WHAT'S IN YOUR COMPANY'S PRODUCTS?

The SEC Wants to Know

By Thomas R. Weirich, CPA

As a management accountant, you've given a lot of thought to how much it costs to produce, market, and distribute the goods your company sells. If you're dealing regularly with only a handful of core products, you may even be able to rattle off some or all of the materials that go into making those items and where they come from.

That familiarity with "components" and their origin is going to become increasingly important, especially next year. That's because the U.S. Securities & Exchange Commission (SEC) plans to regularly test your knowledge of what goes into your company's products as part of compliance with a new securities rule that requires firms to search their supply chains for any "conflict minerals."

These include tantalum, tin, gold, tungsten, and other minerals that may have been sold to finance violence in the Democratic Republic of the Congo (DRC) and the surrounding region. Specifically, Section 1502 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act states that armed groups have exploited and traded conflict minerals to finance the furtherance of deadly conflict and human rights abuses in the region. The new rule is aimed to cut off the rebel groups' funding by eliminating markets for these minerals.

If your company uses any minerals described in the legislation—even if they aren't from the DRC or the nine countries that surround it (Angola, Burundi, Central African Republic, Congo Republic, Rwanda, South Sudan, Tanzania, Uganda, and Zambia)—you must file Form SD with the SEC by May 31, 2014, which covers the 2013 calendar year. (Disclosure reports need to be filed by that same date in subsequent years.) If a company using conflict minerals fails to file an accurate report, the SEC could impose financial penalties under the Securities Exchange Act.

If it seems odd to you that the SEC would get involved in helping to preserve human rights, consider that the disclosure is also intended to provide an investor with an understanding of the potential risk to a company's reputation and supply chain.

This article will highlight how complex and far-reaching this new rule is likely to be and its impact on organizations, including the management accountants and other financial professionals who work for them. You can find the final rule, "Conflict Minerals," at www.sec.gov/rules/final/2012/34-67716.pdf.

What the New Rule Governs

The new SEC rule applies to any publicly traded company that files reports with the Commission under Section 13(a) or 15(d) of the Exchange Act, including domestic companies, foreign private issuers, and smaller reporting companies. Some firms have been proactive in dealing with the rule: In a February 2013 white paper, "Intel's Efforts to Achieve a 'Conflict-Free' Supply Chain," Intel stated that it has achieved its goal of validating that all of the tantalum used in its microprocessors is from conflict-free sources, with a goal for 2013 of manufacturing the world's first verified conflict-free microprocessors. The company has already mapped more than 90% of its microprocessor supply chain, including more than 140 smelters, to begin the process of confirming that they're conflict free.

Compliance with the rule will require a team effort. As a management accountant, you'll surely be asked to work alongside individuals in sales, operations, purchasing, finance, and other departments. Since conflict minerals are found in a large variety of products—from electronics to jewelry, to aerospace and automotive products, to consumer packaged goods—the rule will have a wide-ranging impact. A report from Ernst & Young, "Dodd-Frank Section 1502 and the SEC's final rule," says the SEC estimates that the rule will affect approximately 6,000 publicly traded firms, with estimated initial compliance costs from $3 billion to $4 billion per company and $207 million to $609 million annually thereafter. Considering an entity's entire supply chain, however, the rule will have a trickle-down impact on multiple tiers of suppliers, including nonpublic companies. For example, Hewlett-Packard (HP) reports that approximately 1,000 companies in its supply chain provide a product to HP that may contain a conflict mineral. It's a big undertaking to sort out the good from the bad, so it's no surprise that HP will be asking its suppliers to help in the due diligence process.

If your company has determined that it's subject to the rule, it must conduct a "reasonable country of origin inquiry" (RCOI) to determine if any of the conflict minerals came from the targeted countries—or if they were obtained from scrap or recycled sources, which excludes them from compliance with the rule. (Intel's teams, for example, have already done on-site inspections in many countries, including the DRC and surrounding regions.) After the inquiry, if the company believes that the minerals originated in any of the targeted countries or aren't from scrap or recycled sources, it must conduct a due diligence process to determine if the minerals are "DRC conflict free," "not DRC conflict free," or "DRC conflict undeterminable" and disclose this process in Form SD.

And it isn't only the federal government that's concerned about where certain minerals come from. Some states and municipalities, such as California, Massachusetts, and the city of Pittsburgh, are taking action as well and are placing preferences on vendors that sell products certified to be conflict free. These ripple effects underscore the importance of being compliant with the new rule.

Figure 1 shows the SEC's recommended process for an organization to use in conducting its evaluation and reporting of conflict minerals.

Other Nuances

The rule provides temporary relief to a publicly traded company that's unable to determine whether the conflict minerals originated in any of the specified countries—the previously mentioned description of "DRC conflict undeterminable"—but only for the first two years of reporting under the rule.

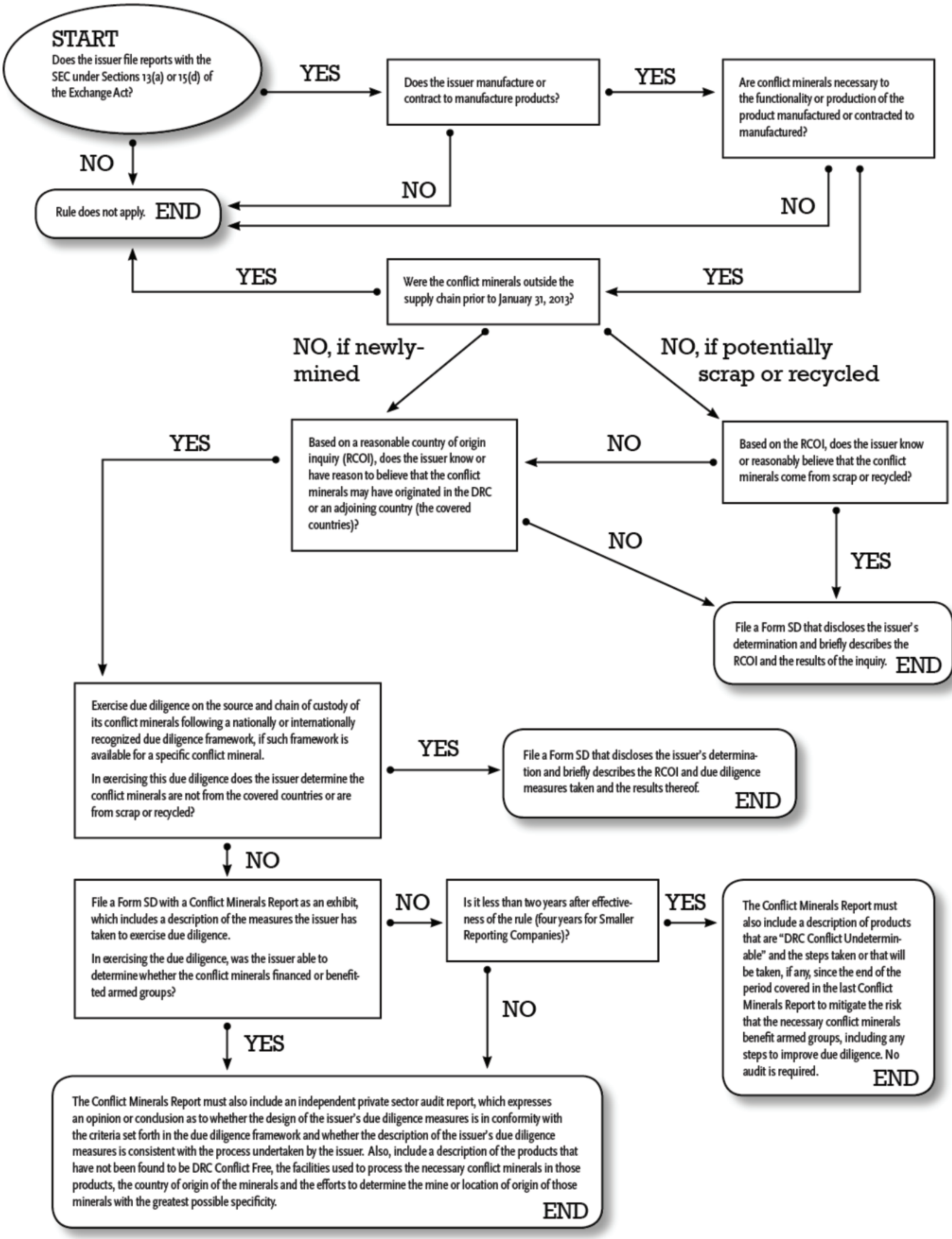
The final rule, the SEC says, applies to any company for which conflict minerals are considered "necessary to the functionality or production" of a product manufactured or contracted to be manufactured. (The rule doesn't define manufacturing since the term is generally understood.) But the SEC doesn't consider a publicly traded company that only services, maintains, or repairs products containing conflict minerals to be manufacturing a product. With regard to the issue of "necessary to the functionality" of a product, the rule describes three factors to consider:

- Is the noted conflict mineral contained in and intentionally added to the product or any component of the product?
- Is the conflict mineral necessary to the product's generally expected function, use, or purpose?
- Is the addition of the conflict mineral only for product ornamentation or decoration?

For example, consider tin buttons on a coat. If the buttons serve a vital function in the manufacturing of the coat, then the tin that's used would be considered a potential conflict mineral. But if the buttons serve only as decoration, then they wouldn't be considered necessary to the functioning of the product, and, therefore, the company wouldn't be in violation. Obviously, the facts and circumstances will dictate how other arrangements are evaluated.

In examining the "contract to manufacture" provision of the rule, a key issue is the degree of influence that the

Figure 1: Are You Subject to the New SEC Rule?



Source: SEC Rule—www.sec.gov/rules/final/2012/34-67716.pdf.

company exercises on the production process because the SEC further believes that the end source of the components (the retailer, for instance) should be held to the same level as if it had manufactured the components. Under the new rule, however, if a company simply slaps its logo or label on a generic product that a third party makes, the company would be deemed not to have any influence on the manufacturing process. Consider Walmart or Nike, both of which do a great deal of outsourcing. Each company will need to evaluate the degree of influence it has on the production process for each item it sells. This means that large retailers conceivably could need to evaluate *thousands* of products under the new rule.

Following Through

In step 1 of your due diligence process, you determine if your organization is subject to the new rule. If it is, step 2 requires that you determine whether the minerals originated in the DRC or a surrounding country. This step is the RCOI. The rule specifically states that this inquiry "must be reasonably designed to determine whether the issuer's conflict minerals did originate in the covered countries, or did come from recycled or scrap sources, and it must be performed in good faith."

So what happens if your team concludes that certain minerals originated in the DRC or the adjoining region or that they may not be from recycled or scrap sources? In this case, you'll have to proceed to step 3, which requires due diligence to be performed on the source and chain of custody of such minerals. Again, the SEC says the inquiry must be performed to a reasonable, but not absolute, standard that will require the exercise of professional judgment. Intel, for example, thought it necessary to do on-site inspections overseas; your organization may not feel the need to go that far, both literally and figuratively.

During step 3, a third-party audit of your RCOI process is also required. The major accounting firms and other organizations are gearing up to provide this audit service. But as you may have guessed, not just any old audit will do. The due diligence measures must conform to a nationally or internationally recognized due diligence framework and be consistent with the Generally Accepted Government Auditing Standards (GAGAS) established by the Government Accountability Office (GAO). A popular and trusted due diligence framework, which you can find at www.oecd.org/fr/daf/inv/mne/mining.htm, has been approved by the Organisation for Economic Co-operation and Development (OECD). The Conflict Minerals Report filed with the SEC must describe the due diligence process that you used, including the minerals in question, the facilities used to process them, and the efforts your organization made to locate their original source(s). This document, as well as the audit report, must be made available to the public via the Internet.

Even if your company determines that the conflict minerals it uses didn't originate in the DRC region, you'll have to disclose this information—along with a description of your RCOI process—to the SEC on the new Form SD. You'll also have to put a link to the description on your company's website and include the Internet address in your completed form.

Impact on Management Accountants

This new SEC regulation regarding conflict minerals no doubt will have a significant impact on manufacturers and their suppliers. In today's business world, manufacturing companies and third-party logistics providers are facing a very complex and volatile environment. For such companies, the rule will impact management's forecasts of inventory needs in connection with supply-chain planning in order to respond rapidly to ever-changing product demands. And, as detailed here, you'll likely be involved in it, too. A compliance committee that includes management accountants should review procurement policies and supplier due diligence practices and also participate in benchmarking your company's supply-chain policy with that of your competitors. And while certainly noble, if a company commits to utilizing only conflict-free minerals in its manufacturing processes, this can result in higher costs for those minerals, impacting pricing, cost, and budgeting decisions. These effects will have to be factored in as well.

Finally, as a management accountant, you should be involved in the risk management function related to the use of conflict minerals and how it impacts investors' views of the company. Though the entire compliance process will probably consume only a small portion of your time, it may become one of the most important—and potentially stimulating—parts of what you do as a management accounting professional. **SF**

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