative (ETI) Base Code**
- **Sustainable Industry Classification System (SICS)**

**ESG in the Supply Chain (PwC)**: In this report, PricewaterhouseCoopers (PwC) compiles findings from a 2022 survey about supply chain trends, including top ESG supply chain challenges and risks.

**Building Supply Chain Sustainability That Can Drive Revenues and Reduce Operational Risks (EY)**: A 2022 Ernst & Young survey that examines supply chain sustainability, including organizational attitudes, challenges, trends, and outlooks around ESG in the supply chain.

**Sustainable Development Goals (United Nations)**: The United Nations has created 17 sustainable development goals to "promote prosperity while protecting the planet."

**WalkFree**: WalkFree is an international human rights group dedicated to eliminating modern slavery around the globe.

## More From Avetta

**How You Can Help End Child Labor in Your Supply Chain**: This blog shares recommendations and tactics organizations can use to combat the use of child labor within their global supply chain.

**Supply Chain ESG Strategy: How to Get Started or Advance in Maturity**: This guide provides recommendations and best practices for organizations starting with ESG or looking to advance in maturity, broken down into feasible milestones.

**ESG & Sustainability Regulations**: Learn about key global ESG regulations, including requirements around sustainability reporting, climate disclosure, and supply chain due diligence.

**ESG vs EHS: A Modern Supply Chain Conundrum**: This whitepaper examines the overlapping roles of EHS and ESG in today's supply chain, plus the benefits of integrating both into a consolidated program.

# Appendix:

Additional Supply Chain ESG Resources

## More From Avetta [Cont'd]

**Benchmarking Organizational Commitment to ESG**: Avetta partnered with the National Safety Council (NSC) to conduct a survey on ESG challenges and trends related to the EHS function within an organization.

**Using Procurement's Power for Good: A Global Approach to Ethical Sourcing**: Avetta collaborated with Procurious to survey procurement and supply chain professionals on key issues, business drivers, best practices, and technology related to ethical sourcing.

**5 Industries in Need of a Clean Supply Chain:** This blog examines five top industries struggling with environmentally friendly and human-rights-conscious supply chain practices, with tips on how to remedy those challenges.

**Avetta ESG Supply Chain Solutions**: Avetta's comprehensive contractor risk management platform offers multiple ways to measure, manage, and mitigate ESG risks within the supply chain, including:

- **Greenhouse Gas and Scope 3 Emissions Reporting**
- **Diversity Sourcing Capabilities & Reporting**
- **Supplier ESG Due Diligence**

**Avetta Case Study: Implementing a Robust ESG Reporting Platform**: This case study of Avetta client Pacific National examines how the Australian rail freight operator uses Avetta to gain critical insights into ESG practices and Scope 3 Emissions within their supplier network.

**Sustainability in the Supply Chain: Setting the Stage for CA 253 and CA 261 Reporting**: This blog sets the stage for reporting on California's ESG regulations, calling for organizations to report on their supply chain sustainability.

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[16] **Source: Avetta Platform Overview;**
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# Avetta Named a Leader in Supply Chain Sustainability Software

Verdantix has named Avetta a leader in its 2024 Green Quadrant for Supply Chain Sustainability Software. Download the report for independent insights into market trends and top software vendors aiding businesses in mitigating ESG risks across supply chains.

[Download the report]


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