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Environmental, Social and Governance in the Supply Chain: Role and Responsibilities

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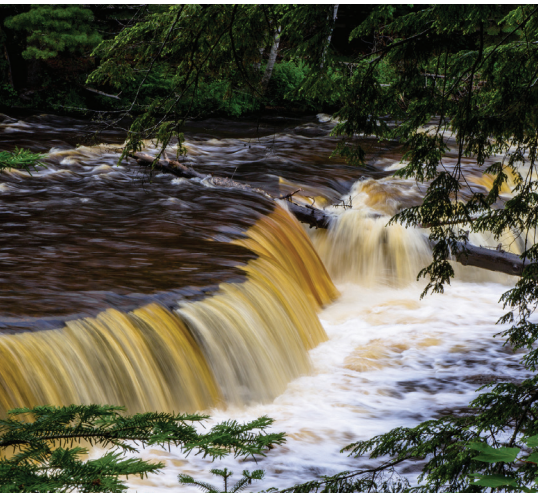
ENVIRONMENTAL, SOCIAL AND GOVERNANCE – ROLE AND RESPONSIBILITIES

Environmental, Social and Governance or ESG has become a growing movement in the global business world over the past decade. As more and more companies learn the importance and impact of ESG, creating measurable metrics, as well as sustainable corporate programs, have become vital. Companies are now investigating how to reduce their carbon footprint, lessen environmental impact and ensuring fair labor practices both within their operations and their supply chain. As financial markets have begun to place a large emphasis on ESG scoring as an indicator of a company's health and investment potential, it has become critical that companies – especially publicly traded companies – begin to fund and implement ESG initiatives and programs.

Francois-Henri Pinault, French billionaire, and CEO of the luxury fashion group Kering, which includes brands like Gucci, Bottega Veneta and Saint Laurent may have said it best, *"Sustainable development is a fundamental break that's going to reshuffle the entire deck. There are companies today that are going to dominate in the future simply because they understand that."*

ESG has been around in different forms for decades, mostly under the title of sustainability. It wasn't until April of 2021 when the European Commission adopted a much stronger and larger scope of reporting – meaning that by 2023, over 50 thousand EU companies will be required to report on their ESG efforts. Many financial institutions around the world have followed suit, including in the US; on March of 2022, the SEC submitted the Climate Disclosure Rule[1] proposal which could open the door for federally mandated corporate ESG reporting. While politically, the US has seen a roller coaster of sorts with its climate control and sustainability efforts; however, it has been several conscientious US corporations that have doubled down on their ESG agendas all while encouraging other organizations to adopt better practices. One thing is sure, the push for standardized ESG scoring is on the horizon and businesses that adopt best practices now will be ahead of the curve.

[1] https://www.sec.gov/files/33-11042-fact-sheet.pdf



EXPLORING THE THREE PILLARS OF ESG

ESG is split into three pillars and represents the framework and three main areas of focus that companies will be expected to report on. While the importance of ESG scoring for companies can vary due to size, industry and overall impact, many companies both private and public have already begun to analyze, fund and report on their ESG activities.

1. The Environmental Pillar

Recycling and use of recycled materials, emissions and greenhouse gases, and air and water pollution are just a small part of reporting companies will need to show on how their operations impact not only the environment around them but also how their products impact landfills and waterways.

Considerations for Environmental Pillar Scoring

- Carbon Emissions
- Product Carbon Footprint
- Climate Change Vulnerability
- Raw Material Sourcing
- Toxic Emissions and Waste
- Packaging Materials and Waste
- Electronic Waste
- Financial Environmental Impact
- Water Sourcing
- Biodiversity and Land Use
- Clean Technology
- Green Building
- Renewable Energy

2. The Social Pillar

The social pillar of ESG focuses on labor practices and the safety of employees, as well as the safety and quality of produced products. Data privacy and cyber security is also a focused topic, as well as vendor and partner sourcing issues that could be considered risky or controversial. Companies could also be scored on how they provide access to their products to marginalized or underprivileged social groups.

Considerations for Social Pillar Scoring

- How Labor is Managed
- Health and Safety Practices
- Worker Training
- Supply Chain Labor Standards
- Product Safety and Quality
- Chemical Safety
- Consumer Financial Protection
- Privacy and Data Security
- Responsible Investing
- Insuring Health and Demographic Risk
- Controversial Sourcing
- Community Relations
- Access to Communication
- Access to Finance
- Access to Healthcare
- Opportunities in Nutrition and Health

3. The Governance Pillar

The governance pillar examines a company's diversity among board members, shareholder rights and corporate behavior dealing with corruption and unethical practices.

Considerations for Governance Pillar Scoring

- Composition of Board in Terms of Diversity and Independence
- Executive Compensation
- Ownership
- Accounting Practices
- Business Ethics
- Tax Transparency

WHY IS ESG IMPORTANT?

From an investment standpoint, investors believe that positive ESG practices reduce risk and create value. A well-run, responsible company that values the environment, their people and has a track record of ethical practices are more likely to outpace their competitors that do not adhere to ESG standards. They are also more likely to be more flexible and resilient when market disruptions occur. Investors are now not only examining current ESG disclosures when evaluating a company, but also an operation's overall strategy and evidence it is keeping its ESG commitments.

From a consumer perspective, many surveys and studies have shown that customers are becoming more aware of ESG efforts and use that information in their buying decisions. One study[2] showed that 76% of consumers will stop buying from companies with a poor ESG record and another stated that 88% of consumers will be more loyal to a company that support social and environmental issues[3]. These developing attitudes also effect the labor market as 64% of Millennials[4] won't take a job from a company that does not have strong sustainability practices.

[2] https://www.pwc.com/us/en/services/consulting/library/consumer-intelligence-series/consumer-and-employee-esg-expectations.html
[3] https://www.pwc.com/us/en/services/consulting/library/consumer-intelligence-series/consumer-and-employee-esg-expectations.html
[4] https://www.forbes.com/sites/afdhelaziz/2020/03/07/the-power-of-purpose-the-business-case-for-purpose-all-the-data-you-were-looking-for-pt-2

SUPPLY CHAINS AND ESG

While global supply chains have seen remarkable disruptions over the past few years, supply chains find themselves on the front lines of the push for ESG improvement. Environmental issues such as delivery vehicles adding to greenhouse gases and the enormity of the supply chain workforce have the potential to expose businesses to unseen risk and public scrutiny through unscrupulous vendor business practices, corruption and worker abuse. Managing vendors and partners throughout the supply chain has become a priority for larger organizations looking to create a more transparent supply chain.

Managing ESG with suppliers is a relatively new exercise for companies; however, there are a few key practices that many businesses have adopted when it comes to communicating the company's ESG message and expectations[5].

- Create ESG metrics for suppliers to measure and benchmark
- Over communicate ESG expectations
- Map suppliers into tiers and evaluate for weakness or possible issues
- Include ESG goals and language in contracts

[5] https://www.thomsonreuters.com/en-us/posts/tax-and-accounting/esg-supply-chain/

ESG SCORING

One of the most widely used and recognized ESG rating systems is the MSCI ESG Score[6]. MSCI currently scores over 8500 companies on ESG. MSCI selects 35 key relevant issues that are industry specific and then scores them from 0-10. They also weight the issues dependent on whether the issue would have an immediate impact or if the impact would not be seen for 2-5 years. After weighting and scoring, the industry adjusted scores are issued from 1-10.

A score of 10 through 7.2 will earn a company the designation of an ESG leader. A score of 7.1 to 1.4 will earn an average label for their ESG score and 1.3 to 0 score comes with the description of laggard.

THE ESG CHALLENGE

As ESG continues to move to the forefront for investors and consumers, businesses will be judged and scored on how they treat the environment in which their business operates, their response to social issues both inside and outside of their operations, as well as governing themselves in a responsible and ethical manner. Companies have now been called upon to play a much larger role in the community and world than just providing a service or a product.

"Companies have now been called upon to play a much larger role in the community and world than just providing a service or a product."

[6] https://www.msci.com/our-solutions/esg-investing/esg-ratings

FORTNA CAN HELP

Reducing carbon emissions, utilizing sustainable packaging, and employing green building strategies are just a few of the ESG considerations that are top of mind for many companies today. Fortna assists companies along the ESG journey by partnering with clients to identify ESG goals and considerations and incorporating them into an operational design that not only ensures ESG standards are kept and maintainable, but also meet and exceed an operation's financial and customer expectation goals.

Visit www.fortna.com to request assistance today.

THE DISTRIBUTION EXPERTS™

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