Board Oversight of Supply Chain Sustainability

Introduction

Most companies are not stand-alone enterprises; rather they are placed in a broader value chain, with both upstream and downstream partners. Each company depends on its supply chains to support the business model. Building strong, long-term, and sustainable relationships can help make these supply chains resilient. Companies can impact the governance, business conduct, social, and environmental factors in their supply chains by establishing and applying the appropriate policies and standards for third-party providers within the supply chains. End consumers, including customers, relevant stakeholders, and investors, are increasingly demanding full supply chain transparency, a trend that is only likely to grow. A proxy for this is the focus by regulatory bodies on Scope 3 emissions targets, supply chain resilience, and workers’ rights in the supply chain, which require companies to engage with their supply and value chains to identify relevant risks and opportunities and have contingency plans in place.

Many businesses have been and are currently experiencing frequent or long-lasting supply chain disruptions for a variety of reasons, such as the recent Covid-related restrictions, labour shortages, geopolitical risks, or sanctions against third-party suppliers, often beyond their control. While these disruptions may not have been able to be averted, we believe that engaged Board oversight of supply chain risk and opportunity management can lead to better planning and ultimately better preparedness of companies in the face of such disruptions.

This Viewpoint sets out investor expectations regarding Board oversight of the company’s supply chain, with a view to supporting the Board’s objective of creating long term value for investors and relevant stakeholders and protecting its workforce.

The 2021 ICGN Global Governance Principles (ICGN GGP) address a Board’s responsibilities relative to its supply chain:

- Principle 1: Board role and responsibilities, focusing on stakeholder engagement, c) understanding the perspectives of relevant stakeholders (including the workforce, customers, suppliers and civil society more broadly) and disclosing how their interests are taken into account to foster positive relations;
- Principle 4: Corporate Culture, and more specifically 4.7 on Human rights, The Board should ensure that it is sufficiently informed of how human rights and modern slavery issues may present material business and reputational risks or might compromise a company’s own values and standards of behaviour. The Board should establish appropriate due diligence processes, strategy, disclosure, engagement, accountability, and other measures to deal with human rights issues which may materialize in connection with the company’s workforce and operations, and
- 4.8 on Workforce safety. The Board should ensure transparent reporting and disclosure of how a company identifies, prevents, and mitigates workforce safety risks in its
operations and supply chains, particularly in terms of the risk assessment process, policies, and procedures.¹

The ICGN GGP tie a Board’s responsibilities of oversight for a company’s entire supply chain, not only as the company addresses current supply chain deficiencies, but to ensure that going forward, a comprehensive strategy is in place that accounts for the requirements of the workforce, investors, and relevant stakeholders.

**State of play of the supply chain oversight**

Investors have an expectation that companies will seek to achieve the successful management of supply chains, which enables businesses to know their corresponding business relationships well, to map out and understand the upstream and downstream part of the value chain to make intentional and well-informed decisions. Companies, through effective supply chain management and oversight, can manage part of their financial and reputational risks, help ensure stable operation by avoiding or minimizing disruptions, get early warning signals about potential workforce instability and ultimately both safeguard shareholder and stakeholder value. Knowing one’s suppliers and requiring their compliance with responsible contractor policies, codes of conduct and timely reporting of incidences reduces the likelihood of companies being caught in a controversy related to supplier misconduct and the potential for negative impact. Regular compliance reporting can also help anticipate supply chain disruptions. For example, engaging suppliers on a company’s environmental sustainability program brings a positive externality of accelerating the transition to a cleaner economy and reducing carbon emission intensity of companies’ production processes. Greater transparency of supply chains and more sustainable supply chain oversight may be reflected in better management and greater trust, which in turn, can facilitate easier access to capital.

Investors have called upon companies to approach supply chain management from a risk management perspective, focusing on financial materiality thresholds, or from a broader value creation, or ‘opportunity’ perspective², looking at human, social, and environmental capitals, and applying the double materiality approach³, which is currently being embedded across certain relevant EU regulations.⁴ Investors have found that targeted supply chain management works best when companies have a clear overview of their principal (adverse) social, environmental, governance and economic risks, impacts and opportunities.

A useful approach to Board oversight responsibility of supply chain has been put forward by the World Economic Forum (WEF), which looks at [Board duties in ensuring company engagement with affected stakeholders](https://www.icgn.org). Some of the levers identified are included in the below visual.

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¹ [ICGN Global Governance Principles 2021.pdf](https://www.icgn.org)
² For example, reducing emissions and shipping cost by streamlining geographic spread of suppliers.
³ The concept of double materiality describes how corporate disclosure should cover both the implications about a firm’s financial value, and about a firm’s social and environmental impact on the world at large.
⁴ EU Corporate Sustainability Reporting Directive and related Sustainable Finance legislation.
While receiving credible and reliable data on third parties’ track records in avoiding forced labour, unfair or unsafe working conditions is difficult, Boards should not be discouraged from asking management the specific questions to work towards obtaining this data. Board members also have a responsibility to hold management accountable for relevant value chain issues, such as product responsibility – ensuring the products and services the company markets are not harmful to the environment, consumers and end users.

There is also a brief guidance document issued by the WEF on effective climate governance on corporate Boards, which could be applied to climate action in the supply chain. The main focus areas identified in this piece are: establishing climate accountability at the Board level, subject command, considering Board structure, encouraging exchange and collaboration, materiality assessment, strategic integration, suitable incentivization and reporting. ICN adopted a similar view and issued a Viewpoint on the Board of Directors and Climate Change in 2020.

A principles-based approach to supply chain management is based on the UN Global Compact Principles, and the OECD Guidelines for Multinational Enterprises, the understanding of which enables meaningful oversight. There are also laws and regulations governing supply chain management and monitoring, most notably the proposed EU Corporate Sustainability Due Diligence Directive, the US Uyghur Forced Labor Prevention Act, the UK and Australian Modern Slavery Acts and the EU Single Market Emergency Instrument. The Organisation for Economic Co-operation and Development (OECD) has built out a dedicated web tool for enabling the

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establishment of more resilient supply chains. This tool also provides guidance for preparedness and responsiveness to supply chain risk, impacts and disruptions.

The company's management and its risk and operations departments are typically responsible for creating supply chain policies and processes, and for implementing them. Investors will have an expectation that these policies and processes have been presented to the Board and updated at regular reporting intervals. In order to increase supply chain sustainability and avoid instances of forced labour, unfair or unsafe working conditions, discrimination, environmental inefficiency or fines, companies should establish and monitor suppliers with supply chain-related targets and measurable KPIs. In practice, digitization has already reduced some barriers between companies and suppliers and enables easier data collection for planning and reporting. Companies may opt for supply chain certification, or even employ distributed ledger technologies for full transparency of the entire chain.

Ensuring this practical approach is overseen by the Board is essential for investors. The Board should approve policies and monitor the implementation of supply chain management standards and controls. Such oversight and accountability may reside with the Board as a whole, the Audit Committee or the ESG / Sustainability Committee to ensure that the principles and values determined by the Board are applied to the supply chain strategy, policies and their implementation. If a Committee charter includes this responsibility, the full Board should receive the reports of the Committee at regular intervals. The Board should also approve the targets and KPIs associated with supply chain management and receive periodic updates on the progress towards them.

**Implementing supply chain oversight to meet investor expectations**

In addition to a comprehensive suppliers’ code of conduct, investors are expecting that issuer companies will incorporate the following components as part of their supply chain oversight and management:

1. Companies should deliver clear expectations to direct suppliers and indirect suppliers as well as across the value chain and have them acknowledge their responsibilities to comply and report as required;

2. Companies should schedule regular monitoring and audit activities: robustness of any audit is largely dependent on the referenced frameworks. On-site audits and credibility of the referenced frameworks and reporting should be considered and verified; and

3. A time-phased escalation strategy with specific action steps (i.e., penalties, withholding of payments or the decommissioning of the supplier in the final stage) to address the potential risks and gaps, ranging from labour or human rights violations, and other social and environmental issues for suppliers.

Investors are asking for companies to implement policies adhering to established frameworks and standards, and seek partnerships with established industry groups and external parties that provide guidance on proactive monitoring, auditing, escalation strategies, and target setting such as

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9 [https://www.oecd.org/trade/resilient-supply-chains/](https://www.oecd.org/trade/resilient-supply-chains/)
as the AICPA SOC for supply chain reports in the United States, or the Supply Chain Resilience Network of Enterprise Europe Network. Investors ultimately also have a responsibility to call for meaningful Board oversight of supply chains, to ensure the long-term resiliency and early signalling of possible disruptions.

Examples of successful supply chain oversight

Case Study 1:

A Japanese company has developed a supply chain plan by backcasting, envisioning the ideal situation in 2050 from the perspectives of both business and social issues and reverse engineering the steps needed to get there. While identifying the need for consolidation of production sites and the mid-term review of the procurement policy from the business perspective, the evaluation of suppliers with human rights risks and power-saving initiatives is incorporated into the review plan for production/procurement approach.

In this case, the Sustainability Committee leads the efforts, working together with the business units to formulate a plan from long-term to short-term, and reports regularly to the Board of Directors. The Board approved the Supply Chain aim in 2050 and the stepping-stones over 25 years to achieve carbon neutrality, zero waste, water reuse and zero work accidents. The plan looks at the programs put in place to reach these long-term goals.

Issues for other companies to consider include:

2. Does the company have a target date in the future for which it can backcast and reverse engineer the steps to meet the future goals?
3. If a company does not have a dedicated Sustainability Committee, is there a Committee in place that would lead such an effort?
4. Does the company have the long-term commitment and perspective that will see the plan through, even as the Board members and senior management may change over the long-term timeline?

Case Study 2: The case study involves a large cap multi-national consumer staples company.

The Conglomerate has committed to build a fully-traceable supply chain in addition to fair payments to farmers. The Conglomerate also partnered with external compliance and social audit programs to monitor progress of its suppliers that are most exposed to risks. For products that are more prone to child labor risks, the company implemented a special monitoring and remediation system to place a heavier focus. The Conglomerate publicly announced its short and medium-term targets to expand the universe of its products that are responsibly sourced.

10 Backcasting is a method used in planning. It begins with outlining a desired goal or object. Next, identify the programs and policies needed to connect that desired future back to the present. Backcasting - Explained - The Business Professor, LLC.
Issues include:

1. **Traceability** of products is challenging, particularly for large cap conglomerates with complex global supply chains. In order to fully trace all suppliers, these companies will need to create a dedicated supply chain that includes all resource groups. While for smaller organizations the supply chain management and oversight may be easier in terms of complexity, it may call for greater resource allocation and therefore might be experiences as more costly.

2. **Effective Audit and Risk Monitoring**: Companies will need to set up external compliance and audit programs to monitor the implementation and progress of suppliers in complying with these policies.

3. **Target Setting**: A company will need to determine how to disclose its short, medium and long-term targets to investors and relevant stakeholders. Regular reporting that is publicly available through filings or reports should be established.

4. **Education**: A company should consider a plan for educating players within the value chain of best practices and audit procedures as another realm of opportunity. Engaging with regulators and communities to build awareness on forced and indentured labor and the company's involvement in such effort not only reduces its exposure to risk but also builds credibility amongst its consumers.

5. **Industry bodies**: If a company is planning to work with peers to create industry bodies to improve traceability, the desired goals of such an effort should be clear and the requisite commitments should be made by all participants.

**Proposed engagement questions**

Investors and investment managers have an important role in encouraging best practices as part of their investment stewardship efforts by engaging with portfolio companies on supply chain oversight. Some engagement questions that can be helpful in this context are:

- Does the Board have any formal supply chain oversight responsibilities? If not, has the Board considered taking on this oversight role? If not, what is the rationale?

- Does the Board consider scenarios of supply chain disruption due to geopolitical risks or changes resulting from climate risk (i.e. need for fuel-switching, friend-shoring, general shortening of supply chains, etc.)?

- Which Board member(s) or Committee has supply chain oversight responsibilities? How closely are they familiar with the supply chain strategy, policies, targets and KPIs? How frequently is the Board updated on the supply chain and associated progress towards KPIs? Is there a regular educational program to update the Board members on supply chain issues?

- How are the values and principles guiding the company’s supply chain management policies and processes being determined? Does the Board set these policies?
• What public disclosure is available on the Board’s involvement and oversight of supply chain-related processes? What is the role of senior management and who is responsible for reporting to the Board?

• How frequently and through what processes are the material supply chain risks and opportunities determined? How are social and environmental issues factored into these risks?

• What is the screening process for suppliers? Does the company have a supplier code of conduct or responsible contractor policy that all suppliers must sign and report against?

• What is the frequency of audits of suppliers? Does the Board receive a copy of the audit?

• What are the consequences for suppliers who fail to comply with the supplier code of conduct, or for suppliers that report an incident under the policy?

• What are the mitigating measures in place to ensure business continuity in case of supply chain disruptions? Does the Board approve the strategy to limit supply chain disruption? In the past two years, has the Board been updated on supply chain disruptions for the company or for its industry sector, or supply chain disruptions that occurred with peers?

• What (annual) public disclosure is available about suppliers’ own sustainability credentials? And how is this aggregated at the company level? Is the Board accountable for these disclosures?

• Has the Board adopted any global or industry standards and/or frameworks to help identify supply chain issues and create a blueprint for the company to follow, in alignment with these standards?

About ICGN Viewpoints

ICGN Viewpoints provide opinion on emerging corporate governance and stewardship issues and are intended to generate debate, whilst not defining a formal ICGN position on the subject. This Viewpoint was drafted by Eszter Vitorino, Co-Chair of ICGN’s Global Governance Committee and was reviewed by other Committee members. ICGN Viewpoints are produced by our Secretariat and member-led Policy Committees and we encourage dialogue by contacting Committee chairs directly or the ICGN Secretariat as follows:

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