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Discussion Paper

Supplier Audits

One way in which companies are seeking to ensure that their final products are socially and environmentally sound is to undertake supplier audits

Charles Cueni

Who doesn't remember the repercussions Nike faced in the late 1990's when it emerged that the Nike T-shirts you and I wear were most probably produced by children working in Nike's supplier sweatshops, deprived of basic human rights?

Not only was there a large public outcry calling for a firms' corporate social and environmental responsibility agenda to be extended to their suppliers and contractors, but Nike also suffered a loss of sales due to boycotts and plummeting brand equity (Stanford Graduate School of Business, 1998). Nike was widely perceived to severely breach its social contract, a term first described by Jean-Jacques Rousseau and John Locke which now also finds its definition as a firms' extended corporate governance model (Sacconi, 2004), which resulted in the public withdrawing its trust.

This discussion paper aims to shed light on the still relatively young and not extensively researched field of supplier audits. The first part of the paper shall give a description of what is involved in such audits. In order to better comprehend the complex field of supplier audits, it shall be illustrated by examples of Roche and Marks & Spencer.

The second part of the paper would like to critically evaluate whether supplier audits really achieve the desired outcome of making an entire value chain more socially and environmentally responsible.

What are Supplier Audits?

Supplier audits must be seen as an integral part of the larger sustainability reporting domain. Sustainability reporting which is the same as triple bottom line reporting or CSR reporting sheds light on a corporation's economic, environmental and social aspects of its performance. Its primary goal is to contribute to improve stakeholder engagement by offering quantitative and qualitative insights into the company itself and the scope of its operations, products and services. The reported information is usually matched against formulated objectives or industry benchmarks. Furthermore, an organization can enhance its own performance by including a description of the corresponding performance of subcontractors, suppliers and vendors, and thus demonstrate a "broader vision of sustainability through greening the supply chain." (PwC, 2004 , p. 13)

Although CSR reporting has often been perceived to be nothing more than a "strategic resource to enhance business performance" (Bakan, 2004, p. 44) by creating a favourable corporate image which creates goodwill, it is important to recognize its wider implications on the legitimacy and sustainability of doing business.

There is a strong demand for corporations to embrace a multi-stakeholder approach when reporting in order to make the corporation accountable to broader domains of society. This calls for organizations to create a code of conduct, which is already mandatory for corporations listed on the New York Stock Exchange or Nasdaq. According to Paine, Deshpandé, Margolis & Bettcher (2005, p. 123) companies can clarify for all parties, internal and external, by adopting its own code "the standards that govern its conduct and can thereby convey its commitment to responsible practice wherever it operates". Further, Paine, Deshpandé, Margolis & Bettcher (2005) point out that a code may also help a diverse mix of employees work more effectively across geographic and cultural boundaries, serve as a reference point for decision making or even serve for recruitment purposes. One of the more important aspects of a code of conduct is deemed to be helping corporations reduce the likelihood of damaging misconduct. As part of managing their own brands, several companies, e.g. Roche, audit the codes of their potential suppliers and partners in order to align them with their own.

Although Roche states that it cannot take responsibility for activities undertaken by its suppliers, Roche wants them to apply and comply with applicable laws, regulations and contractual terms as well as provisions relating to sustainability e.g. child work, forced labour, safety, protection of the environment, human rights etc. Roche expects from its suppliers that within "the sphere of their influence they act in the sense of sustainable development in a socially responsible and ethical way" and also apply Roche's code of conduct to their subcontractors. (Roche, 2006)

Before entering into a new business agreement with a prospective supplier, Roche performs a due diligence audit by studying publicly available information about the supplier as well as test and interview on the premises of the prospective supplier to get first hand assurance about its suitability, quality and credibility. If successful, the prospective supplier may engage in contractual terms with Roche. Then, it is contractually bound to adhere to the same standards as Roche and report any event and incident that could seriously infringe applicable laws, regulations, contractual terms and social responsibility principles. Roche continuously monitors and audits the suppliers' performance in accordance with Roche's risk assessment. In case of a breach, Roche will request remedy of any abuse within a specific timescale and take appropriate measures, including, "as *ultimo ratio*, termination of any cooperation with unqualified business partners." (Roche, 2006)

Thus, from a corporation's perspective, supplier audits have become an increasingly important aspect of risk assessment. It usually involves a detailed and in-depth review of appropriate documents and records, tour and tests on the premises and interviews with employees. The aim of supplier audits is to assure its compliance with applicable laws, regulations, contractual terms and corporate social responsibility principles. Problematic areas are addressed and sought to be remedied by the supplier, often with the help of the contractual business partner, within a given timescale. Areas where the supplier greatly exceeds the organization’s criteria may be used as good or best practice examples. Supplier audits can be carried out as part of the due diligence process in order to approve new suppliers, as a follow up audit to ensure compliance of a previously addressed critical issue and on an annual basis.

Marks & Spencer further differentiate between internal and external auditing of their suppliers. As part of the internal audit process their direct suppliers appoint individuals as “social compliance managers”, to report on the rate of progress. These records are stored in databases which are reviewed by Marks and Spencer. Internal auditors are trained and then allow the person in charge of the audit to take responsibility for the actions which come out of it. This process has resulted in significant changes for the better. External auditors are engaged for initial due diligence audits, when an audit is particularly complex or when independence of the audit report is pivotal. (Marks & Spencer, 2006)

A Critical Evaluation of Supplier Audits

Over the years, supplier audits have arisen in many different forms in various management tools or initiatives such as the balanced scorecard, as first described by Kaplan & Norton (2005) in 1992; ISO 9000, a standard for quality management systems or ISO 14001, which specifically provides certification of various levels of social accounting and performance; the Global Reporting Initiative (GRI), a relatively new initiative with the aim to establish globally accepted guidelines for reports incorporating social and environmental information (GRI, 2006); AA1000, a standardized method for social and ethical reporting (AccountAbility & KPMG, 2005). The list continues. The aim of this chapter is to take a closer look at various nuances of supplier auditing and critically evaluate whether their efforts result in the desired outcome of making the entire value chain more accountable towards achieving sustainable development.

The ISO 9000 series of standards, as an early advocate of a kind of supplier audit, is primarily concerned with quality management systems and compliance with applicable regulatory requirements while also enhancing continuous improvements in the light of customer satisfaction (ISO, 2006). Many organizations require their suppliers to be ISO certified as it attests that the supplier has appropriate systems in place to guarantee a benchmark performance. Saunders (1994) states that although the ISO 9000 series of standards is used as the basis of assessment, it is the auditor’s role to identify areas for improvement in the partnership between the organization and its suppliers.

Saunders (1994) advocates that two of the most important aspects of ISO 9000 are to check a suppliers’ system for internal quality audits and the manner in which corrective or preventive action is incorporated into operations. Thus, the aim of ISO 9000 is to make suppliers think about how they can make their operations more efficient, doings things right first time, at minimum cost.

Barthelemy & Zairi (1994) further advocate that an organization can develop a culture of continuous improvement, innovation and advancement by embracing an audit methodology.

Thus auditing, as seen from an evolutionary standpoint, can lead organizations to exploit otherwise missed opportunities and build a strong capability in their systems and processes, which enables sustainable competitive advantage.

Furthermore, in an era where competition has shifted from being between individual corporations to being between supply chains (Christopher, 1998), Macbeth (1990) claims that the supply chain competitiveness can be improved through buyer/seller relationship audits.

However, it is important to note that ISO 9000 is only concerned with one aspect of supplier audit and neglects the wider implications negative social or environmental reports of an organization’s supplier may have on its performance. From a risk management perspective, one may assert that ISO 9000 is more concerned with operational risks, whereas ISO 14000 and similar certifications are more concerned about reputation risks, which according to Handfield & Nichols (1999) may be passed on through suppliers and have the potential to gravely harm an organization.

This ties in with Gyöngyi ‘s (2005, p. 1) statement of “no business is an island”. Gyöngyi (2005) embraces the cradle to grave principle of a holistic life cycle assessment and thus extends producer responsibility beyond just direct (first-tier) suppliers, although this rarely occurs in practice.

Although internal audits are an integral part of ISO 9000, which are later again verified by an external audit, the above Marks & Spencer example illustrated that this is not necessarily the case for social and environmental reporting. This may be perceived to be a problematic issue as one of the core principles of any audit as promoted by the Auditing Practice Board (APB) or Securities and Exchange Commission (SEC) is seen to be its independence in order to maintain a sense of accountability and reliability.

According to the New Economics Foundation (2000), the need for credibility of such reporting to both internal and external audiences has accelerated the development of assurance frameworks such as the AA 1000AS and ISAE 30000 series. The ISAE 3000 provides meticulous procedural guidance for undertaking a social and environmental assurance engagement, whereas in AA 1000AS the emphasis lies in the relevance of the reported information for stakeholders.

Such assurance standards must be greatly supported, as analogous to the financial sphere, information needs to be assured by an independent party in order to regain trust in the corporate reporting supply chain. The big four of the professional service firms are now all offering audit services related to social reporting as they have discovered this field to offer attractive opportunities for future growth.

Marks & Spencer (2006) state that their efforts in auditing suppliers has resulted in suppliers gradually taking responsibility for compliance on a local level, which has resulted in real change. The challenge is therefore to build local capacity and an understanding of the social audit process, both internal and external.

Supplier auditing as part of organizations' non-financial reporting is thus deemed to continue to grow in importance, driven by demands for more transparent and extended corporate governance agreements and thus for organizations not to breach their social contract. This means that organizations will be held accountable for their social and environmental impacts (New Economic Foundation, 2000).

A report commissioned by the Association of Chartered Certified Accountants (2003) points to the subjective nature of most social and environmental reports. Therefore, objective measurement on the basis of a code of conduct which incorporates social and environmental responsibility is very difficult and thus heightens the need for independent CSR auditing if the report is to convey credibility to stakeholders.

Although the Association of Chartered Certified Accountants (2003) pertains that CSR reporting may improve a corporation's (economic) bottom line profitability, there is to date no concrete evidence that CSR reporting, with supplier auditing as an integral part, results in improved social and ethical performance (New Economic Foundation, 2000). However, with links to legislation and corporate governance, it can contribute to improved accountability. Social and environmental accountability may result in giving stakeholders a bigger say in corporate decision making and thus make them more responsive to broader social and ethical concerns. (New Economic Foundation, 2000).

Zairi & Peters (2002) state that how organizations perceive CSR reporting, and as such supplier audits, will very much depend on a variety of external and internal factors associated with the need to derive economic benefits and various efficiencies, the need to build a positive corporate image, the need to comply with scores of regulations, but hopefully with the appreciation that a focus on social responsibility can be an area of high leverage and as such enable organizations to derive a sustainable competitive advantage. In order to maximise the potential benefits from this source of competitive advantage Gyöngyi (2005) claims that organizations must align their social and environmental efforts and reports with their supply chain collaboration.

Conclusion

After having described supplier audits and critically evaluated its potential goals we may pose the question: would Nike have been able to evade much of the turmoil and negative impacts if it had incorporated supplier audits in the broader context of CSR reporting? Although it is evident that supplier auditing and resulting corrective measures would have obliterated the economic loss for Nike, their (extended) social and environmental performance is less clear. This is demonstrated by the fact that they have currently subscribed to supplier auditing, yet what they report and how they act in practice are very different matters.

This illustrates the need for a global standard on CSR reporting which must be verified by independent, external auditors.

With the domain of CSR reporting gaining importance in the future, organizations must pay attention to align their strategy with stakeholders' expectations and recognize that demands for social and environmental reporting arise from a multitude of stakeholders, each of which has to be managed individually. CSR reporting should thus be seen as a key driver for engaging the wider community as an important stakeholder in business activity.

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