CSRD REPORTING SERIES

III.

TAKING A RISK-BASED APPROACH TO THE VALUE CHAIN

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Shift

TAKING A RISK-BASED APPROACH TO THE VALUE CHAIN

What you will learn:
In this third article in our CSRD mini-series, we dive into the option provided under the ESRS for companies to take a risk-based approach to human rights (and environmental) impacts across large and complex value chains, in order to then focus their reporting on the most severe impacts within those high-risk areas. We'll look at what this risk-based approach entails and how it offers companies a principled, workable way to start reporting in line with the ESRS and progress over time.

1. WHAT IS MEANT BY THE VALUE CHAIN?

The ESRS define the value chain as, "the full range of activities, resources and relationships related to the undertaking's business model and the external environment in which it operates."[1] They further state that "a value chain encompasses the activities, resources and relationships the undertaking uses and relies on to create its products or services from conception to delivery, consumption and end-of-life… Value chain includes actors upstream and downstream from the undertaking."[2]

This definition reflects the responsibility of all companies under the UN Guiding Principles on Business and Human Rights (UNGPs) to address negative impacts on people's human rights that are connected with their activities, products or services, whether they occur in their own operations (e.g. offices, sites, factories etc), their upstream value chain (e.g. through the actions of suppliers through which they source raw materials or products), or their downstream value chain (e.g. third party sales channels, distribution and logistics networks, waste and end-of-product lifecycles).

2. HOW A RISK-BASED APPROACH HELPS MANAGE SCALE AND COMPLEXITY

Business models today – and value chains in particular – can be highly complex and involve many layers of upstream and downstream entities. How,

1 EU ESRS, Annex II, Acronyms and Glossary of Terms, p30
2 EU ESRS, ibid

then, can companies stay on top of a broad mapping of this value chain, not to mention keeping track of all potential and actual impacts on people across it?

It's useful perhaps to start with what the standards of conduct say. The UNGPs state that:

> **"Where business enterprises have large numbers of entities in their value chains it may be unreasonably difficult to conduct due diligence for adverse human rights impacts across them all. If so, business enterprises should identify general areas where the risk of adverse human rights impacts is most significant, whether due to certain suppliers' or clients' operating context, the particular operations, products or services involved, or other relevant considerations, and prioritize these for human rights due diligence."[3]**

It is this same expectation that we see reflected in the reporting standards of the ESRS. Hence, under Disclosure Requirement IRO-1, companies are asked to disclose:

b) an overview of the process to identify, assess and prioritise the undertaking's potential and actual impacts on people and the environment, informed by the undertaking's due diligence process, including an explanation of whether and how the process
   i) focuses on specific issues due to heightened risk of adverse impacts;
   ii) considers the impacts with which the undertaking is involved through its own operations or as a result of its business relationships;
   iii) [...]
   iv) prioritises negative impacts based on their relative severity and likelihood, [...]

Point (ii) here reminds companies that they should describe how their assessment methods apply across the whole value chain; point (i) recognizes that those methods may start with a broad risk-based approach to identify general areas of significant risk to people (or planet); and point (iii) asks for information on how impacts are prioritized within those risk areas, including how severity and likelihood inform the prioritization of negative impacts (this latter step is discussed more fully in the first article in this mini-series regarding the materiality assessment).

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3 UNGP 17 and Commentary

In other words, companies are not expected to go supplier by supplier, tier by tier, upstream and downstream until they find the major problems. Indeed, to do so would be a waste of resources and a missed opportunity to identify material issues. Rather, they can begin by looking at the whole value chain to determine where risks to people are likely to be most significant. The Application Requirements of the ESRS specify that “when describing where in its **value chain** material **impacts, risks** and **opportunities** are concentrated, the undertaking shall consider: geographical areas, facilities or types of assets, inputs, outputs and distribution channels.”

In taking this risk-based approach, companies already have a considerable range of resources which they can draw on for insights into the typical risk areas for different industries, in different geographies and in different types of business relationship. These include the Business and Human Rights Resource Centre; industry group publications; investor publications and engagement activities; civil society and media reports; data on where incidences most frequently arise for certain sectors; and both government-issued and independent publications on country-level human rights risks.

3. KEEPING THE RISK-BASED APPROACH IN CONTEXT

The risk-based approach can be a vital tool for larger companies, as well as those just beginning their assessment of social or environmental impacts and risks, to take a principled and practical approach to their value chain reporting. But it’s important to keep in mind that it’s a dynamic concept. As clarity emerges on material impacts and risks in certain high-risk areas of a value chain, and companies have the data to report on those issues, so the scanning for other high-risk areas will continue and expand. This builds an ever-broader mosaic of material impacts, risks and opportunities, and enables companies to mature and deepen their reporting. Both they and their stakeholders should be seeking this kind of evolution over the years of company reporting under the ESRS.

INSIGHTS FROM THE CS3D

Defining the Value Chain:

The Corporate Sustainability Due Diligence Directive (CS3D) that is currently being negotiated will also contain a definition of the ‘value chain’ of a company. The EU’s co-legislators' current definitions of the 'value chain' are more limited than that of the ESRS and the UNGPs. In practice, this will mean that while companies have an obligation to report on all material impacts, they will only have to address a subset, which may exclude highly material impacts that fall outside the CS3D definition. Many companies and industry sustainability initiatives are therefore calling for full alignment between the CSRD and the CS3D on this important point.

CSRD REPORTING SERIES: PART III

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ABOUT SHIFT

Shift is the leading center of expertise on the UN Guiding Principles on Business and Human Rights. Shift's global team of experts works across all continents and sectors to challenge assumptions, push boundaries, and redefine corporate practice, in order to build a world where business gets done with respect for people's dignity. Shift is a non-profit, mission-driven organization, headquartered in New York City. Visit **shiftproject.org** and follow us at **@shiftproject.**

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