

Supply chain audits—only as strong as the weakest link

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Commercial analysis: As businesses face ever-increasing regulatory pressures and supply chain transparency obligations, they confront more challenges within the complexities of supply chains audits. Simon Garbett, Sarah Rathke and Dynda Thomas, partners and supply chain lawyers at global law firm Squire Patton Boggs, assess how businesses can meet those obligations and reap the benefits of thorough audits.

What are the most vulnerable areas in supply chain audits?

Supply chain audits are great for verifying supplier policies:

- o Do they have robust codes of conduct and workplace safety standards?
- o For sensitive or contamination-prone materials, are there policies in place governing handling and storage?
- o For a workers' rights audit, are there corporate records verifying all employees' identities and employment terms and conditions?

Companies can easily ensure that their auditors are capturing this type of information.

Audits are less effective, however, at verifying suppliers' actual practices and at detecting problems. This can happen for a number of reasons. First, auditor skill can be an issue. Some auditors, left to their own devices, do not drill down and verify the answers they receive from suppliers' managers. Sometimes, too, the company commissioning an audit is more invested in completing the audit than in obtaining and critically analysing the information the audit should have been designed to elicit. In particular, audits may not be as thorough as they should be—sometimes because companies dictate the precise ambit of the audit based on cost and/or board level set tolerances to risk or because companies have no contractual right to audit the operations in their supply chains. As a result, some significant risks and exposures in a particular corporate's supply chain may be missed altogether, for example a failure to critically assess their supplier's suppliers' working conditions.

Either way, it comes down to establishing an effective audit protocol. An audit is only as good as the protocol and parameters the auditors are given to follow. Indeed, it is vital in a risk and compliance context that the audit gets to the heart of the issues and does not merely seek to scratch the surface.

How can business control supply chain audits in an outsourcing situation?

Hiring a third-party auditor can boost a company's corporate social responsibility profile to the outside world, but it does not always mean that the job will be done well. Not all auditors are equally skilled, so it is important to check out the bona fides of any auditing firm you consider retaining. Critically check references, both for the complexity of their prior work, and for the reputation of the companies that have hired them in the past. Again, however, it all comes down to the audit protocol. Do not leave this solely up to your auditors to determine. Rather, it is usually best to ensure that you include auditing of several layers of evidence relevant to the issue being audited. For instance, if you are auditing to ensure that there is no child or trafficked labour in your supply chain, make sure that your auditors appreciate this at the outset of the audit. They should be asked not only to inspect employment records on-site, but they also should be allowed to talk to the suppliers' workers and ask probing questions about labour conditions. Important probing questions concerning child or trafficked labour might include asking about foreign nationality, eg who actually holds employees' passports and/or work authorisation papers, what happens when workers are too sick to work, and what has the workforce turnover been in the past one to two years. Ideally, auditors should also assess whether those employees they meet with are really able to speak freely or are operating under duress or otherwise feel compelled to tow the supplier company line.

If an audit is being performed of a supplier in an industry or geographic region that has received non-governmental organisation (NGO) attention, rather than resisting the NGO's involvement, or hoping merely to placate the NGO, it may be helpful to enlist the NGO's support in your auditing efforts. Sigwatch, a global network that tracks activist campaigns, annually ranks the companies that work best—and worst—with NGOs. It is a good place to start to determine how companies can successfully collaborate with NGOs, and with broader industry efforts, to eliminate bad practices from

supply chains. Working alongside your industry partners, competitors and suppliers, who are all likely wrestling with the same compliance issues, also makes sense and can deliver time and material cost savings. Keep in mind, however, that partnering with NGOs in this way does not mean that they (or other activists) will not press you for further action. But, if you have an active compliance programme, it can be helpful to have such a working relationship with NGOs.

What are the legal and regulatory risks businesses open themselves up to if supply chain audits aren't properly conducted?

Some highly regulated industries, such as pharmaceuticals and medical devices, are increasingly requiring auditing and verification measures—less to protect against poor supplier conditions, and more to ensure product quality and unadulteration. But, the trend is toward requiring more audits and verifications of companies' responsible sourcing activities. In certain jurisdictions, companies that don't properly audit, but claim that they do, can open themselves up to serious liability to consumers and regulators. In the US in 2015, claimants' lawyers began filing 'consumer class action' lawsuits against companies whose actual supplier practices allegedly did not match up with what the companies reported in their required disclosures. These kinds of lawsuits often involve millions of dollars in legal fees and in negative awards. And, they can have an immediate and negative impact on the corporate share price too.

Allegations of environmental degradation, poor or dangerous working conditions and human slavery frequently generate negative publicity, particularly if played out against the backdrop of certified audits that previously gave supply chains a clean bill of health. Well-publicised and high profile cases, such as the collapse of the Rana Plaza garment factory in Dhaka, Bangladesh in 2013, unavoidably throw a dazzling spotlight on businesses caught up in the midst of them. The Rana Plaza case brought into sharp focus for 27 global garment brands their responsibility for the labour conditions and safety of the workers who made their products. The tragedy initially resulted in significant negative publicity and brand damage for, among others, Adidas, Sainsbury's, Matalan, Marks & Spencer and Primark.

Indeed, the adverse publicity angle was again recently highlighted in the UK in January 2016. Adverse publicity followed the successful prosecution of the boss of now defunct Ravensthorpe, West Yorkshire based bed-making firm, Kozee Sleep, for employing a Hungarian 'slave workforce'. Prosecutor Christopher Tehrani QC told the court that regular ethical audits by leading high street retailers, such as the John Lewis Partnership and Dunelm Mill, had failed to spot anything untoward going on, even though '...As part of the contract, Kozee Sleep was required to adhere to each company's policies re ethical trading, which included how they treated persons who worked on their premises.'

Criminal penalties (such as imprisonment and confiscation of property) and fines, for example in the context of a failure to prevent bribery, may also be imposed. Failures in supply chain audits therefore raise very serious issues that should be addressed at the very highest level within all organisations.

What can companies do better?

Companies need to be actively engaged with their supply chain audits, and not just go through the motions. If you have someone qualified on your staff to oversee the process, have them do so, with a critical eye to ensuring that the auditors are doing a good job—policing the police! If you do not have someone qualified, then hiring consultants and lawyers specialising in supply chain issues may be the answer to oversee your audits. But again, it is important to check qualifications and references. Also, sometimes having a lawyer oversee the auditing process can add a layer of confidentiality to the audit itself, provided that all of the other conditions required to assert the lawyer-client privilege test are met. This can be helpful if you have any specific concerns ahead of conducting the audit.

It is also important to 'walk the talk' and, subject to what is said immediately below, as a general rule it is good practice to follow up expeditiously and diligently on any pertinent issues and risks arising from an audit. Also commercial organisations should not simply satisfy the basic audit requirements, but should actively consider going further to develop and implement 'best practices' and leverage these best practices as a differentiator. Indeed, some companies may even determine that putting responsible social and ethical considerations at the heart of their business and decision-making is a sound commercial decision. For some companies, responsible sourcing represents a significant opportunity to meet customer demands and to be viewed positively for its sustainable supply chain activities. Best practice may include better understanding the organisation's operations, implementing effective risk analysis audits, undertaking further supply chain mapping and due diligence, developing hotlines and ongoing monitoring processes, as well as introducing consistent

internal policies, procedures and training. More careful due diligence will be necessary in those geographies and sectors most likely to be affected by particular compliance risks, such as slavery and human trafficking.

What should be done if weaknesses have been identified?

It depends. Of course companies should not misrepresent facts about their audit findings or procedures. Beyond that, however, the solution depends on the nature of the problem. If the 'weakness' identified is that the auditing firm was not very good or very thorough, that should simply be corrected with a new and better firm of audit professionals—immediately, if possible, rather than completing such an audit or waiting for the next audit period to begin. If the 'weakness' discovered is an unsavoury practice at a supplier, then that also should be addressed immediately. If you have a Supplier Code of Conduct that addresses the specific weakness identified, you will need to do what the Code of Conduct dictates. Most Supplier Codes of Conduct leave some discretion as to how to deal with a non-compliant supplier. We suggest treating a supplier breach or violation regarding working conditions and responsible sourcing in the same way the company would if the suppliers' products exhibited quality issues or specification non-conformances. The company should report the breach/violation to the supplier and make a corrective action proposal to remedy the problem within an agreed time period. The supplier should not be left to its own devices, however, to institute and carry out the remedy. Rather, the company should be involved in follow-up verification efforts, whether those fall into the category of increased site visits, additional screenings, or other measures.

Responding quickly after issues emerge is also vital. To their credit, Primark's very positive and proactive response to the garment factory disaster at Rana Plaza in Dhaka—paying compensation quickly, proactively seeking to improve working conditions and terminating contracts of suppliers who were unwilling to evacuate unsafe buildings and accept financial and other support to deliver required building and infrastructure improvements—resulted in much good coming from the tragedy.

What are the trends in this area?

Businesses now face ever-increasing formal regulation and supply chain transparency obligations. The pressure and power of the internet, particularly from social media and an ethically conscious 'Facebook' Generation Y, will also continue to serve as a more informal check on companies that are viewed as not complying with those obligations.

These overarching audit and compliance trends are certainly likely to continue—with astute companies recognising the need and advantages of embracing and policing their own supply chains better to avoid negative publicity, reputational harm, damage to their brand/values and strained investor relations. For example, several of the UK's biggest tea brands, including PG Tips, Tetleys and Twinings, relatively recently and publicly recognised their collective need to improve the tea estates they buy from in India, following an investigation by the BBC and Radio 4 in 2015 which identified unacceptable living and working conditions of tea plantation workers.

Further, compliance statements and robust audits may well become a pre-requisite for tenders for certain work from UK government and other concerned bodies. It is also highly likely that, once published, statements of brand name multi-nationals and significant businesses in, for example, the Modern Slavery Act 2015 context, will be scrutinised by interested parties—a culture of 'private' enforcement will likely snowball and serve to monitor whether companies are really doing what they say—and those with poor rankings and lagging audit practices are likely to be targeted by activists and investors in social media communities and by civil society organisations with calls to boycott them.

Smaller businesses in the supply chain will also be impacted too, as they are likely to be subject to increased scrutiny as a result of requests made of them by larger organisations seeking to comply with their obligations, as well as there being increased stakeholder, consumer and media interest more generally.

The trends in this area, unfortunately, are also for NGOs and the consuming public to trust audits less and less. That is a shame, since robust audits can, if properly developed and implemented, provide corporations with a way to gather and verify more information about their supply chains. Already, the NGO community is calling for increased government involvement in supply chain regulation, as well as for more funding and stronger mandates for regulators, to address their belief that industry is not doing enough to police itself. Recent developments in Thailand in 2014 and 2015, where the government has had to respond to allegations that its shrimp and seafood industries are not well policed for human trafficking violations, show not only greater state regulation, but also negative effects resulting from suppliers' fear of

reprisals: rather than improving conditions of seafood industry workers, fishing businesses in Thailand are allegedly 'disappearing' their trafficked workers to other locations. These are the kinds of unintended results that audits alone cannot track or correct.

Ultimately it should be about business putting in place fit for purpose policies and procedures relating to audits, as well as doing the right thing when no-one is looking because it is the right thing to do.

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