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Managing Supply Chain Risk: Reputational – Ethical – Environmental - Legal

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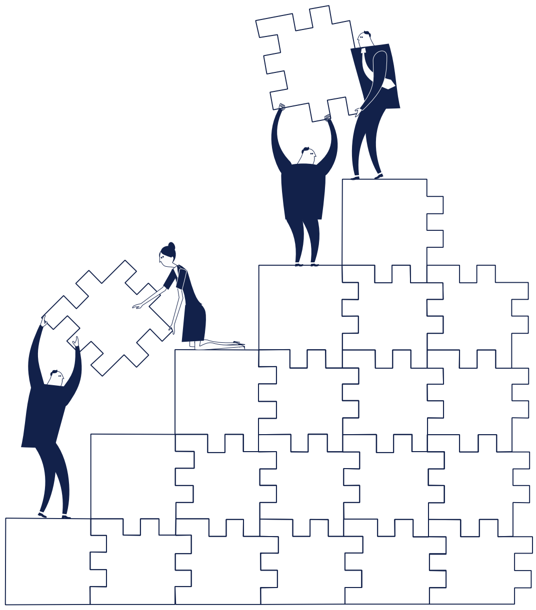

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Managing Supply Chain Risk

Reputational – Ethical – Environmental - Legal

Steve New and Laurence Cranmer

SUMMARY

Drawing on interviews with seven major UK-based companies in the construction, property, utilities and rail sectors, we review companies' approaches to reputational, ethical, environmental and legal supply chain risks (REEL risks for short). We suggest that firms need to ensure that the reality of their supply chain practice is not outstripped by their claims, that they engage with their supply base to adopt best practices, and that they seek a better understanding of their supply networks.

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INTRODUCTION[1]

In this short report we explore some key aspects of supply chain risk. In particular, we examine a category of risks that are especially difficult to evaluate and manage – risks connected to reputation, ethics, environmental impact, and legal responsibility (REEL risks for short). These risks arise where the actions of a supplier may damage its customer – even if the customer is separated from the supplier by several links in the chain.

Examples of this kind of risk include the reputational damage inflicted on a firm when one of its suppliers is found to be illegally or unduly damaging the environment, or hiring illegal labour, or engaging in some other breach of acceptable business practice. Fairly or unfairly, large companies may be held to account *as if* they were the culpable party, and are seen as sharing at least some of the responsibility for the supplier's behaviour. In addition, recent examples have seen firms seeking to capitalise on claims about the probity and virtue of their supply chains, as shown in the growth of marketing based on product provenance such as Fair Trade and eco-labelling. Public opinion and the regulatory climate are now clearly aligned with the idea that buyers (as customers within supply chains) have extended responsibilities. The California Transparency in Supply Chains Act of 2010 is one significant portent of a shift in the way firms see their obligations.[2]

What firms should actually do in the face of these challenges remains unclear. How much should firms seek to know about the deep structure and activities of their supply networks; and, what actions should they take to mitigate REEL supply chain risks. By exploring these issues with seven large companies in the UK we suggest a series of insights that may help organizations navigate this complex terrain. We think all companies keen to establish coherent and effective strategies will benefit from examining the issues raised in this report.

[1] This short report was written as part of the Oxford-Achilles Working Group on Corporate Social Responsibility in 2012. This version includes updates made in October 2015.
[2] The UK Modern Slavery Act 2015 may be seen as a recent and further example of this shift.

ANALYSIS FOR "REEL" RISK

Many organizations have well-developed systems for thinking about conventional supply chain risk – for example, what happens if my key supplier fails to deliver on time? Furthermore, firms have mechanisms for identifying their 'strategic' suppliers – and can focus their attention on these key external resources.

Issues of reputation, ethics, environment and legal responsibility, however, do not always fit well into traditional purchasing strategies. One concern is that major problems may arise from relatively insignificant players in the supply network – firms that the 'principal contractor' may not even know much about. In 2010, a Channel Four documentary showed shocking footage of illegal sweatshop labour in abusive conditions in a Leicester factory supplying some of the major UK clothing retailers[3]. The fact that the firm was a relatively insignificant supplier did not stop a documentary seen by millions, and extensive press coverage, placing responsibility for these conditions at the doors of the retailers. Conventional approaches for focusing attention do not work well with REEL risks.

We explored this issue by examining the practices of seven major UK firms in the construction, property, rail and utilities sectors. Unlike, for example, traditional manufacturing firms buying components, these firms' procurement is dominated by procuring subcontract engineering services and so-called 'MRO' (maintenance, repair and operation) suppliers. All of these firms promote their commitment to sustainability, and publish policies relating to supplier management.

In the firms in our study, we found a mixed approach to the analysis of supplier risks. All the firms understood the need to take a holistic view of the supply chain, and readily accepted the problem of identifying risks. But none of the firms had developed complete systems for handling risks in a comprehensive way, and we suggest that the problem was largely one of fitting REEL risk analysis into business practices established for other purposes. This can be broken down into at least three challenges: how far to go; how to prioritize attention; and, where to locate the activity in the organisation.

[3] Dispatches: Fashion's Dirty Secret, Channel 4, 8th November 2010

HOW FAR TO GO?

Many organisations work with thousands of suppliers, and so even dealing with 'tier one' suppliers is a complex exercise in data handling and basic administration. One firm in our study discussed the challenge of handling 300 tier two firms, and 7,000 tier three firms, with a central team of just three people. Extending the reach of supply chain analysis to the second or third tier – or even beyond – entails necessary compromises and a means of assessing relative risks. Existing mechanisms for handling procurement and supply chain information may have been designed primarily for dealing only with tier one suppliers; as a result, more holistic, risk-based analysis of suppliers further down the chain may have to be handled by informal and ad hoc systems. This means that analysis beyond tier one is often conducted on an exception basis, without the rigour that can be applied to immediate suppliers. Additionally, gathering information beyond the first tier presented problems, and firms had to live with the issue of dealing with fragmentary and incomplete information. The more distant – culturally and geographically – the supplier, the harder the information was to acquire, and the more complex and interconnected the potential risks became. Only one firm in our study spoke of visibility of the supply chain at tier levels three and four, and this was in terms of 'awareness' rather than detailed information.

HOW TO PRIORITIZE ATTENTION?

Firms seemed to need to adopt approaches that enable human judgement to be applied to the task, as programmatic and rule-based approaches were difficult to construct and implement. For example, for one of the firms in our study there was a sense that firms some way down the chain, but located in less regulated countries – specifically, China – presented some of the most challenging issues. Several firms appeared to find it difficult to operationally disconnect risk analysis from their general schemes for identifying important suppliers.

WHERE TO LOCATE ANALYSIS?

> For some of the firms in our study, it was not clear where to locate supply chain risk analysis within the corporate structure. A key point is that many organisations locate specific expertise (for example, compliance, safety, environment) within specialist functions separate from the procurement and contracting organisations; this means that firms may lack the opportunity to bring disparate information together easily. Storing information centrally was also a challenge. A conundrum for some companies was the extent to which supply chain risk analysis needed either to be centralised or to be devolved to operating units.

None of the firms in our study – despite their size and sophistication – appeared to operate with a coherent 'map' of the relationships across their extended supplier network. Although several could identify the problem of risk emerging at lower tiers, the ability to analyse risk was largely limited to the first tier. Some exceptions to this involved those cases where second-tier suppliers could be brought into the orbit of various industry schemes or benchmarking initiatives; for one firm industry rules included a ban on the use of subcontractors.

An interesting complexity emerged in the firms' accounts of how they handled risks associated with smaller suppliers. On the one hand, there was acknowledgement that smaller suppliers present a problem because they might themselves not have the management systems or internal sophistication to handle some of the REEL and other risks. This particularly applied to small suppliers' ability to manage *their own* supply chains robustly. Furthermore – especially in the current challenging economic environment – there was a greater chance of business failure with smaller firms. There was also a perception that where subcontractors to main suppliers drifted into bad practices – for example, in relation to the use of illegal labour – this could lead to a general degradation of standards in other risk domains (such as health and safety). Some firms in our study confirmed that part of the enhanced risk presented by small suppliers was that they were simply paid less attention than larger firms in the contracting process.

Simultaneously, smaller supply chain partners could sometimes benefit from compensatory features that partially mitigated this enhanced risk. For example, smaller firms might be more eager to demonstrate compliance with the purchaser's policies, and be more willing than larger suppliers to adapt their own systems.

An important issue in firms' analysis of REEL supply chain risks was that decisions about appropriate strategies for identifying these risks could not easily be based on actual experience: cases in which REEL risks actually impact on businesses are rather rare – but when they do happen they can be devastating, and expensive. Therefore, as with other high impact but low probability risks, REEL risk management cannot easily be based on empirical experience, or on trial and error. We asked companies about their awareness of prosecutions, investigations or enforcement actions by UK or international regulatory bodies; we also asked related questions about adverse publicity and whether this formed part of the company risk assessment. From the responses, there appeared to be very limited incidence of prosecutions, enforcement actions or adverse publicity, although some specific issues were mentioned. However, companies suggested that this did not mean that REEL risks were not taken seriously in the organisation.

ACTIONS

The companies in our study adopted a variety of strategies to handle supply chain risk, but by far the most common approach was to seek information and reassurance from first tier suppliers that their own procedures and actions were in line with the buying company's policies. Some of the firms had developed their own 'toolkits' to guide strategic sourcing, or adopted a 'category management' approach to organise their own activities.

As part of action to anticipate and to mitigate these risks we asked companies about their stipulation of codes of conduct with principal contractors and with suppliers across the supply chain.

Most of the companies appeared to require that codes of conduct or standards are adopted by tier one suppliers in addition to compliance with legislation. In some cases, there was either an expectation that tier one would cascade these codes down the supply chain or, in one case, that the company had plans to implement this cascade. In general we found that there appears to be limited rigorous application of codes of conduct beyond tier one. One firm described how it attempts to operate a sustainable procurement approach and assess suppliers against ten criteria ranging across waste management, employment, human rights and prompt payment of suppliers. The company also uses a 'sustainable procurement charter' with its top fifty suppliers, and encourages and expects promotion of this approach down the supply chain as a cascade of best practice – both improving the performance of the chain, but also reducing its own risk exposure.

This 'cascade' approach appeared to be the central motif of the firms' attempts to mitigate and manage supply chain risk. Our sample of firms varied, however, on the extent to which this was enacted; for some, issuing codes of practice and questionnaires was the principle measure; for some, but not all, this was then followed up with a degree of audit and verification. In some of these cases, third parties were used to help oversee the qualification process and to provide audit services.

One company went further, organising supply chain fora attended by up to 250 first tier suppliers; in part this was to provide information on the firm's policies and expectations, but it was also designed to facilitate learning and the exchange of best practices. This activity was then followed up by direct engagement with selected suppliers to encourage continued improvement. Another company was developing a project-based approach on specific issues with selected suppliers – for example, working with 45 top contractors on environmental footprinting. Other firms took a more passive approach, trusting that the first tier suppliers would both conform to necessary standards and seek to transmit best practice through the chain. Some issues were monitored, others not.

ISSUES

Our interviews have led us to three broad insights relating to the management of REEL supply chain risks. Although necessarily speculative, and based on a limited sample of firms, we draw out the following insights.

DOING IS BETTER THAN SAYING

We note that some firms have published supply chain policies that may seem to imply more substantive activities in their supply chain than appears to be the case. This seems to be less a case of so called 'greenwash', and more a case of two less egregious, but nevertheless problematic, temptations. The first is that the language of 'the supply chain' (and similar terms) is vague enough to cover a wide range of meanings. For example, the phrase 'working with our whole supply chain to ensure compliance with best practice' could mean working across all first tier suppliers (a horizontal interpretation), or with suppliers at multiple tiers (a vertical interpretation involving suppliers of suppliers, and so on). When firms use this kind of language, it rarely means nothing: but it may mean less than it could be *taken* to mean. The second temptation is for aspirational policies – however genuine – to be presented in ways that can be read as accomplishments. Firms may indeed aspire to understand their suppliers' risk profiles, and to work on projects to reduce supply chain risks, but these intentions may be presented in ways that imply more action than is actually the case.

There are several potential traps that arise from these common problems. Perhaps most important is that over-egged claims of supply chain risk management may mean that the boards and senior management of firms are lulled into a sense of false security, and fail to take action and direct sufficient resources to the area. In addition, firms may find that excessive and unsubstantiated claims may increase reputational risk because these firms are held to higher expectations and standards that they can in fact reasonably support. This may in turn have the effect of undermining firm's efforts to address REEL risks because the public loses confidence in the validity of firm's claims.

Our initial insight, then, is that firms should regularly ensure that their actual programmes of supply chain risk management in relation to REEL risks, although they may be ambitious, are consistent with their public declarations. The logistical and administrative challenges of handling these issue are very great indeed, and substantive progress is hard to make. Over confident rhetoric is unlikely to be helpful.

ENGAGING IS BETTER THAN ASKING

For the most part, the firms in our study were reliant on variants of one simple tool – the questionnaire, and on one model of propagation – the idea of a cascade. In other words, firms were trying to manage their REEL supply chain risks by seeking written assurances from a group of suppliers, and asking or hoping for this pattern of assurance to flow from these suppliers to *their* suppliers, and so on.

In general questionnaires seek straightforward assurances for example, can you confirm that you are behaving acceptably in regard to a particular issue, or do you conform to this standard. There appear to be two ideas that underpin this approach. On the one hand, the problematic idea that should anything unfortunate emerge then responsibility has been handed over; so, our supplier was caught polluting/employing illegal labour/etc, but we had made it clear such behaviour was unacceptable, and they promised to comply. On the other hand, the idea that the questionnaires act to change substantive behaviour; so, not only do they make the buyer less culpable, they make the supplier actually more likely to change what they do for the better. In this way, for example in regard to labour and environmental standards, some people have envisaged procurement being a major agent of change for areas beyond the traditional responsibilities of firms, and even as an alternative to government regulation.

There are, however, some substantial potential weaknesses in this latter model. First, there is a risk that some cases questionnaires leave room for ambiguity, and little scope for sanction or risk of consequence if the respondent stretches the truth or gives 'aspirational' answers. Second, it is possible that in some cases the issuing and return of questionnaires has a rather ritualistic and mechanistic feel; just as in other kinds of risk management, it is possible to seek solace in the completion of forms and the filing of paperwork, even if substantive issues remain unattended.

Several of the firms in our study had clearly recognised this limitation and responded in two main ways. First, some combined the process of harvesting information (and assurances) from their suppliers with a degree of audit and follow-up. There was also some evidence of suppliers being delisted in the event of adverse findings, and these approaches helped to ensure the process was taken seriously.

Second, and perhaps most importantly, was the addition of the ideas of engagement and education. Rather than presenting attention to REEL risks as a mere hoop-jumping or box-ticking exercise, some firms were able to articulate a clear business case to their suppliers. In other words, some companies had made progress in not just communicating a set of standards, but in communicating the rationale and significance of the standards too. This is important not only because it appears likely that this will produce the most meaningful response in the supplier, but also be more likely to lead to the supplier taking the issues seriously across *its own* supply base.

SEEING IS BETTER THAN HOPING

Our final insight relates to the limitations of visibility of the character of the supply base. Few firms appeared to have more than a fragmentary understanding of what happens beyond the first tier of suppliers, and there are many reasons why information is hard to gather. However, it appears that the reasoning that has led many firms to concern themselves with REEL risks leads inexorably to the need for firms to find ways of gaining a better grasp of who is supplying their suppliers. Without this, in many situations, supply chain risk management becomes a gestural activity. This means that firms may need to consider substantial changes to the contractual conditions they use with their suppliers so that, for example, the identification of the lower tier suppliers becomes mandatory. Firms will also need to address the capabilities of the information systems that support their activity, to allow the collation and analysis of this kind of information.

APPENDIX: METHODOLOGY

The empirical research for this Report is based on seven semi-structured interviews; in most cases 45-60 minute telephone interviews. Each interviewee responded from their own perspective within their respective company. The firms were all major firms in the construction, rail, property and utilities sectors: the average turnover of the firms was just under £4bn, with an average number of direct employees of just under 8,000. Some of the companies were subsidiaries of global corporations. The firms participated under the condition that their identity would remain confidential.