The Carrot isn’t Attached to the Stick:
The Misalignment between Firms’ Sustainability Practices
and the Rating Indices that Reward Them

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Abstract

In our globalized economy, multinational corporations (MNCs) often work with multiple tiers of suppliers, many of them located in developing nations with poor infrastructure and fewer government regulations. The multi-tiered nature of modern supply networks creates a complex network of producers responsible for the goods of a single firm which makes tracking production and managing disruption exceedingly difficult. Adding to that challenge is the increasing demand by the MNCs’ customers for ethically sourced products and a desire to understand where and how an item is made. With each passing year and especially in the face of COVID-19 pandemic and its multitude of challenges, MNCs have made efforts to improve practices and meet ever changing environmental, social, and governance (ESG) standards and expectations. Common practices for ESG standards implementation, where procurement takes a central role in communicating and working with the firms’ suppliers to achieve these standards, have been well documented in the literature. These common practices that have been shown to be effective in affecting change in supplier behavior, however, are not often considered when an ESG rating organization confers its grades. By outlining the current practices and detailing several common ESG rating indices, this paper highlights the misalignment between ESG procurement practices and the rating indices that reward firms for their ESG efforts.

Keywords: sustainability, ESG performance, ESG ratings, behavioral operations, supply chain governance, supplier behavior, firm reputation
I. Introduction

In imagining a chain, one probably visualizes a linear formation, comprised of connecting points where one link neatly leads to the next. Decades ago, when much of product manufacturing was completed domestically, this mental image was a fairly accurate depiction of a firm’s operations and its supply chain. Depending on the industry, where the number of suppliers was limited, firms carefully managed their relationships with their select few suppliers and vice versa. Globalization, however, has enabled firms to broaden their operations to locations halfway across the world from corporate headquarters. Thus, the term supply chain now stands as too simplistic a descriptor. More accurately, one can look at a multi-national corporation (MNC)’s relationships with its hundreds – maybe thousands – of suppliers as a complex network or a constellation (Ramirez and Normann, 1993). Two key consequences of this shift are the increasing complexity and opacity of these networks, and the subsequent effect that it has on the relational dynamics between MNCs and their suppliers.

Being physically located further from the firm’s resident country, particularly those operating in developing nations where environmental and labor regulations may be less stringent, multi-tier suppliers are not easily held to higher standards of operation. This lack of accountability, however, does not align with the increasing demand and expectation from consumers, investors, and governments for firms to place a heavier emphasis on sustainability, especially in the wake of the COVID-19 pandemic. Environmental, social, and governance (ESG) standards have been developed to measure the sustainability and ethical performance of companies, and companies have been motivated to develop their own ESG goals that meet or exceed their industry standards for several reasons. For one, sustainability efforts have become not only an ask but an expectation among consumers. The Global Sustainability Study 2021
survey found that 60 percent of consumers rated sustainability as an important purchase criterion, and, moreover, that 34 percent of the population is willing to pay more for sustainable products or services (Pope, 2021). In addition, sustainability issues—natural disasters, labor rights abuses, environmental degradation, etc.—pose threats of significant supply chain disruption and, subsequently, a significant operational and reputational risk to the firm. “This ongoing marketplace instability has prompted alternative fund managers to think beyond immediate short-term navigation of the global economy and markets. In addition to delivering on their commitment, they are thoughtfully embracing a more long-term view of their overall business to position it for the future” (Jaros et al., 2022). It comes as no surprise, then, that global ESG assets are on track to exceed $53 trillion by 2025, which is more than one-third of the projected $140.5 trillion in total assets under management (Adams, 2021). Managers are responding by “developing policies and governance structures to set policy and embed ESG into their corporate governance and investment decision-making” (Jaros et al., 2022).

Bové and Swartz (2016), from McKinsey Consulting, estimate that the supply chains of the consumer sector account for more than 80 percent of greenhouse gas emissions and more than 90 percent of natural capital impacts. Wanting to mitigate the associated operational and reputational risks to the firm, managers are highly incentivized to ensure that their suppliers are, at the very least, compliant with the firm’s ESG standards. Due to the complexity of modern supply chain ecosystems, however, the ability of a firm to enforce its sustainability expectations beyond its own headquarters is exceedingly difficult. As the liaison to a buying firm’s suppliers and the experts of the supply base landscape, the responsibility to implement and enforce supplier ESG behavior largely falls on the procurement function in the firm. The management of suppliers’ ESG risks is an ongoing process and requires continual improvement in multiple areas,
such as the implementation of individual firm and industry ESG frameworks, mechanisms to monitor suppliers’ behavior, the development of useful ESG measures, and the effective reporting of those measures to firms’ stakeholders.

To address the latter, firms have begun to engage in voluntary ESG reporting, but they have also become increasingly dependent on third-party ESG rating agencies to grade their ESG performance. Consequently, ESG rating agencies, and their respective indices, play an important role in communicating their ESG efforts to their many stakeholders in a concise, digestible way. Nevertheless, with more than 600 agencies operating in the market, each using different metrics for the same construct and entity; managers, consumers, and investors alike are faced with a complex and inconsistent ESG rating landscape (Deloitte, 2021). For firms to incorporate various ESG measures into their procurement management in a meaningful way, it is imperative to understand the evolving ESG procurement practices and the ESG rating landscape that grades them. To contribute to this understanding, the author briefly discusses the role of supply chain management, and more specifically, procurement to facilitate a more comprehensive look at the mechanisms commonly used by firms to engage their suppliers in the implementation of those standards. The paper then presents a comparison of the major ESG indices and a discussion of how their rating systems align with the defined common practices.

II. The Role of Procurement and ESG Standards

The Role of Procurement

It has been well documented that the modern supply chain is the leading culprit for negative environmental impacts. While many firms run highly successful sustainability initiatives in their local communities, for most products “80 to 90 percent of greenhouse-gas emissions are ‘Scope
3’: indirect emissions that occur across the company’s value chain…Of these emissions, two-thirds are usually from the upstream supply chain” (Cherel-Bonnemaison et al., 2021). Not only does today’s globalized structure lend itself to more environmental damage due to increased emissions, among other issues, but the inherent opacity of modern supply chains exacerbates the challenges firms face in developing, implementing, and reporting ESG goals and standards. The further down in the supply network, the less transparent supplier practices become, and the more difficult it can be to assess their performance along these metrics. “Consumer companies do not deal directly with all the firms in their supply chains. Primary suppliers routinely subcontract portions of large orders to other firms, or they rely on purchasing agents to place orders with other firms…Subcontractors can be managed loosely, with little oversight regarding workers’ health and safety” (Bové and Swartz, 2016). As a result, it is exceedingly difficult for firms to enforce desired behaviors beyond their first-tier suppliers, thus increasing the risk that poor environmental and labor practices go unnoticed (Cherel-Bonnemaison et al., 2021).

Procurement serves as the primary interface with the upstream supply chain as it shapes purchasing decisions and influences product design (Cherel-Bonnemaison et al., 2021). Ramirez et al. (2020) similarly assert that at the center of this necessary evolution in how firms manage their supply chains is procurement due to its direct and indirect connection to all stakeholders along the value chain. Thus, unlike other departments in a firm, procurement has the capacity to connect individual stakeholders like points in a constellation, each incomplete without the other. Doing so requires a close relationship between buyers and suppliers, which can prove difficult when the supply network can consist of multiple tiers of suppliers. As previously indicated, the voluntary reporting of ESG standards serves as an opportunity to communicate a firm’s ESG efforts to its many stakeholders. Moreover, the development of ESG standards represents a
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means for firms to organize their ESG goals and help inform better decisions throughout the value chain process.

*ESG “Standards” but a Lack of Standardization*

It has been well-founded in the literature that through relevant and reliable information sharing about their sustainable operations both upstream and downstream, firms can enhance their relationships with their respective stakeholders and improve firm performance by meeting those stakeholders’ diverse expectations (Schuster, 2020; Gualandris et al., 2015; Gualandris and Kalchschmidt, 2014; Gonzalez-Benito et al., 2011; Branco and Rodrigues, 2006; Hall and Vredenberg, 2003; Orlitzky et al., 2003; Jones, 1995; Hill and Jones, 1992). On the other side of the same vein, however, failure to meet adopted ESG standards could present its own calamity. Accidents, or even associations with accidents, can consequently be very damaging to a firm’s reputation, especially if that firm is perceived to be responsible for the accident (Coombs and Holladay, 2002). All four supplier firms associated with the space shuttle Challenger disaster, for example, suffered negative stock market reactions, and the firm considered most responsible was punished more severely than the others (Maloney and Mulherin, 2003). After admitting in 2015 to selling 11 million vehicles worldwide with its illicit emissions control software, VW’s stock price dropped by 32 percent within one week, which translated to about $17 billion in shareholder value loss (Jacobs and Singhal, 2020). Jacobs and Singhal (2020) further consider the effect that the VW emissions scandal had on the automotive ecosystem and find that tier-1 suppliers and business customers, particularly those suppliers dependent on revenue from VW, were the most negatively impacted by mean stock price reactions of -2.69 percent and -5.28 percent, respectively. Based on these findings, procurement managers have clear incentives to want to meet ESG standards and avoid risk as they seek to meet the expectations of their
stakeholders. These studies (Jacobs and Singhal, 2020; Maloney and Mulherin, 2003), however, reference grievous disasters, which, though important, do not capture the nuance of ESG standard effectiveness in day-to-day operations. Moreover, they assume that ESG standards are unequivocally effective in enforcing desired behavior.

In fact, Pucker (2021) finds that the effectiveness of ESG standards can be limited by the lack of standardization and inconsistency in ESG reporting, which can make it difficult to compare the performance of different companies. Therefore, efforts to develop more standardized and consistent ESG metrics are necessary to increase their effectiveness and impact. The effectiveness of ESG standards is also entrenched in the assumption that a cascade effect exists, wherein standards adopted by MNCs will naturally pass down to, and get adopted by, the first- and lower-tier suppliers. Villena and Gioia (2020), however, dispute this assumption in an analysis of three exemplary MNCs known for their sustainability focus, including nine of their top-tier suppliers, and 22 of their lower-tier suppliers. In their assessment, they found that the different sustainability standards among industries, limited resources and expertise, and lack of a direct contractual relationship with the MNCs led to glaring failures in the supply network. With an MNC potentially serving as one of many customers, perhaps from varying industries, the incentive to comply is limited. Thus, it falls to procurement managers to engage with suppliers—sharing information, selecting the best partnerships, and effectively managing supplier relationships to enable the value offered by ESG standards (Sanchez, 2021).

III. Common Procurement Mechanisms for ESG Implementation

Here, the author will outline and examine commonly implemented ESG procurement mechanisms in terms of what they are, how they are implemented, what their benefits and their drawbacks are, and which of them are considered most effective in the literature. To do so, the
The author adopted the classification scheme posited by Villena and Gioia (2020), who divide the common practices into four key areas: Direct, Indirect, Collective, and Global. Each of these approaches is defined as follows:

- **Direct**—The buying firm sets and monitors social and environmental targets for their first-tier suppliers regarding lower-tier suppliers.
- **Indirect**—The buying firm delegates elements of lower-tier-supplier sustainability management to first-tier suppliers.
- **Collective**—The buying firm collaborates with its competitors and major suppliers to develop and disseminate industry-wide sustainability standards.
- **Global**—The buying firm collaborates with international organizations and NGOs that share their goals.

According to Villena and Gioia (2020), MNCs should use a combination of these approaches to encourage sustainable practices throughout their supply chain. As previously indicated, monitoring suppliers’ behavior in multi-tier supply networks can be challenging for firms, as they are often several steps removed from the primary supplier. At their very least, both these individual or combination of mechanisms will serve as opportunities for conversations and education around these incredibly important topics. At their best, however, they can lead to great sustainability improvements within the multi-tier supply network and meaningful engagements between the supplier and buyer. In reviewing the relevant literature, the author found several common strategies that firms can use to monitor and manage their suppliers’ ESG behavior, including traceability, goal setting, self-assessments, audits, peer collaboration, expert collaboration, and contractual requirements. Following is a discussion of each of these strategies.
in terms of implementation, benefits, drawbacks, and the categories they belong to are based on Villena and Gioia (2020) classification scheme.

**Traceability and Transparency**

Put simply, traceability means tracking products or components through each stage of the product’s life cycle. Traceability is important due to its links to risk management, firm sustainability, compliance, stakeholder engagement, and innovation. Because supply-chain mapping is led and implemented by the buying firm, it is classified as a direct approach. Greater supply chain complexity can lead to lower supply chain visibility. Consequently, mapping a complex supply network can be time-consuming and exceedingly difficult. Nevertheless, among the practices listed in this paper, and identified in the literature, it is the most critical for companies to perform to gain an accurate insight into their potential risks, to set firm environmental standards, and to monitor firm and supplier performance (Sanchez, 2021; Villena and Gioia, 2020; Bové and Swartz, 2016). Common risks seen in the supply chain today include disruptions in production or delivery, changes in regulations, quality issues, and environmental disasters. A map of a firm’s supply chain helps it to identify and manage risks within its supply chain, which enables the development of well-founded contingency plans and quick and effective risk responses.

Let us consider risk management through the lens of the Rana Plaza disaster. In 2013, a garment factory in Bangladesh collapsed, which resulted in the death of over 1,100 people and injured more than 2,500 (Thomas, 2018). Of course, part of the blame falls on local governments for keeping labor safety and environmental regulations to a minimum. However, it is important to note that the garment manufacturers operating out of the Rana Plaza facility were third-tier suppliers to large MNCs, such as Benetton, Mango, Primark, Walmart, and Zara (Webster,
In addition to the tragedy of this event, these businesses saw several consequences. With the supply disrupted, retailers were not able to sell the lost product to consumers, which would negatively impact the firms. Moreover, while the MNCs may have had plausible deniability of the working conditions due to poor supply chain visibility, their involvement and the associated negative publicity resulted in reputational damage and public outcry. Had there been greater supply chain transparency, enabled by an accurate map of the supply chain, wherein the buyers knew that some of their business was being outsourced to manufacturers at Rana Plaza, they might have been able to avoid such a horrific tragedy and the reputational risk that came with it.

Beyond knowing the suppliers at each stage of the production process, supply chain traceability also helps firms understand how natural and human resources are used to identify the most critical sustainability supply chain issues in their own supply chain (Bové and Swartz, 2016). By partnering with organizations experienced in sustainability analytics, firms can gain insight into sustainability risks associated with their operations. While risk assessments may be conducted solely by the buying firm, leading us to refer to it as a direct approach, it is very common for firms to outsource this type of analysis to experts in sustainability risk assessment. As such, for the purposes of this paper, the expert collaboration will be referred to as a global approach. Bové and Swartz (2016) highlight two key frameworks that companies can use, including the following:

- The Sustainability Insight System (THESIS) is a research database, developed by The Sustainability Consortium (TSC) that highlights sustainability hot spots for more than 110 consumer product categories across 8 industry sectors: Paper, Pulp, and Forestry; Clothing, Footwear, and Textiles; Food, Beverage, and Agriculture; Electronics; General Merchandise; Home and Personal Care; Toys; and Packaging. THESIS provides
supporting documents to respondents, such as Assessments, Sustainability Snapshots, and Supply Chain Diagrams (Figure 1).

**Figure 1: Example of a Supply Chain Diagram provided by THESIS**

![Supply Chain Diagram](https://sustainabilityconsortium.org/thesis/)

Based on firms’ responses to survey questions and the firm’s industry sector, which can be completed annually for year-over-year benchmarking, “TSC identifies the most significant hotspots within a product category supply chain and designs key performance indicators (KPIs) to measure supply performance on those hotspots” (The Sustainability Consortium).

While TSC also provides tailored programs to support supplier education, it is important to note that TSC provides insights on risk, not recommendations on how to address it. As a result, firms using the tool, already an intensive survey process, may be more bewildered than when they started, requiring them to expend more resources to unpack the information and choose an appropriate strategy going forward. A 2016 McKinsey survey reflected this conundrum, indicating that only one-fifth of the 1,700
respondents to the TSC survey felt that they had a comprehensive view of their supply chains’ sustainability performance (Bové and Swartz, 2016).

- Like TSC, The World Wildlife Fund (WWF) maintains a sustainable sourcing framework that leverages geographical data, secondary research, and its global network to identify priority commodities and analyze supply risks. The Supply Risk Analysis measures the risk associated with the production of a range of commodities according to 50 key performance indicators (KPIs), which inform the type of risk, the probability of occurrence, and the severity of the impact. Unlike TSC, however, the WWF will work with firms on the development of risk mitigation strategies and continued process improvement monitoring (Figure 2).

Figure 2: The World Wildlife Fund Supply Risk Analysis Process

![Figure 2: The World Wildlife Fund Supply Risk Analysis Process](https://www.supplyrisk.org/)

The frameworks developed by TSC and WWF, while not perfect, are two of the most well-established tools available to firms that seek to better understand the social and environmental impacts of their operations. Moreover, both frameworks are effective as a tool for benchmarking a firm’s practices against its competitors within its industry sector and, therefore, represent a critical aid for firms setting their own sustainability goals and developing their own standards.
Adoption of ESG Framework and Reporting Standards

Sustainability standards are guidelines or principles that define what constitutes sustainable practices in a particular industry or context. They are typically developed by industry associations, non-governmental organizations, or government agencies, and are intended to guide companies in their efforts to operate sustainably. Some examples of sustainability standards and certification programs include:

- Those developed by the Sustainability Accounting Standards Board (SASB) for public companies looking to give investors sustainability information about their operations (Bové and Swartz, 2016);
- The Global Reporting Initiative framework (GRI), which provides guidelines to report on their sustainability performance, including environmental, social, and governance factors (Bové and Swartz, 2016);
- The Forest Stewardship Council (FSC) certification for responsible forest management;
- Those developed by the Marine Stewardship Council for sustainable seafood, which looks at the management of fisheries and the protection of marine ecosystems;
- The LEED Certification for green building design and construction, which looks at energy efficiency, water conservation, indoor air quality, etc., and;
- The Roundtable on Sustainable Palm Oil (RSPO) certification, which sets standards for environmental and social practices in the palm oil industry.

Overall, sustainability standards are an important tool for companies to ensure that they are operating sustainably and responsibly. They provide guidance and benchmarks for sustainable practices and can help companies to build trust and credibility with stakeholders. The work that a firm does to benchmark its operations according to industry standards using an external tool
would represent a global approach. Furthermore, the annual sustainability report that a firm
publishes also represents a global approach. The continued evaluation of those standards and
their implementation among suppliers via KPIs, however, serves as a direct approach in Villena
and Gioia’s (2020) classification scheme.

When it comes to sustainability standards and reporting, the assumption is that if
companies committed to measuring and reporting publicly on their sustainability performance,
four things would happen (Pucker, 2021):

1. Individual companies’ ESG performance would improve (because what gets measured
gets managed).
2. A link tying companies with better sustainability records to better equity returns would
emerge.
3. Investors and consumers would reward companies with strong sustainability
performance—and put pressure on those that lagged.
4. Ways to measure social and environmental impact would become more rigorous,
accurate, and widely accepted.

The reality, however, is less idealistic. While there exist some comprehensive standards
and certifications, like those put forth by the GRI and SASB, there are also many specialized
standards that focus on a specific issue or an industry. Because of the variance in the certification
process and criteria, existing standards may not address broader environmental and social issues,
and standardization remains lacking. These shortcomings make it difficult for companies and
stakeholders to compare and evaluate sustainability performance. The cost of certification can
also serve as a barrier to adoption, particularly for small- and medium-sized enterprises (SMEs),
and because participation is strictly voluntary, the specialized standards may have limited
effectiveness in driving widespread change across an industry or sector. Pucker (2021) asserts that the lack of standardization serves as the greatest crux to reporting. Unlike the agreed-upon standards in place for financial reporting, where compliance is ensured by the U.S. Securities and Exchange Commission, sustainability reporting standards lack a referee, meaning companies have complete discretion over what standard-setting body to follow and what information to include in their annual sustainability reports. And due to the global nature of today’s supply chains, it is incredibly difficult to ensure that these standards are being upheld beyond the focal corporations and their first tier of suppliers. It is not to say that ESG reporting has no purpose or is not a valuable tool. But, for it to be effective, the standards need to reach down to the lower-tier suppliers and across industries, and they need to be supported by other procurement mechanisms. Such mechanisms include codes of conduct, supplier self-assessment surveys, audits, peer collaboration, incentive programs, and contractual requirements as further discussed below.

*Contract Design and Supplier Engagement*

Working with offshore suppliers, as previously noted, comes with inherent risks, including, but not limited to, supply shortages and logistics disruptions (de Treville and Trigeorgis, 2010). But in the last few years, Chen and Lee (2017) indicate that more than half of corporate supply chain executives have expressed concern about the risks associated with irresponsible suppliers. Not only are supply disruptions more frequent, but they can also be very damaging to a company’s brand and reputation. Assuming firms continue to primarily assess supply chain success on lowest costs and, subsequently, continue to utilize outsourced labor, Chen and Lee (2017) suggest a series of controls to address “supplier responsibility problems”. These controls fall into two categories: problem identification, which can be achieved through supplier screenings and
regular audits to detect violations, and behavioral change incentives, which can be accomplished by using recognition, increased future business, or investment in training (Chen and Lee, 2017). More often than not, a combination of the two is required and the implementation demands a deep understanding of different suppliers’ responsibility problems and careful use of incentives to mitigate the known bad behaviors. To do so, firms must have rigorous supplier selection requirements and regularly engage with their suppliers to ensure compliance. Sanchez (2021) highlights the critical role played by supply managers as they “build supplier relations, set expectations, and create joint initiatives that transform the commitment to sustainability performance improvement.

Consequently, it is evident that contract design is crucial for both suppliers and buying firms to understand each other’s expectations. Contracts serve as the initial opportunity for firms to communicate their sustainability standards to their suppliers, and how the suppliers are expected to uphold these standards within their own facilities and with their own suppliers. While the language may vary, these codes of conduct set forth by the firm establish the bar for suppliers to follow in order to ensure ethical and sustainable business practices and mitigate risks to the company’s reputation and operations. In addition, contracts also allow companies to introduce other useful tools for engagement, notably self-assessment surveys, incentive programs, and audits, each of which is further elaborated as follows:

**Self-Assessment Surveys**

Self-assessment surveys, also referred to as supplier audits, are typically administered by the primary firm and carried out by the supplier. Ideally, the results then allow the firm to identify opportunities for improvement and to collaborate with the supplier on how to implement
necessary changes. Morrel-Samuels (2002) outlines the following guidelines for obtaining useful survey responses:

1. Ask questions about objective, observable behavior, not thoughts or motives.
2. Include items that can be independently verified.
3. Measure behaviors with an established link to firm performance.

While the focus in his work (Morrel-Samuels, 2002) is on workplace surveys, the principles are applicable to supplier self-assessment surveys as well. MNCs can use surveys to assess their first-tier suppliers on their performance, prompting these first-tier suppliers “to engage in internal discussions about whether they should and could alter their procurement practices to adopt industry-wide sustainability standards” (Villena and Gioia, 2020).

Morrel-Samuels (2002) noted, however, that “not all [self]-assessments produce such useful information, and some of the failures are spectacular”. Consider the results of self-assessment surveys. If a firm uses survey responses as a weapon with which to punish suppliers, this action may discourage suppliers from being forthcoming about its practices, or even encourage dishonesty. The same could be said if the outcome of the survey is a reward, especially if there are suppliers in competition with one another. A key survey guideline identified above is the ability to independently verify the responses. Therefore, it is imperative that the firm issuing the survey verify the responses, perhaps via an annual audit, and respond accordingly.

**Audits**

Audits are an opportunity for the buying firm to follow up on the veracity of supplier survey responses and can be conducted in a few ways in which individual, joint, and shared
audits are the most commonly adopted approaches. The first—the individual audit—is identified as a direct approach while the latter two represent collective approaches. Typically, firms tend to adopt “an independent audit-penalty mechanism in which they independently conduct audits of their suppliers’ factories and impose individual penalties when noncompliance is detected” (Caro et al., 2018). Even under the assumption that their independent auditors are responsible and honest, the audit process can still be very costly and time-consuming, which means that they may not occur at an optimal frequency. The resource requirement may also pose a barrier to engagement for SMEs, who may lack the funds and expertise to conduct an audit. If they can, it might be a service outsourced to an external, independent auditor. Moreover, since it is typical for suppliers to manufacture products for multiple customers, the penalty imposed by a single buyer may not be severe enough for the supplier to comply with the required safety standard (Caro et al., 2018). Caro et al. (2018) consider two other audit-penalty mechanisms: joint audits and shared audits. Joint audits are conducted by a consortium of buyers who share the total audit cost, and the supplier is subjected to a collective penalty in the event of an audit failure. Shared audits, on the other hand, are conducted individually and the results are shared with the suppliers’ buyers. Both mechanisms increase buyer leverage and reduce buyer costs, but Caro et al. (2018) conclude that collective penalties in joint audits yield better results, both in terms of buyer profit and supplier compliance. In industries that typically use short-term contracts, however, audits may not be as effective. Joint audits also demand that all participating firms share the same standards and agree on the incurred costs and penalties. If some firms do not agree on a standard being measured and, in an effort to compromise, throw out that KPI, the audit effectiveness is diluted (Schuster, 2019).
**Incentive Programs**

Supplier incentivization is another mechanism of supplier engagement. Incentives and their implementation can vary dramatically, though they are generally classified as indirect approaches based on Villena and Gioia’s (2020) classification scheme. When contracting with a supplier, the firm may be able to reward good behavior (in this case, meeting sustainability standards) with a long-term contract or with preferred supplier status. Depending on the industry, the competitiveness of that industry, and the nature of the product provided by the supplier, these tactics could serve as a significant incentive to the supplier. For example, a car manufacturer may suggest a long-term contract to its supplier for car seats in a saturated car seat market if it meets the car manufacturer’s sustainability standards and ensures that its own suppliers do the same. The car seat supplier might go to great lengths to obtain and maintain that long-term contract with the car manufacturer because it would mean consistent business, thus reducing its own financial uncertainty and risk. The car manufacturer would then meet its standard and help its supplier do the same; however, given that the market is saturated, it could also lose some of its leverage to reduce costs. In this circumstance, other incentives could be considered, which could come in one or more of the following forms:

- **Training programs**—The buying firm can provide sustainability training to its first-tier suppliers that would teach them how to implement sustainability standards within their own operations and engage their suppliers to do the same.
- **Pilot sustainability initiatives**—The buying firm can reward high-performing suppliers by working with them on the implementation and innovation process.
• Awards and product labeling—The buying firm recognizes its sustainability leaders among its suppliers and adds a label on its product identifying the supplier, giving the supplier more ownership of the product.

• Special financing—The buying firm provides favorable financing to high-rated suppliers for their operational improvements.

It is important to note, however, that such indirect approaches as supplier incentives do not carry much weight as stand-alone initiatives. A common criticism of these incentive programs is that they may only help those suppliers who are already performing well. To really affect change within the supply network, the challenge will be in engaging and encouraging those underperformers. Furthermore, if the incentives for fast delivery still outweigh those for sustainability standards, suppliers may still opt for the status quo. The industry circumstances are also going to impact the effectiveness of incentivization. Return to the car manufacturer and seat supplier example, and now consider that the seat supplier services many car manufacturers, each of whom has different sustainability standards. Losing business from the focal car manufacturer might not have as much bearing on the seat supplier because it has so many other customers.

In contrast, if all the car manufacturers had the same standards to which they were all holding their suppliers, the seat supplier would have a lot more to lose. As mentioned previously, the lack of standardization of sustainability metrics and goals within an industry minimizes the positive impact that the set standard can have. In his experience with Timberland, Pucker (2021) laments that even though Timberland was recognized for its sustainability leadership in the shoe and apparel industry, it takes more than one good actor to change the rules of competition within an entire industry. Such realizations lead to another commonly used ESG sourcing mechanism, namely peer collaboration.
Peer Collaboration

Peer collaboration, a collective approach in the Villena and Gioia’s (2020) classification scheme, represents a key practice for driving the commitment to industry-wide standards and the implementation of those standards among the industry’s suppliers. Typically organized through consortia or industry organizations, participating firms can share resources with their competitors and major suppliers to achieve industry-wide sustainability goals (Villena and Gioia, 2020). Suppliers can also take part in these organizations and take advantage of collective training provided by all member firms. These approaches, however, are vulnerable to common pitfalls, such as the following:

- **Competition**—Coalitions are often comprised of member firms from the same industry, which also makes them competitors and discourages information sharing.

- **Resources and Capabilities**—Member firms may also have different resources and capabilities to devote to sustainability efforts. For example, a smaller firm may not have the leverage to demand that its suppliers meet its sustainability standards. On the other hand, while a larger firm maintains more leverage, the resources required to meet a goal may be far greater than a smaller firm can afford. Thus, the distribution of the burden may vary.

- **Dilution**—To ensure that all members can meet the same goals, the stringency of the requirements may be diminished, which dilutes the coalition’s power to identify and meet meaningful standards.

- **Enforcement**—A coalition may also lack power if it lacks the ability to enforce behavior from its member organizations.
The success of collective approaches, therefore, hinges on the open sharing of information and the subsequent spirit of collaboration.

**ESG Procurement Segmentation Analysis**

Applying Villena and Gioia’s (2020) classification scheme, this paper develops the Sustainability Implementation Matrix (SIM), a segmentation framework of the common ESG procurement mechanisms discussed above (Figure 3). The classification of approaches remains the same, except for the “Global approaches” which are labeled in the SIM as an “External approach”. The reason for this modification is to capture the collaboration and leadership required of external organizations, like NGOs, to engage in global mechanisms. The common practices are defined according to the degree of coordination required in contract design with the supplier along the vertical axis and where responsibility resides—either with the buying firm, the supplier firm, or the third-party organization—along the horizontal axis.

*Figure 3: The Sustainability Implementation Matrix*

Note: * Referred to as “Global” in the literature
IV. Overview and Comparison of Sustainability Rating Indices

Most of the tools identified above are utilized by internal stakeholders to ensure they are meeting their firm’s sustainability standards and to encourage their network of suppliers to do the same. While some of these activities may be vaguely communicated to external stakeholders in annual reports, ESG rating indices also serve as sources to inform external stakeholders of firms’ ESG efforts and risk exposure. These indices assess the sustainability performance of companies based on various ESG criteria, allowing external stakeholders to make informed decisions about investments, partnerships, consumption, and other business relationships. The rankings landscape (Figure 4), however, is busy and inconsistent.

Figure 4: The ESG Rankings Landscape

Some of the most widely used sustainability rating indices include, but are not limited to, the following: Dow Jones Sustainability Indices (DJSI), FTSE4Good Index, Institutional Shareholder Services ESG (ISS ESG), Refinitiv, Sustainalytics, and MSCI ESG Rating. Below is
a discussion of these indices with an emphasis on how their frameworks are structured and how they award ratings.

**Dow Jones Sustainability Indices (DJSI)**

To be included in the DJSI, a firm needs to be among one of the top 10 percent in its industry based on the S&P Global Corporate Sustainability Assessment (CSA) and the S&P Global Trucost Data. The S&P Global CSA is an annual evaluation “for companies looking to establish a sustainability baseline and gain independent insight into their sustainability performance relative to peer companies” (ESG Scores—S&P Global, 2023). The participating firm completes an industry-specific questionnaire, of which there are 62, containing approximately 100-130 questions that span 23 different key factors across the environmental, social, and governance/economic realms (Figure 5). The web-based questionnaire and publicly available information serve as the basis for the approximately 1,000 data points on which the company is assessed, which focuses on financially material factors (Figure 6) that “can affect the entity’s business operations, cash flows, legal, legal or regulatory liabilities, access to capital or reputation, as well as relationships with key stakeholders” (ESG Scores—S&P Global, 2023).

**Figure 5: S&P Global Corporate Sustainability Assessment**

Like the DJSI, FTSE Russell publishes its FTSE4Good Index to measure the performance of companies demonstrating specific ESG practices (FTSE Russell, 2023). It includes over 7,200 securities in 47 Developed and Emerging markets. ESG overall scores serve as the basis of inclusion in the FTSE4Good Index Series and range from 0 to 5, where 5 is the highest rating. To be included in the FTSE4Good Index, a company must have an overall ESG score of at least 3.3 out of 5 for developed markets, and 2.5 out of 5 for emerging markets, thus ensuring only strong managers of ESG risk are included. Firms with high exposure to significant controversies, such as those in the tobacco and weapons systems industries, are automatically excluded from the FTSE4Good Index. Shown in Figures 7 and 8 below, the overall ESG score is based on over 300 individual indicators that inform the three Pillar – environmental, social, and governance – scores and 14 Theme Exposure scores.
Figure 7: FTSE Russell ESG Score Depiction

Measure of the overall quality of a company's management of ESG issues

<table>
<thead>
<tr>
<th>Pillars</th>
<th>100% Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental</td>
<td>Measure of the quality of a company's management of Environmental issues</td>
</tr>
<tr>
<td>Social</td>
<td>Measure of the quality of a company's management of Social issues</td>
</tr>
<tr>
<td>Governance</td>
<td>Measure of the quality of a company's management of Governance issues</td>
</tr>
</tbody>
</table>

- Biodiversity
- Climate Change
- Pollution and Resources
- Supply Chain
- Water Security

- Customer Responsibility
- Health and Safety
- Human Rights and Community
- Labor Standards
- Supply Chain

- Anti-corruption
- Corporate Governance
- Risk Management
- Tax Transparency

Over 300 indicators in the model with each Theme containing 10 to 35 indicators. An average of 125 indicators are applied per company.

Source: https://content.ftserussell.com/sites/default/files/ftse4good-index-series-overview.pdf

Figure 8: FTSE Russell ESG Score Framework

As of January 2023, ISS ESG provides corporate ratings on 12,500 issuers (7,800 companies) and fund ratings on 26,500 funds (Institutional Shareholder Services, 2023). Previously owned by MSCI, ISS ESG similarly places a heavy emphasis on governance and seeks to enable investors to develop and integrate responsible investing policies by identifying material social and environmental risks and opportunities. A depiction of ISS ESG’s framework could not be found easily; however, Figure 9 shows the ESG rating performance scale on which a firm is evaluated. Like other frameworks, ISS ESG relies on public and quasi-public data, which includes online reporting and corporate filings, company policies, and firm ESG disclosures, as well as information gleaned from media sources, social media, NGOs, government agencies, and inter-governmental agencies. They assert that their materiality approaches closely align with those developed by the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI).

Figure 9: ISS ESG Corporate Rating Performance Scale

Companies are rated, from D- to A+, on their sustainability performance on an absolute best-in-class basis.

D- poor  D  medium  C+  C+  B  B+  A-  A  A+ excellent

Introducing the Financial and ESGF (ESG + Financial) Ratings

The Financial Rating is a standalone rating that can be used on its own to assess companies’ financial performance. The ESGF Rating combines the Financial Rating and ESG Rating to provide a holistic assessment of companies’ performance. Both ratings and the underlying data factors leverage data from ISS EVA, an established standard in measuring, analyzing, projecting, valuing, and discounting a firm's underlying economic profit rather than its accounting profit.

Source: https://www.issgovernance.com/esg/ratings/corporate-rating/
Refinitiv

Refinitiv publishes ESG ratings on 11,800 companies (Larcker et al., 2022) based on publicly available data (Refinitiv, 2023). Refinitiv captures and calculates over 630 company-level ESG measures, 186 of which are compared to industry standards and materiality to yield an overall company assessment across 10 main categories. The category scores, similar to the 14 identified by FTSE Russell, also serve as the basis for the same three primary pillars—environmental, social, and corporate governance. Additionally, each category has a controversy score, and the aggregate of all 10 category controversy scores results in a single Controversy score. The ESG pillar score is a relative sum of the category weights, which vary according to the industry for the “Environmental” and “Social” categories; “Governance” remains the same across all industries (Figure 10).

Figure 10: Refinitiv ESG Framework


Sustainalytics

Sustainalytics, owned by Morningstar, publishes ESG ratings on over 13,000 companies (Larcker et al., 2022). Funds with higher ratings are indicative of lower ESG risk. At first glance,
the Sustainalytics framework (Figure 11) appears to depart from those detailed previously. While the total exposure is defined by exposure to material ESG issues, Sustainalytics breaks down its “total exposure” into “manageable risk” and “unmanageable risk”, where the former measures how well a company could mitigate its exposure and the latter measures that which is out of the company’s control. “Managed risk”, then, is assessed by reviewing the firm’s policies, programs, and practices to determine how it is addressing its “manageable risk”. The difference between “manageable risk” and “managed risk” gives us the “management gap”, which is exacerbated by controversies that reflect a failure in firm policy and procedure in addressing the risk. Thus, the framework shows that the “unmanaged risk” is defined as the sum of the “unmanageable risk” and the “management gap”. This assessment is conducted for each material ESG issue, which defines the firm’s total “ESG Risk Rating” (Sustainalytics, 2023).

Figure 11: Sustainalytics ESG Framework

Finally, the most robust and well-known among the ratings identified in this paper, MSCI publishes ESG ratings on 8,500 companies globally. To assess companies’ exposure to and management of ESG risks and opportunities, and like other rating agencies, they collect data from publicly available sources and focus on industry-specific KPI metrics that are relevant to a company’s bottom line compared with its peer group (Figure 12). The metrics considered can be arranged into environmental, social, and governance pillars.

Figure 12: ESG Ratings Key Issue Framework


Depending on the firm’s industry, the ESG issues are assigned a weight according to the time horizon and impact of the risk, and once the data is normalized relative to industry peers, they are assigned an overall ESG rating on a 7-degree scale of AAA to CCC, similar to the ISS ESG
Corporate Rating Performance Scale. Due to its robustness and influence in financial markets, the author conducted a deeper dive into the methodology and metrics that define the MSCI ESG rating index.

*A Deeper Dive into the MSCI ESG Ratings*

This section contains a discussion about how MSCI derives its weights that fuel firms’ final industry-adjusted ESG scores and their letter ratings (Figure 13).

*Figure 13: Hierarchy of ESG Scores*

Like its peers, the MSCI framework is organized according to the standard environmental, social, and governance pillars, each of which houses several underlying themes, which are defined according to 35 ESG key issues (Figure 14).
In other words, there are potentially 35 key issues on which a firm is assessed to calculate its overall ESG score. However, due to materiality, firms are not typically assessed on all key issues. According to MSCI, its ESG Ratings model seeks to answer four questions about the firms it assesses (June 2022):

- What are the most significant ESG risks and opportunities facing a firm and its industry?
- How exposed is the firm to those risks and opportunities?
- How well is the firm managing those risks and opportunities?
- How does the firm compare to its global industry peers?

Some metrics are mandatory (Figure 15), which means that all firms are assessed on these items (MSCI, December 2022) regardless of industry.
Figure 15: Sample of Mandatory ESG Metrics

<table>
<thead>
<tr>
<th>Metric Name</th>
<th>Metric Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board Diversity %</td>
<td>Weighted average percentage of women on the boards of index constituents.</td>
</tr>
<tr>
<td>Bribery &amp; Corruption</td>
<td>Total number of controversy cases in the last three years related to board</td>
</tr>
<tr>
<td>Controversial Weapons %</td>
<td>Total number of controversies cases in the last three years related to board</td>
</tr>
<tr>
<td>Decarbonization %</td>
<td>Degree to which the IPCC decarbonization targets (1.5°C with no more than 1°C)</td>
</tr>
<tr>
<td>Green Capital %</td>
<td>Weighted average of energy-related capital expenditures (GDP) divided by</td>
</tr>
<tr>
<td>Green Revenue</td>
<td>Weighted average of total revenue from alternative energy sources (GDP)</td>
</tr>
<tr>
<td>High Climate Impact Factor</td>
<td>Exposure to companies that belong to the high climate impact sectors based on</td>
</tr>
<tr>
<td>Lack of Due Diligence Policy</td>
<td>Exposure to companies without due diligence on labor issues addressed by the</td>
</tr>
<tr>
<td>Social Violations (Count)</td>
<td>Absolute number of index constituents involved in social violations. Social</td>
</tr>
<tr>
<td>Social Violations (% of Constituents)</td>
<td>Percentage of index constituents involved in social violations. Social</td>
</tr>
<tr>
<td>Tobacco Violations (High Restrictive)</td>
<td>Exposure to companies classified as tobacco producers, and companies that</td>
</tr>
<tr>
<td>Total Recordable Injury Rate</td>
<td>Weighted average total recordable injury rate (TIRR) per million hours worked.</td>
</tr>
<tr>
<td>Year on Your Decarbonization Trajectory</td>
<td>Forward-looking year on your decarbonization trajectory. (This is not a</td>
</tr>
</tbody>
</table>

| Enterprise Carbon Emissions (tonnes CO2 eq) | Weighted average Scope 1, Scope 2 and Scope 3 carbon emissions (tonnes CO2 equivalent) |
| Emission Reduction Percentage | Percentage of emissions reduced from previous year (Scope 1, Scope 2, and Scope 3) |
| Gender Pay Gap                    | Weighted average difference between male and female employees at a percentage of  |
| Fossil Fuel-Based Capital          | Exposure to companies that are invested in fossil-fuel-intensive industries. The  |
| Fossil Fuel-Based Sector Exposure | Exposure to companies that are invested in fossil-fuel-intensive industries. The  |


While some consideration is given to emissions and climate impact, mandatory key issues largely relate to governance issues—board diversity, board independence, gender pay gap, and female: male board diversity ratio—and exposure to controversy—social violations, involvement with controversial industries like tobacco, injury rate, lack of due diligence policy, and fossil fuel-based sector exposure.

The ranges and average values of risks and opportunities within the industry define the quantitative model that helps identify the firm’s material, or relevant risks and opportunities. These key issue items are considered voluntary (Figure 16).
Once the appropriate key issues have been selected, they each receive a weight to determine their contribution to the overall rating. Of the Key Issues being assessed, MSCI considers their risk exposure and their management of that risk, both scored on a scale of 0-10, with 0 representing no exposure and no management efforts and 10 representing high exposure and very strong management, respectively (MSCI, June 2022). The Key Issue score, also evaluated on a scale of 0-10, shows the interplay between risk exposure and management. Risk exposure is assessed on relevant measures to the firm’s business operations, such as the core product or business segment, the location of its operations, reliance on government contracts, and the amount of outsourced production. If the company has developed strategies and maintained a strong track record of managing its risks, i.e., avoided controversy related to this risk, then it receives a higher risk exposure and management score. To achieve a high overall Key Issue score, “a higher level of exposure would require a higher level of demonstrated management capability” (MSCI, June 2022).

Considered separately from the Governance Pillar, the Environmental and Social Key Issues whose weighted average yields their respective pillars account for only 5 percent to 30%.
percent of the total ESG Rating. “The weightings consider the contribution of the industry, relative to all other industries, to both negative or positive impact on the environment or society; and the timeline within which it is expected for that risk or opportunity to materialize for companies in the industry” (Figure 17).

*Figure 17: Framework for Setting Key Issue Weights for the Environmental and Social Pillars*

![Diagram showing the framework for setting key issue weights](https://www.msci.com/documents/1296102/15388113/ESG-Ratings-Methodology-Exec-Summary.pdf)

Any Key Issue defined as “High-Impact” or “Short-Term” is weighted three times higher than those defined as “Low-Impact” and “Long-Term” (MSCI, June 2022). The Environmental and Social Pillars’ Key Issue weights are “based on the sub-industry’s contribution to the negative externality associated with the Key Issue and the expected time horizon for the Key Issue to materialize” (MSCI, June 2022). Any firm-specific Key Issues may be considered by a committee to approve for inclusion in the firm’s model. The Environmental and Social Theme scores are derived from the weighted average of underlying Key Issue scores, and the weighted averages of those themes yield the Environmental and Social Pillar scores. Conversely, the Governance Pillar has a deduction-based score with a weight floor of 33 percent (Figure 18), thus the Governance Key Issue scores carry a great deal of power and are far less subjective than those that drive the Environmental and Social Pillars.
To make scores comparable to other firms in their industry, MSCI calculates an Industry-Adjusted Score (IAS), which is “defined by the weighted average of the Environmental and Social Key Issue Scores and the Governance Pillar Score and normalized based on score ranges set by benchmark values in the peer set” (MSCI, June 2022). The IAS, shown in Figure 19, corresponds to a letter rating ranging from AAA (the best) to CCC (the worst).

**Figure 19: Industry-Adjusted Company Scores and Letter Rating**

<table>
<thead>
<tr>
<th>Letter Rating</th>
<th>Leader/Laggard</th>
<th>Final Industry-Adjusted Company Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Leader</td>
<td>8.571* - 10.0</td>
</tr>
<tr>
<td>AA</td>
<td>Leader</td>
<td>7.143 - 8.571</td>
</tr>
<tr>
<td>A</td>
<td>Average</td>
<td>5.714 - 7.143</td>
</tr>
<tr>
<td>BBB</td>
<td>Average</td>
<td>4.286 - 5.714</td>
</tr>
<tr>
<td>BB</td>
<td>Average</td>
<td>2.857 - 4.286</td>
</tr>
<tr>
<td>B</td>
<td>Laggard</td>
<td>1.429 - 2.857</td>
</tr>
<tr>
<td>CCC</td>
<td>Laggard</td>
<td>0.0 - 1.429</td>
</tr>
</tbody>
</table>

*Appearance of overlap in the score ranges is due to rounding imprecisions. The 0-to-10 scale is divided into seven equal parts, each corresponding to a letter rating.*
V. The Challenges of Misalignment

A firm’s ability to attain ESG goals and capitalize on the value gained from its ESG commitments requires both effective ESG-oriented supply chain strategies and impartial avenues for demonstrating its efforts. Sustainability rating indices have received growing attention in the latter aspect, and, generally, are an important tool for evaluating the sustainability performance of companies and promoting transparency and accountability. However, their purported value—how they are interpreted by external stakeholders—may not align with how the rating agencies calculate their scores. Consider again the commonalities among ESG rating indices introduced above:

*The Divergence of ESG Rating Commonalities*

Table 1 provides a brief overview of how major ESG rating agencies conduct their ESG assessment and highlights areas of commonalities characterized by five themes as further discussed below.

*Table 1: Commonalities among ESG Rating Indices*

<table>
<thead>
<tr>
<th>Commonalities among ESG Rating Indices</th>
<th>ESG Ratings Index</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DJSI</td>
</tr>
<tr>
<td><strong>Themes</strong></td>
<td></td>
</tr>
<tr>
<td>Overall Score based on E-S-G Pillars</td>
<td>✔</td>
</tr>
<tr>
<td>Pillar scores assessed on sub-theme scores</td>
<td>✔</td>
</tr>
<tr>
<td>Industry Materiality considered</td>
<td>✔</td>
</tr>
<tr>
<td>Entirely dependent on public data</td>
<td>✗</td>
</tr>
<tr>
<td>Risk exposure as primary factor in weights</td>
<td>✔</td>
</tr>
</tbody>
</table>
Aside from Sustainalytics, all the indices organize their frameworks according to environmental, social, and governance pillars, each of which contains several related categories or themes to define and standardize the pillar score. That said, while organized differently, Sustainalytics still uses these same pillars within each risk assessment, so, ultimately, little differentiates it from the rest.

Furthermore, each index highlights that they cater the measures for each firm according to material, or relevant issues to that firm and the environment in which it operates. This method helps to ensure firms are being compared fairly to others in their industry and are not being scored on irrelevant items that could otherwise affect their total ESG rating. Another common characteristic is that all rating indices rely on public data for scoring each category, though some, like DJSI and FTSE Russell, also allow firms to complete surveys or questionnaires to assist in the scoring process.

Finally, and perhaps most importantly, it is clear that risk exposure serves as the primary factor in weighting the importance of certain categories to yield a total ESG score among all rating agencies. The agencies assert that this method helps standardize the scores to the relevant industry. Consequently, the weights that define each of the categories play a critical role in rating a firm’s ESG efforts and have a significant impact on the annual assessment.

Based on the previously discussed observations, one might assume that these similarities would naturally lead to similar results. After all, they are getting their information from the same public sources and, presumably, measuring the same constructs. However, the low correlations across ESG ratings (Larcker et al., 2022; Prall, 2021), as well as across the individual environmental, social, and governance components (Larcker et al., 2022; Dimson et al., 2020), show a significant divergence among the indices and what they claim to measure. The natural
inclination would be to question the consistency of the weights being applied to each of the categories and pillars. To explain the variance across ESG ratings providers, however, Berg, Kölbl, and Rigobon (2022) find that the scope—the attributes the ratings providers attempt to measure—and the measurement—the measures used to evaluate the same attributes—account for 56 percent and 38 percent of the divergence, respectively; while differences in the weights assigned to those attributes only accounted for 6 percent of the divergence (Larcker et al., 2022). This variance is unexpected and disconcerting, especially because the rating agencies claim to provide a similar value to all stakeholders. Additionally, more disclosure does not lead to more consistency and instead gives rise to more divergence (Christensen et al., 2022; Larcker et al., 2022), which suggests that much is dependent on the way in which the same information is interpreted by different ratings agencies and even the analysts working for them.

Larcker et al. (2022) note that ESG rating providers have come under scrutiny in recent years over concerns about their reliability and how they may elevate firms that may not be as deserving of praise as external stakeholders are led to believe. Expanding upon this notion, Raghunandan and Rajgopal (2022) find that firms participating in ESG ratings had worse records of environmental and labor law compliance than those firms that did not. The inconsistency among rating agencies and the concerns over their effectiveness to influence firm behavioral change thus calls into question their value in evaluating and elevating ESG performance.

*The Discordance between ESG Ratings and ESG Sourcing Strategies*

In addition to the systematic failures, upon a more complete review of the rating agencies’ methodologies, the author can also assert that the management scores designed to assess firms’ abilities to address ESG risks do not evaluate the practices that have been shown to drive behavioral change among a firm’s suppliers. Concerted efforts by supply chain organizations,
particularly in procurement areas, can be observed. Villena and Gioia (2020) emphasize that a combination of direct, indirect, collective, and global approaches is essential to the successful implementation of firm ESG standards. In an ideal ESG development situation, ESG rating agencies’ claims to capture firms’ ESG efforts should be warranted and should be realized as illustrated in Figure 20. The investigation conducted in this paper suggests, however, that this is not the case.

Figure 20: Ideal Distribution of Rating KPIs across the SIM

Note: * Referred to as “Global” in the literature

Let us consider the mechanisms informing the Key Issue scores for MSCI. While MSCI refers to the management of risk, the meaning, and the mechanisms by which they are evaluating management, remain unclear. Instead, management for both the Environmental and Social pillars is wrapped up in vague discussions of strategies, programs, and controversies, where the presence of the latter indicates poor management. Like all the ESG rating indices, MSCI may consider partnerships with other firms and organizations as part of the governance or social pillars, which were designated as external approaches. In reviewing both the MSCI and DJSI
frameworks, relevant Key Issues to procurement, such as supply chain management, operational eco-efficiency, local impact of business operations, and packaging are considered in the analysis. However, none of those Key Issues is considered mandatory for consideration, nor are they clearly defined. More importantly, none of these Key Issues are specifically geared towards how buyers are managing relationships with their suppliers in efforts to improve their sustainability practices in the multi-tier supply networks. Therefore, the author finds that very little overlap, if any, clearly exists between the KPIs being measured by the ESG rating agencies and the Sustainability Implementation Matrix (Figure 21).

**Figure 21: Overlap between ESG Rating KPIs and the SIM**

To be fair, as previously stated, all the ratings agencies’ methodologies rely heavily on public and quasi-public data. Insights into procurement practices are difficult to obtain without private data acquired from each firm, which would be resource-intensive to acquire and nearly impossible to standardize. Because the ESG implementation practices themselves are not
standardized across firms within an industry, they would be difficult to compare to one another and, therefore, difficult to assign a consistent weight in the ESG score assessment. Even firms that have similar supplier programs may implement them differently, and these minutely different approaches could result in varied effects. Moreover, if these approaches are most effective in a mix, a single mechanism, depending on the implementation and the other practices used in conjunction, could not be assigned a uniform weight by which the rating organization can assess it. Changes made to these programs year-over-year could also impact their evaluation. The external approaches that are emphasized in press releases, financial statements, and annual reports, however, are more easily measurable because the existence of a partnership with an NGO or participation in an industry-wide sustainability organization are easily seen.

Despite these considerations, the fact remains that the ESG rating agencies that claim to grade firms’ ESG performance are not measuring the practices that truly affect change across a firm’s supply chain. None of the ESG performance indicators employed by ESG rating agencies address the environmental impact of firms’ complex supply networks. This negligence sends mixed signals to the internal stakeholders in charge of making important changes in a firm’s operations, and the external stakeholders that rely on indices for concise and accurate information. In this sense, one can look at ESG interests from two primary perspectives—that of the conscious consumer and that of the investor. While both may be interested in understanding a business’s ethical practices, the motivation that drives that interest may differ. For instance, the former may be concerned about firm ethics and sustainability practices to help them make purchasing decisions. The latter, on the other hand, is more concerned with the longevity and reputation of the firm, i.e., how the risks with which the firm is faced will affect the bottom line and its investment (Larcker et al., 2022; Simpson et al., 2021). Firms care deeply about ESG
ratings, not only because they purport to provide benchmarks for firms’ ESG performance, but also because of the message they convey to consumers and investors. If measuring performance against set goals increases accountability to make a success of achieving that goal more likely (Henderson, 2015) and ESG rating agencies reward risk aversion and external approaches, then one can suggest that firms will be motivated to engage more in external approaches. Knowing that these ratings serve as a primary mechanism for investors to assess ESG efforts and, therefore, inform investment, firms may be dissuaded from engaging in the best mix of common practices to affect change within their supply networks because they are not being rewarded for it. The assertion, then, that ESG ratings help firms to set useful ESG benchmarks and influence practices is wildly inflated. Consequently, ESG ratings may serve as mere window dressing for firms to advertise sustainability efforts—allowing firms to claim sustainability victory points without ever needing to engage with their suppliers to affect meaningful, and necessary, behavioral change.

VI. Conclusion

In this assessment, the author finds that a misalignment exists between the common practices to improve ESG performance in a firm and among its suppliers, and the key performance indicators that ESG rating agencies use to reward firms for their ESG efforts. While the literature asserts that a mixture of direct, indirect, collective, and global/external approaches is essential for firms to improve practices in their complex, multi-tier supply networks, these practices are not included in the consideration of ESG performance evaluations. This misalignment is dangerous due to the unrealized expectation that external stakeholders have a tool for delivering accurate sustainability performance assessments, and that the internal stakeholders rely on indices to
provide the correct information. Knowing that firms are being rewarded for less effective metrics may encourage complacency or an emphasis on ineffective practices.

While the immediate reaction to this paper might be a call to make changes to the ESG rating indices and their frameworks, their reliance on public information poses a particular challenge in conveying these practices, much less their effectiveness. Furthermore, the practices themselves are subject to variability in their delivery and success, thus making them incredibly difficult to standardize. Finally, the “right mix” of practices, if one exists, is unknown, which would render consideration of a single mechanism superfluous.

Opportunities for Future Research

Bearing this paper’s findings in mind, there are paths forward for promising research and collaboration among firms. For one, it may be possible to work with firms in a variety of industries to ascertain the mix of practices being implemented within their supply networks. While this research would be an extensive study, or series of studies, finding the best variety for different industries may enable the definition of best practices, which could then be conveyed to rating agencies. Doing so may also help firms to work together in setting better industry standards, thus improving their own and rating agencies’ ability to benchmark their ESG performance.
Works Cited


