Curtis C. Verschoor, CMA, Editor

Why Is the Scrutiny of Supply Chain Vendors So Varied?

Companies that use conflict minerals face reporting requirements to ensure they aren't helping to fund violence and human rights abuse, but retailers of imported cheap clothing face no mandate to determine that their products are manufactured under safe conditions.

The collapse of the factory in Dhaka, Bangladesh, that killed more than 1,100 workers is just the latest tragedy connected to Asian clothing and footwear manufacturers that employ sweatshop working conditions. Five months earlier, a fire in a garment factory in Dhaka killed more than 100 people, and another recent factory fire there led to the death of eight people. In September 2012, a fire in a clothing factory making cheap jeans in Karachi, Pakistan, killed 300 workers. While some companies have responded to the building collapse by vowing to end production in Bangladesh, the consequences of extreme human rights violations have faced no Congressional mandate for corrective actions.

Since the elimination of import quotas from developing countries some eight years ago, importers and retailers have been free to buy from the cheapest supplier in any country. The claims of international clothing brands of success in self-regulation, mainly through semi-independent factory inspections to ensure worker safety in developing countries, appear to be vastly overstated.

California is evidently the only state to enact a Transparency in Supply Chains Act. Under this law, "Every retail seller and manufacturer doing business in this state and having annual worldwide gross receipts that exceed $100 million shall disclose…its efforts to eradicate slavery and human trafficking from its direct supply chain for tangible goods offered for sale." The threshold for what constitutes "doing business" is rather low, and the disclosure must be posted on the company's website.

In contrast to the garment industry, an area that has received considerable Congressional attention is conflict mineral mining in Africa, which addresses minerals being mined in abusive conditions and to finance conflict. Congress has set forth elaborate and costly reporting and auditing requirements for U.S. publicly traded companies. The objective is humanitarian—to stamp out the financing of violent, armed groups reigning over the eastern Democratic Republic of the Congo (DRC) that particularly focus on sexual- and gender-based violence. The provisions were added to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and seem to have nothing to do with the main objectives of the Act.

Section 1502 of the Dodd-Frank law mandates the Securities & Exchange Commission (SEC) to enact rules establishing a Conflict Minerals Statutory Provision (CMSP). This requires public companies to submit a Conflict Minerals Report (CMR) on how they have provided due diligence in regard to the source and chain of custody of conflict minerals. The CMR must include an audit by an independent auditor using Generally Accepted Government Auditing Standards (GAGAS) set forth by the U.S. Government Accountability Office (GAO). All of these extensive requirements seem far removed from the SEC's mission "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."

The 356-page SEC final rule, which implements Section 1502, notes that the "exploitation and trade of conflict minerals by armed groups [in the DRC and adjoining countries] is helping to

finance the conflict and that the emergency humanitarian crisis in the region warrants the disclosure requirements established" by the new section. Because they were intended as a temporary measure, the President may terminate the CMSP requirements when the armed groups cease to be involved with conflict minerals operations. The final rule also states that Congress chose the disclosure requirements of the securities laws to both motivate greater due diligence on conflict mineral supply chains and achieve greater public awareness of where companies' raw materials are being sourced.

The DRC conflict has been brought up repeatedly in Congress for a number of years.

The DRC conflict has been brought up repeatedly in Congress for a number of years. An indication of the foreign policy emphasis of the provision is a requirement that mandates the submission of an assessment of how effective the CMSP was in promoting peace and security in the DRC, starting two years after the Act was implemented and annually thereafter. The first report by the GAO was issued in July 2012—before the SEC issued its final rule—and urged swift completion.

A key disclosure that a company must include in its CMR is a description of products it has manufactured or contracted to be manufactured that are *not* "DRC conflict free." Preparing the full report involves a three-step process. The first step entails determining whether the company does in fact manufacture or cause to be manufactured a product for which a conflict mineral is "necessary to [its] functionality or production."

The second step requires a company to exercise due diligence to conduct a reasonable country-of-origin inquiry to determine if its conflict minerals come from the DRC or adjoining countries. If the results show that the conflict minerals didn't originate in the DRC area (or at least the company has no reason to believe they did) or came from scrap or recycled sources, then no full CMR and chain of custody study is required. The company only needs to briefly describe its due diligence process. If the results are inconclusive or show a DRC link, however, then a full CMR must be prepared.

Step three of the report preparation process involves the content of the report and supply chain due diligence. The CMR must include, among other information, "a description of the measures taken by the [company] to exercise due diligence on the source and chain of custody of its conflict minerals, which measures 'shall include an independent private sector audit'" of the report. The CMR must also report on the products that aren't "DRC conflict free" by describing the company that performed the audit, the facilities that processed the conflict minerals, the country where the minerals originated, and how they determined the specific place of origin (such as the mine or region name).

Because supply chain due diligence mechanisms haven't been established yet in many cases, a temporary designation of "DRC conflict undeterminable" has been created. It allows more time for the many companies who are unable to "determine whether their conflict minerals did not originate in the [DRC], did not finance or benefit armed groups, or did come from recycled or scrap sources." Such reports don't need to be audited. This reporting possibility will be allowed only during 2013 and 2014. Smaller reporting companies will be given an additional two years to describe their products as "DRC conflict undeterminable" because they might not have the resources to locate the original source of their minerals.

Companies and auditors need further guidance in determining what constitutes "due diligence" when preparing their CMRs. The SEC's rule resolves this by mandating a nationally or internationally recognized due diligence framework. This is an interesting new concept for government regulation. The SEC rule states that,

continued on page 69

For guidance in applying the *IMA Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USA Direct Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

"We are persuaded by commentators that requiring [a company] to use a nationally or internationally recognized due diligence framework that is relevant to the audit objectives and permits consistent assessment of the subject matter will provide an independent private sector auditor with a structure by which to assess [a company's] due diligence."

The objective of the independent audit is to ensure that the company's due diligence framework aligns with the nationally or internationally recognized due diligence framework and that the steps the company took in due diligence followed the guidelines outlined in the CMR.

The SEC's estimate of the initial cost of compliance of this extensive reporting and auditing initiative to U.S. public companies is approximately $3 billion to $4 billion. The ongoing annual cost of company compliance is believed to be between $207 million and $609 million. The potential benefits from these considerable efforts to reduce the flow of funds to armed groups in the DRC are social and humanitarian, not economic in nature.

These expensive efforts are admirable, but whether they will be successful at all in stopping violence in and around the DRC isn't subject to real measurement. On the other hand, the benefits from improved working conditions in unsafe sweatshop clothing factories could be rapidly and directly measureable in terms of human lives saved. Congress should act to require retailers to assure consumers their low-priced goods aren't made under conditions of low wages, forced overtime, poor health practices, sexual harassment, and hazardous working places. **SF**

Curtis C. Verschoor, CMA, is the Emeritus Ledger & Quill Research Professor, School of Accountancy and MIS, and an honorary Senior Wicklander Research Fellow in the Institute for Business and Professional Ethics, both at DePaul University, Chicago. He was selected by Trust Across America as one of North America's Top Thought Leaders in Trustworthy Business Behavior, 2013. You can e-mail him at curtisverschoor@sbcglobal.net.