White Paper

Audit Score Analysis
Identifying Risk in the Supply Chain and Improving Audit Scores

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Background

If you only had one tool to judge the likelihood that your suppliers are a high risk of brand damage, what tool would you use? What is the best indicator that your suppliers are socially and environmentally responsible, have proper management systems in place and are transparent? Here is a hint… it's not an audit.

Increasing pressure from stakeholders including governments, customers, Non-Governmental Organizations (NGOs) and investors put the social and environmental responsibility of the supply chain squarely on the manufacturer of the product. How does a producer of a product monitor the safety and wellbeing of hundreds of thousands of workers, who live and work thousands of miles away, all while ensuring compliance to a code of conduct where there may be no direct contractual or employment relationship.

In addition to the brand risk and the accountability issue, there are business challenges and opportunities for the companies who manufacture a product responsibly. So a company might ask itself, is it best to meet the minimum standard in the countries they do business or is it better to engage constructively in corporate social responsibility, set aspirational goals, and possibly risk criticism if you (or worse, someone else) find non-conformances to a code of conduct? These are all common problems that the electronics industries, and many other industries, face.

Audits are one of many tools companies currently use to achieve the quality and accountability they want in their supply chain. Qualified individuals are sent to the factories where product is manufactured. A long list of questions is presented and supporting evidence is required to demonstrate that the supplier is meeting the agreed-to standard. When an audit is complete, a corrective action plan is created to address any gaps between the requirements and actual performance. Recurring meetings are set to check on progress until all action items are closed and the supplier passes the audit. Manufacturers typically intend to audit the highest risk supplier first, but what is an easy way to determine which suppliers may be high risk? Is there one indicator of risk better than others?

Relevance

Increased accountability

Supply chain responsibility issues are chronic, wide spread, and seen in most every industry. As multi-national companies will attest, governments around the world are beginning to write legislation to ensure social and environmental responsibility in business is the accepted standard of the future.

There are many examples showing a trend to use corporations to uphold social expectations in all parts of the world.

> The UN Guiding Principles are a guideline for countries and companies to collectively adopt to help ensure workers are respected, protected and provided remedy in the event of an issue, providing both companies and governments standards for implementing and enforcing responsible business practices.

> The Dodd-Frank Consumer Protection Act section 1502 requires publicly traded companies in the US to disclose if their products are made with tin, tantalum, tungsten or gold from the conflict region of Democratic Republic of Congo (DRC), even if they do not buy from the mines directly.

Audit results

Audits are conducted at thousands of suppliers in every region of the world each year and each supplier is given a score. These audits are used to drive improvement in the supply chain and are a fundamental component of any quality program addressing issues from health/safety to labor and environmental practices to ethics.

Taking the electronics industry as an example, the top non-conformances found in audits across the industry have hardly changed over the years. The Electronic Industry Citizenship Coalition (EICC) annual report states that the top issues found year over year continue to be related to working hours.

Excerpt from EICC 2012 Annual Report: http://eicc.info/documents/EICC_2012_Annual_Report.pdf

Non-Conformances in audits by section of the EICC Code

YEAR	GENERAL	LABOR	HEALTH & SAFETY	ENVIRONMENT	ETHICS
2011	18%	34%	24%	14%	10%
2012	17%	35%	24%	14%	10%

Top Nonconformances to Version 3.0

2012 RANK	PROTOCOL QUESTION	2011 RANK
CODE SECTION: LABOR		
1	The average hours worked in a week over the last 12 months at this facility does not exceed 60 hours or the legal limit (whichever is stricter).	1
2	Are workers provided with at least one (1) day off per every seven (7) days on average?	2
3	Is the overtime wage calculated and paid at the premium as legally required?	8

Complication:

Let's look at the bigger story behind audits and some challenges we have as an industry.

Audit Fatigue

In addition to the common practice of auditing, the industry also has significant overlap of suppliers, which means the same suppliers are being audited multiple times by different EICC members, and others, not at all. Suppliers refer to this as 'audit fatigue.'

Lack of Data Sharing

Next, there is very little sharing of audit data between companies. This is not surprising since there are sensitive data in audit reports and it could potentially impact the brand if a company generally publicizes the challenges found in the supply chain. While the amount of data shared is increasing because of work being done by groups such as the EICC and Global Social Compliance Program (GSCP), the full adoption of the "Data Sharing" philosophy is years away.

Generalized Risk-Assessment

In addition, there is little consistency on how to pre-determine who in the supply chain is the highest risk and needs to be audited first. Basic risk assessment tools all apply criteria such as region of the world, annual spend and type of manufacturing processes to assess risk but when a majority of the supply chain sits in the same region of the world and does basically the same things, you end up with suppliers that have a similar risk profile and little differentiation between risk categories for prioritizing audits.

Negative Perception

Finally, if you continue to audit the highest risk suppliers, you likely will have low audit scores and therefore not show an improvement year over year. While this is actually shining a flashlight on the highest-risk suppliers, it appears as though you have significant and continuing problems in your supply chain.

So again, I ask, if you only had one tool to judge the likelihood that your suppliers are a high risk, what tool would you use?

Dell Research:

Companies need to know which suppliers in the supply chain are the highest risks, and focus their audit dollars and resources there. On the other hand, they need to spot check the low-risk suppliers to catch any outliers, show appropriate averages and to reward these high performing suppliers with fewer audits. What tool can you use to do this?

We benchmarked with other well respected companies asking what indicators they use to determine risk. The list was long but here are the most common:

- *Spend*
- *Region*
- *Previous audit scores*
- *Size in revenue*
- *Multiple vs. single source suppliers*
- *Percentage of student workers*
- *Conflict Minerals Declaration*
- *Dedicated Corporate Responsibility staff*
- *CDP reporting*
- *Publishing a Corporate Responsibility Report*
- *Number of historic audits (by any company using an EICC audit)*
- *Freedom index*
- *Population of Student workers*

Hypothesis: There are a limited number of factors that have a material impact on audit scores. The most likely indicator would be a published CR Report as it would require at least a basic understanding of the most relevant metrics and enough internal scrutiny to gain approval to make the document public.

We ran statistical analysis on the Dell supply chain data and found that one indicator did stand out with the strongest correlation to higher audit scores.

Findings:

The publication of a publically available Corporate Responsibility Report was the single factor with a significant correlation to audit score. Factors typically associated with risk, like geographic location and spend, showed no correlation.

Process: We ran Dell audit scores through this analysis and found that suppliers who had a publically available Corporate Responsibility Report had audit scores significantly higher than those suppliers without a public report. We followed that up by including another year's worth of audit results and the findings were the same.

Given this strong hypothesis we wanted to get more information to validate the idea so we found three other large multi-national companies in our industry from various parts of the supply chain to participate in this study.

Companies included
- Dell:

- Well-known and respected software company

- Well-known and respected retailer

- Well-known and respected component manufacturer

Information included
- Supplier designate such as "Supplier A" (no supplier names) to allow for anonymity

- Supplier location

- Actual audit score

- Publication of a CR Report (Y/N)

Results:

The findings were even more compelling with the increased dataset of companies. There is the possibility that there are duplicate suppliers in this study for the reasons listed earlier, however, the correlation is strong enough to carry the idea forward for consideration. Here are the details:

Findings

More than half of the suppliers who were audited (across 4 major brands) do not publish a CR Report.
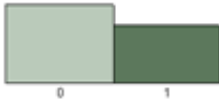
Suppliers who publish a CR Report have a mean audit score of 81.0 versus those who do not publish a CR report, with a mean audit score of 48.1
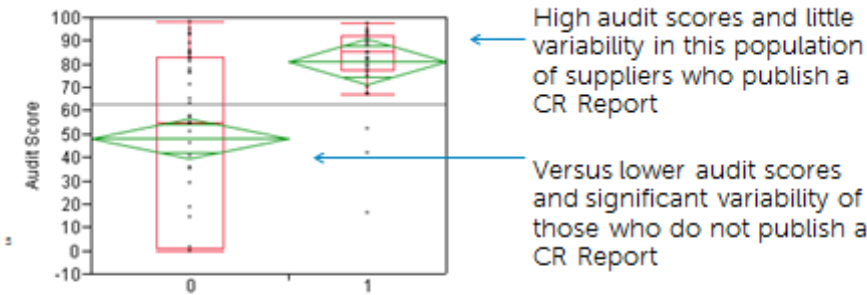

Mean audit score of those who publish a CR Report
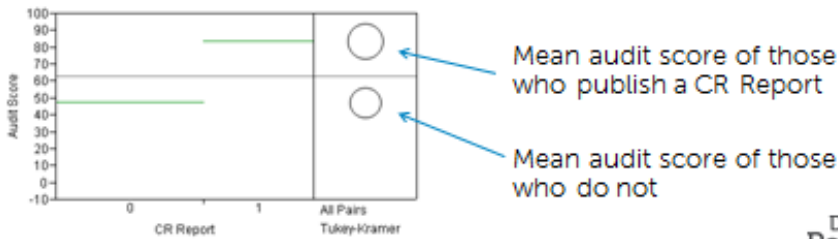
Mean audit score of those who do not

Findings continued

The difference in audit score between suppliers who publish a CR Report and those who do not is significantly higher and statistically significant.

High audit scores and little variability in this population of suppliers who publish a CR Report

Versus lower audit scores and significant variability of those who do not publish a CR Report

The population of supplies in this analysis that published a CR Report **scored 33 points higher in an audit** than suppliers who did not.

Conclusion:

Suppliers that publish CR reports appear to have a better understanding of the scope of standards, related metrics, process management, and controls necessary for responsible operations. By requiring suppliers to publish a CR report we believe companies can address some of the complications discussed above:

Better Risk Assessment
- This approach allows companies a simple way to prioritize audits based on potential risk of suppliers or enhance their current risk assessment

Better Utilize our Resources
- Companies can selectively audit suppliers with a published CR Report to validate the belief that these suppliers perform better with an audit score 80+.

- Companies can reduce the scope of an audit for suppliers with a published CR Report, leaving full audits for those who do not publish a CR Report, getting more audits completed in a year for the same cost.

- Sharing the audits with EICC allows other member to see the audit, avoiding duplicative audits and spreading the total audits over more unique suppliers.

Ability to Recognize Suppliers for Better Performance
- Reduced audit scope
- Longer audit cycle
- Reduce audit fatigue

Brand Protection
- By validating the higher performing suppliers and focusing efforts on the lower performing, higher-risk suppliers, we bring visibility to the deeper challenges while raising the bar on the lowest-performing suppliers.

Recommendation:

The simple step of requiring all suppliers to publish a CR Report can have a significant impact on your supply chain, this is particularly important for smaller companies with less money and fewer resources to manage social and environmental responsibility. Adding fresh language to supplier contracts, offering CR Report templates and trainings to suppliers, and verifying that the reports are made public during business reviews are just a few actions that can result in a greater focus on CR and higher audit scores in your supply chain.