



## GLOBAL SOURCING FORUM REPORT Industry Leaders Meet to Share Perspectives

RISK ADVISORY • TAX • FINANCE & ACCOUNTING

In February 2008, a group of 25 risk, internal audit and finance executives representing multinational retailing organizations participated in a Global Sourcing Forum sponsored by Jefferson Wells and Lowe's. The forum featured discussions on emerging issues in global sourcing. Participants shared their thoughts on management challenges related to supply chain risk, the Foreign Corrupt Practices Act (FCPA), corporate social responsibility, product quality, health and safety and best practices for meeting those challenges.

### EXECUTIVE SUMMARY

U.S. firms seeking to conduct business globally face increasing risks and challenges. Identifying, assessing and managing risk is an extraordinarily complicated, ongoing process, particularly for those companies with operations and suppliers around the world.

The forum sessions revealed that, while no one organization has established best practices in all risk management areas of global sourcing, each organization had developed practices and strategies that reflect a common set of principles for identifying and managing global sourcing risks.

Those principles are:

1. Standardizing global audit and assessment procedures and coordinating efforts between organizations, among entities within the organization and across supply chains;

2. Exposing "gray areas" in markets of operation to remain completely transparent;
3. Maintaining a broader global presence by participating in coalitions of organizations that share audit and assurance practices;
4. Systematically forecasting and planning for seasonal surges; and
5. Fostering a sense of global citizenship within the organization's culture so all employees know they have a stake in mitigating global sourcing risk.

### SUPPLY CHAIN VARIABILITY

Supply chain variability risk involves a broad spectrum of issues, from product quality, internal corruption and production capacity to issues over which the organization has little control, such as terrorism, natural disasters and political instability. Global organizations struggle to manage supply chain risks because the risks are complex and varied. Only recently, after discovering a suitable regulatory standard for risk modeling does not exist, have organizations begun collaborating with their peers to identify and mitigate risks.

Managing supply chain variability risk should include the systematic identification, assessment and quantification of potential supply chain disruptions with the objective of controlling exposure to risk or reducing its negative impact on supply chain

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performance. Potential supply chain disruptions can occur because of poor quality, unreliable suppliers, machine breakdown, or uncertain demand. Outside the supply chain, disruptions can be due to natural disasters, terrorism, labor strikes, significant variability in demand, etc. Risk management should include the development of strategies designed to control, mitigate, reduce or eliminate risk and provide for business continuity in the event a risk does occur.

Useful strategies include closely managing the supply chain to mitigate or eliminate the risk of subcontracting with non-approved vendors, and consolidating the vendor base to improve the organization's presence in each market and facilitate monitoring. Those strategies are labor-, cost- and time-intensive, however, so organizations are seeking ways to leverage existing supply chain vendor assessment or certification.

Key remaining challenges include balancing compliance, price and quality in managing contractor and sub-contractor relationships. While forum participants were willing to adopt a standardized approach to contractor and subcontractor requirements, they expressed concern that such a standard might lower the bars many have already established for their own organizations.

Additional challenges include:

- Sourcing audits, requiring organizations to shift away from monitoring and toward building vendor capacity for meeting regulatory, stakeholder and industry expectations
- Using audit reports to drive improvement in the organization and its vendors
- Reliability of source vendor audits
- Quantifying compliance, audit and production program effectiveness
- Driving improvement in the organization and its vendors based on audit and assessment reports, relying on reports of source vendor audits and quantifying program effectiveness

## FOREIGN CORRUPT PRACTICES ACT

The U.S. Foreign Corrupt Practices Act (FCPA) and its international counterparts represent significant supply chain risk. U.S. firms seeking to or already doing business in foreign markets must be familiar with the FCPA, which prohibits corrupt payments to

foreign officials for the purpose of obtaining or keeping business. In addition, other statutes such as the mail and wire fraud statutes, 18 U.S.C. Sections 1341 and 1343, and the Travel Act, 18 U.S.C. Section 1952, which provides for federal prosecution of violations of state commercial bribery statutes, may also apply.

Forum participants agreed that natural collusion exists within each market, especially when organizations are forced to hire a local third party to audit or inspect locations. It is difficult to ensure the third party's integrity and the reliability of the vendor's reports. One strategy for assessing these market-specific risks is to network with peers who already have a presence in the area. Even organizations in different industries can have keen insights into the challenges peculiar to specific geographies.

The U.S. Department of Justice (DOJ) intends to expand enforcement efforts overseas beyond official corruption to commercial bribery schemes. This type of corruption is much more common in retailer supply chains, and global retailers face an ever-increasing risk of running afoul of the FCPA, primarily because supply chain vendors are difficult to govern from a distance. Recent DOJ statements reveal an expectation that companies that discover such schemes should voluntarily disclose

## THE FOREIGN CORRUPT PRACTICES ACT

In addition to prohibiting corrupt payments to foreign officials for the purpose of obtaining or keeping business, the FCPA also requires companies whose securities are listed in the United States to meet its accounting provisions (15 U.S.C. Section 78m). These provisions, designed to operate in tandem with the FCPA's anti-bribery provisions, require corporations covered by the provisions to record the corporation's transactions, accurately and fairly, and devise and maintain an adequate system of internal accounting controls.

Penalties under the FCPA are significant:

- Corporations can be fined \$2,000,000 for each violation
- Individuals face five years imprisonment and \$250,000 for each violation and cannot receive reimbursement for the fine
- Non-prosecution agreements include fines, compliance monitors and new compliance obligations going forward

them to the Department, although it has not demonstrated any leniency toward organizations that have self-disclosed.

## TRANSPARENCY INTERNATIONAL

As organizations expand into countries with unfavorable Transparency International Corruption Perception Index ratings, they face an even higher risk of violating the FCPA. And while industries tend to focus on the FCPA's bribery provisions, the books and records provisions work hand in glove with the bribery provisions. They are hazardous to organizations because retention requirements are difficult to navigate. Retaining the wrong records, or too many or too few records, can lead to additional legal issues. Violations have included documentation of transactions that could be deemed by the DOJ as misleading or inaccurate.

The United States is enforcing requirements under the FCPA and similar laws by treaty with other countries. Enforcement does provide for more even competition, but also a broader regulatory risk horizon. To have a defense under FCPA, organizations should be aware of and deal with any red flags proactively.

In addition, for international acquisitions the due diligence process should include a thorough review of compliance programs surrounding

FCPA-related requirements. If the target organization has violations, the acquiring organization will be held responsible for the target's prior misdeeds.

Organizations should establish written policies for hospitality expenditures, as well as payments and gifts to government officials. These policies, which must be sensitive to the requirements of international anti-bribery and anti-corruption laws and regulations, should also cover international charitable contributions.

Forum participants identified the following best practices: performing due diligence and background reviews

for employees who represent the organization in a foreign environment; establishing certification of compliance programs with respect to related laws and regulations; and formalizing investigation processes with support from internal audit.

Other best practices include:

- Identifying and communicating the appropriate vehicles for reporting potential violations, including employee interviews, vendor interviews and tip lines
- Developing an information technology strategy to support the anti-corruption program
- Scrutinizing payments to intermediaries to identify any points where there might be interaction with the government or other integrity risks

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*“When organizations run into problems it’s usually because they’ve rationalized gray-area behaviors, like paying for escalating miscellaneous payments to a local third-party agent and then disavowing any responsibility for detecting the illegal payments to government officials. When it comes to light that payments were made, the first thing the Department of Justice asks is – what did the company do to ensure the payments were legitimate?”*

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*– Forum participant*

## WHAT IS TRANSPARENCY INTERNATIONAL AND THE CORRUPTION PERCEPTION INDEX?

Founded in 1993, the politically non-partisan Transparency International (TI) is a global network of locally established national chapters and chapters-information that fight corruption. TI brings together people from government, the public sector, business and the media “to promote transparency in elections, public administration, procurement and business to end the devastating impact of corruption on men, women and children around the world.” TI's global network of chapters and contacts also lobby governments to implement anti-corruption reforms.

TI's Corruption Perceptions Index (CPI) ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, drawing on corruption-related data from expert and business surveys by a variety of independent and reputable institutions. The CPI reflects worldwide views, including those of experts living in the countries evaluated.

- Leveraging market resources such as TRACE Group, which has developed a consistent standard for assessing anti-corruption efforts with respect to intermediaries

Organizations that have established integrity as a vital corporate value have had the best success in avoiding ethics-related pitfalls under anti-bribery and anti-corruption laws. These organizations have incorporated specific provisions in their FCPA policies and procedures, including those for:

- Environmental issues, supplier responsibility and community engagement
- Employee compensation and retention, recruiting and morale
- Avoiding negative publicity by partnering with local government and public officials to expand opportunities and for other initiatives
- Scrutinizing all “things of value” to ensure that strict controls around expenses related to business agreements are enforced (a good test is how the treatment compares with what the organization does for its own employees)

Effective FCPA programs specify responsibilities and accountability for all employees, suppliers and affiliate entities. These programs are risk-based and focused on activities and geographies that present a heightened challenge for the organization. Beginning with a risk analysis that reviews foreign government sales, infrastructure-related integrity risks and merchandise risks, organizations should address those risks identified in the analysis by strengthening controls to cover the gaps. Once the program has been developed, training and ongoing education should target specific roles and responsibilities, including the types of risks inherent in job functions.

Some organizations find that leveraging their Anti-money Laundering and Bank Secrecy Act (AML/BSA) procedures, like Office of Foreign Asset Control searches, can improve FCPA process efficiencies.

A final note on establishing FCPA policy and procedures: Simply having compliance certification provisions offers

no safe harbor if there is no real enforcement or demonstrated assurance of those certifications. Internal audit plays a key role in helping enforce the organization’s FCPA policies. Preserving audit rights under a contract is not enough – performing audits is critical to mitigating risk and identifying problem areas. Due diligence reviews performed after the fact can also expose problem areas.

## CORPORATE SOCIAL RESPONSIBILITY AND PRODUCT SAFETY, QUALITY AND HEALTH

Corporate social responsibility (CSR) is closely linked to supply chain variability risk. In the global sourcing arena, social responsibility requires internationally accepted codes on labor, environment and ethics to be met by all suppliers. While those codes provide some guidance, community perceptions vary by geography, presenting risks and opportunities for organizations. The global landscape can be confusing without a solid understanding of social responsibility-related expectations from market to market.

Consider a recent case involving a U.K. pharmaceutical firm that was portrayed negatively in a television program with respect to its policy on animal rights. Social responsibility generally, and animal rights in particular,

is a hot-button issue in the U.K. Not surprisingly, there was a concerted and tenacious response to the television program by animal activists – first against the company, then its financiers and suppliers, and finally its customers. The firm’s share value was decimated and it was forced to relocate its

corporate headquarters to another country. For their relationships with the firm, its banks, customers and suppliers were subjected to similar campaigns, intended to force the relationships to end so the firm would have to shut down. Even though it managed to conduct business through the activists’ campaigns against it, the company’s profitability suffered along with its share price, and obtaining financing became nearly impossible.

Global organizations must understand the capabilities, limitations and motivations of their operational partners, especially regarding their commitment to the communities where they have a presence.

A recent spike in state-level product safety regulations presents another challenge. Stricter regulations for toy

*“Commitment to a market is a process. The entire market as a community is keenly aware when a major retailer pulls out of the market. They’re invested, so they don’t want organizations to cut and run, they want you to stick it out and do what you can to fix the problem and implement solutions.”*

– Forum participant

makers, clothing and consumer products manufacturers and the retailers who stock their wares, require them to closely watch the ever-changing regulatory landscape and, with each change, carefully weigh the cost of compliance.

Add to those concerns political shifts and unrest, especially in emerging markets, and it is easy to see that communication and coordination among an organization's internal teams is critical. Integrity and the risks related to corruption should be addressed across the board – within the organization, among affiliates, vendors, suppliers and other providers – and assessed according to local and U.S. market standards.

The pressure to become good corporate citizens is increasing, and social responsibility is now a critical part of organizations' strategic planning processes. Those organizations able to effectively navigate the relative CSR regulatory void and varying market and stakeholder expectations have developed guiding principles for CSR.

### Developing Principles for CSR

Forum participants identified effective, practical approaches to control costs and create internal efficiencies, including coordinating efforts across the organization; standardizing global audit procedures for vendors, suppliers and affiliates; and developing stepped training and awareness programs according to responsibility levels.

The best practices below reflect participants' focus for CSR:

- Develop partnerships with global organizations to examine the impact of the organization's business practices on the factories and communities in which they operate
- Be absolutely transparent in the marketplace. Identify gray areas and ask enough questions to fully understand the environment (leveraging trade groups, etc.)

- Employ green initiatives; reduce energy use; increase paper/cardboard recycling; launch organic cotton products and explore alternative fibers like hemp, organic linen, bamboo, etc. – and include those efforts in the audit plan
- Transition to quantified benchmarks that prove the benefit of the organization's efforts
- Track the evolution of voluntary CSR efforts and how they migrate or evolve from compliance to voluntarily assumed standards (because it's not a long walk from voluntarily assumed standards to a regulatory compliance requirement) and include that in the risk assessment and management program
- Participate in coalitions of organizations that share internal audit and other assurance practices, leveraging unions and non-governmental organizations to execute a common standard/code to maximize efforts

Partnering with peers can further improve the efficiency and effectiveness of an organization's CSR efforts. Peer groups can be defined across industry, size and geography, since organizations in different industries have discovered shared risks – for example, risks associated with human capital where the number of employees, employee population composition and geographic location may be the same. Likewise, regulatory compliance requirements often are driven more by geography, transaction numbers and size than they are by industry.

Global organizations still face significant issues in managing their CSR efforts – namely, finding a CSR standard that levels the playing field among peers and implementing that standard with a common vision and understanding. Organizations also struggle with stakeholder expectations that require enforcing more stringent CSR standards than those of the market, geography or their peers. In addition, standardizing audits and definitions and identifying

*“The best chance organizations have of improving quality and CSR efforts, and of better sustaining their workforce, is to approach the whole process differently than we have in the past. Rather than competing for a set of best practices, we should collaborate on them, recognizing that all retailers are facing the same challenges. This is especially important in emerging markets, where recourse against buyers is a more effective means of ensuring compliance than law.*

*- Forum participant*

major players in global standards-setting without market collusion present additional corporate governance challenges.

## CONCLUSIONS

Forum participants agreed that the primary global sourcing concern is sustainability. The benefits of pursuing sustainable practices outweigh the costs, driving a shift from defensive behavior toward more active exploration of the opportunities sustainability can provide.

Risks for global organizations shift from market to market and change over time. Managing supply chain variability risk, FCPA and other corruption- or fraud-related risk requires a broad view of the organization, a clear and fully informed perspective of the organization's markets. As they struggle to meet complex and sometimes conflicting stakeholder, community, regulatory and director expectations, global organizations will seek standards for identifying, assessing and managing those risks. In addition, audits will have to assess the effectiveness of an organization's risk mitigation program against its risk assessment.

To adequately address risk, the global marketplace requires organizations to coordinate their risk assessment and management activities. Fostering a culture of global citizenship helps engage employees at all levels in the process of risk management. This also holds true for suppliers and vendors, as supply

chains evolve from largely linear arrangements to more complex, webbed configurations.

Assessing and managing risk in a global environment requires input from all appropriate levels of company management, a comprehensive view of processes, a risk management program that can be stress-tested and flexible enough to change with market risks, and a thorough understanding of the organization's goals and appetite for risk.

## JEFFERSON WELLS AND MANAGING RISKS IN A GLOBAL ENVIRONMENT

Based on risk surveys and interviews with members of senior management and independent governance representatives, Jefferson Wells internal audit professionals help organizations identify business risks and challenges. We assist in prioritizing key risks and aligning them with business processes, identifying risks that can be audited, monitored and mitigated, and determining risk ownership.

A Jefferson Wells enterprise risk assessment will identify and classify controls to reduce risks, providing a risk and control matrix aligned with primary risk processes and a multi-year audit plan based on risk.

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