Insulating the Supply Network from Corporate Social Responsibility Risk

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Abstract. The rapid globalization of supply chains exposes companies to myriad opportunities, but also heightened risks – including increased exposure to corporate social responsibility ("CSR") risks from the supply base. This paper and the presentation will frame the challenges and opportunities of managing CSR risk in the extended supply chain, as well as explore elements of effective tactics based on demonstrated best-practices from leading global supply organizations.

Introduction. Supply management professionals play an increasingly critical role in the development and enforcement of social responsibility principles for their organizations, as supply chains become ever more global. Abuses several tiers back in the supply base can have devastating public relations consequences for corporations and government or non-profit organizations alike. Going well beyond the by-now familiar headlines about sweatshops overseas, sources of CSR risk include everything from suppliers being environmentally unsafe, to mishandling intellectual property or customer information, to engaging in unethical financial practices – whether that supplier is located next door, or thousands of miles away. And as supply chains continue to lengthen, companies are increasingly exposed to CSR risk whether or not they're directly sourcing goods and services in emerging markets. It's common knowledge that sectors ranging from pharmaceuticals to automotive to high tech are already sourcing significant amounts of goods and services from emerging markets, and most anticipate doubling their share of emerging-market spend over the next several years. But even sectors commonly believed to be insulated from emerging-market sourcing risks like CSR, actually <u>are</u> exposed – perhaps unknowingly – through their suppliers' suppliers two, three, or more tiers back in the supply chain.

Definition of Corporate Social Responsibility. While there are as many definitions of CSR as there are organizations working to monitor and encourage it, the World Bank calls corporate social responsibility "the commitment of businesses to contribute to sustainable economic development by working with employees, their families, the local community and society at large to improve their lives in ways that are good for business and for development."

The Challenge. Corporate social responsibility and ethical sourcing issues are hardly new, but several factors are bringing them to the forefront for supply professionals now:

- <u>Large scope of risk, with ambiguous boundaries</u>. CSR risk is unique in that intermediate suppliers often do not provide effective insulation against harm. Many other supply-related risks (e.g., financial insolvency, late delivery) that occur with so-called "lower-tier" suppliers will likely be absorbed to a great extent by the middle-tier, and thus the impact on customers further down in the value chain is often minimized. CSR risks like poor working conditions, unfair labor practices, or environmentally

destructive operating practices are different: they can impact any company anywhere along the value chain – but they pose the greatest risk to well-known, highly-branded companies or public institutions. No single supply organization has sufficient resources to adequately manage CSR risks, or take action to address shortfalls, in 100% of its supply chain. Yet the organization may still be held responsible for those shortfalls – as was a large financial services institution recently, when the media reported that the promotional t-shirts given away by the company at a sports event were "manufactured under sweatshop conditions." The company was caught unawares by the reports of working conditions four tiers back in its promotional-goods supply chain. With examples like this making headlines, it's no wonder that supply managers feel increasingly overwhelmed by the scale of the challenge. A recent Institute for Supply Management (ISM) survey asked over 900 supply executives about the level to which they currently assess secondary suppliers to ensure these suppliers are compliant with human rights and social responsibility practices. Only 11% of respondents cited their capabilities in this area as "good" or "great;" the other 89% reported "little/some" activity to "almost none/none whatsoever."

- Unclear standards. One indicator of the growing public recognition of the importance of CSR issues is the increasing amount of related documentation being published by organizations from NGOs to private companies to universities, labor organizations, governments, and more. But this increased acknowledgement comes with a downside for supply professionals: confusion due to proliferating CSR guidelines, checklists, and protocols. The ISM has been working to help streamline standards, by developing its Principles of Social Responsibility (April 2004). Yet there are still few truly universally-accepted standards, and as documentation continues to multiply, many organizations are left unclear about exactly which guidelines to follow in their own policies, and uncertain about what to do if they come across conflicting recommendations.

- Unreliable information. A common roadblock to many traditional CSR audit efforts is the difficulty of obtaining accurate and credible information on small or emerging-market suppliers' social responsibility practices, such as adherence to environmental, labor, and financial standards. In some cases this may be due to suppliers' lack of experience or resources, a lack of clarity in data collection guidelines, or scarcity of information available from local government institutions. Deliberate falsification of records is, unfortunately, also common: one social compliance auditing group working in China believes that 90% of factories they see are doctoring or disguising at least some of their records.

Elements of Effective Practice. Leading-edge supply organizations are developing CSR programs that successfully meet these challenges, and that have resulted in demonstrable positive results at the supplier and community levels. Four characteristics underlie success:

1. Placing analysis in the appropriate context: Start CSR risk assessment with a commodity- (or service-) and country-level analysis, in order to put supplier-level analysis in a more informed context. Progressive companies are deploying analytical tools, including segmentation grids and supplier audit decision rules, to prioritize efforts and sort suppliers (or potential suppliers) early in the sourcing process.   They are finding that in some cases, the same raw material, component, or service might have different levels of CSR risk exposure for

the organization, depending upon the country it is sourced from and the level of the product or service's association with the brand. Similarly, the same country might carry different levels of risk exposure depending on the category or service being sourced. As a result, supplier-level analysis and sourcing decisions are much better informed.

2. Avoiding a one-size-fits-all approach:
- Use multidimensional analysis to focus the organization's risk mitigation resources and catch red flags that might otherwise be overlooked.   One leading global food and beverage company has developed a tiered model to target different types of CSR risk monitoring and compliance activities, each with different levels of resource investment, depending on level of exposure – enabling the supply organization to conduct detailed evaluations of over 100 first-tier suppliers in 40 countries in a short time, and simultaneously cascade ethical trading policies into everyday sourcing documentation reaching literally tens of thousands of suppliers.

- Deploy a tailored mix of incentives and enforcement tactics. A major international consumer products manufacturer segments different types of supplier CSR infractions into five categories, ranging from minor to "zero-tolerance." Supply managers can select from an implementation menu of different action plans, corresponding to the number and severity of supplier performance problems or violations in each category. Another company employs different response tactics depending on "supplier intent" – that is, whether a CSR problem is self-reported by the supplier, uncovered in the course of a regular audit (but promptly acknowledged by the supplier), or discovered to have been actively concealed. The goal is to encourage suppliers to fully disclose issues or problems as they happen.

3. Finding resource-efficient ways to improve the quality of CSR audit data:
- Ensure that data collectors are well-equipped to make accurate assessments. One leading international telecommunications company adapted its supplier audit toolkit to provide specific guidelines on how to conduct site visits and worker interviews – including region-specific interviewer profiles, to help auditors find interviewers most likely to know when workers are being coached or pressured to give canned answers during site-visit conversations. The same company provides a suggested list of information sources and data corroboration tactics intended to help auditors verify audit results and increase the likelihood of uncovering inconsistencies. The company packages the resulting information into a broader CSR risk-assessment report that includes an additional audit step to further cross-check findings.

- Take advantage of (and help to strengthen) the network effect. An increasing number of leading-edge companies are pooling resources to fund much more comprehensive CSR monitoring efforts, and eliminate inefficiencies and duplications of effort (thereby also reducing the resource burden on the small and emerging-market suppliers being audited). Examples include (but are certainly not limited to) shared secure supplier-information databases such as the Fair Factories Clearinghouse in the apparel and footwear industries, and developing a common approach to supplier audits as in the Electronic Industry Code of Conduct.

4. <u>Leveraging supply chain partners</u>:   Enlist strategic suppliers to act as risk managers on your organization's behalf. The telecommunications company mentioned earlier is enfranchising its emerging-market strategic partner suppliers in CSR activities through a combination of one-on-one meetings, building CSR workshops into supplier summits, best-practice sharing sessions between suppliers, and the inclusion of CSR activities in supplier partners' performance dashboards/continuous improvement plans – in other words, measuring their suppliers' effectiveness at managing CSR risk in their own supply bases. By making CSR an integral part of their overall supplier collaboration initiatives, the company has been able to increase the scope of CSR monitoring efforts, and influence positive change as well, in a cost-effective manner.

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